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AUDIT RISK ALERTS

Retail Industry Developments—2001/2002

Complement to the AICPA
Audit Risk Alert—2001/2002

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

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. The AICPA staff has prepared this document. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Lori West
Technical Manager
Accounting and Auditing Publications

Special thanks to David J. Middendorf, CPA, for his assistance in developing and reviewing this Alert.

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Retail Industry Developments—2001/2002

How This Alert Helps You

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

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

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2001/2002* (Product No. 022250kk).

Economic and Industry Developments

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

For a complete overview of the current economic environment in the United States see the AICPA general *Audit Risk Alert—2001/2002* (Product No. 022250kk).

The Christmas shopping season, of crucial importance to retailers, netted dismal results for 2000. The poor holiday season showing led to reduced profits early in 2001 as retailers were forced to offer steep discounts to move unsold inventories. High levels of promotional activities have accompanied the product discount programs. In light of these advertising activities, discounts, and other incen-

tives, auditors may need to consider whether their clients have properly addressed the accounting and disclosure issues relating to these matters. The accounting treatment for advertising costs and incentives is addressed in the "Accounting for Advertising Costs" and "Special Customer Programs" sections of this Alert.

As the third quarter of 2001 passed, retailers continued to post losses and those retailers reporting profits were fewer than expected. Consumers are frequenting discount stores and warehouse clubs looking for bargains during this time of uncertainty. In fact, discount store sales have risen 6 percent from the past year.

In addition to operating losses, retailers are reporting huge losses due to one-time writeoffs for investments in Internet firms and telecom businesses, restructuring charges due to store closings, inventory liquidations, employee layoffs, and bad debt writeoffs. In fact, net income for a number of the nation's largest companies plunged two-thirds in the second quarter as a result of the massive writeoffs and charges related to the slowing economy.

Consumer Spending Sluggish

Customer turnout continues to remain sluggish as consumer shopping traffic has fallen for the fourteenth week straight through August 2001. Consumer confidence declined for the second month from 116.3 in July 2001 to 114.3 in August 2001. With new jobless claims at a nine-year high, corporate layoffs rising, and a volatile stock market, consumers are cutting spending on discretionary items. Household purchasing power has increased as wages are rising at 4.3 percent, which is still 1 percent faster than inflation. Real consumer spending grew to 1.5 percent annually in the second quarter of 2001, which is the lowest pace in nearly six years. The influx of about $38 billion in tax rebates and the wave of approximately $50 billion in mortgage refinancing appear to be helping retail sales in the beginning of the third quarter of 2001.

The September 11, 2001, attack on America injected further agitation and uncertainty into the U.S. economy. The ramifications of that attack and the ensuing war against those responsible for it

may deepen the economic slowdown and lead to a recession; however, at the time of the writing of this Alert, the short- and long-term effects of the attack on the economy are uncertain. Nevertheless, only nine days after the attacks, the National Retail Federation lowered its sales growth forecast for the fourth quarter, speculating that the effects on the economy and consumer responses will affect retailer's future sales.

Help Desk—The Financial Accounting Standards Board's (FASB) Emerging Issues Task Force (EITF) reached consensus on issues of accounting for the terrorist attacks of September 11, 2001. This guidance was issued as EITF Issue No. 01-10, *Accounting for the Impact of the Terrorist Attacks*, to provide financial statement preparers and auditors with guidance. The Task Force concluded that, while the events of September 11 were certainly extraordinary, the financial reporting treatment that uses that label would not be an effective way to communicate the financial effects of those events and should not be used in this case. Readers of financial reports will be intensely interested in understanding the whole impact of the events on each company. The EITF concluded that showing part of the effect as an *extraordinary item* would hinder rather than help effective communication. Practitioners should go to www.fasb.org/eitf/eitf911-101.html for further information about EITF Issue No. 01-10. Also, the AICPA general *Audit Risk Alert—2001/2002* contains an extensive discussion of accounting and auditing issues related to the September 11 attacks.

Retailers' Response to the Weak Economy

In response to the weak economy, retailers are taking steps and pursuing policies designed to help them weather the rough economic seas. They are buying less merchandise for fear of getting stuck with too much again (see the "Inventory" section of this Alert), cutting back on expenses, and creating contingency plans if sales fall below predictions. They are also preparing for what could be the worst Christmas season in a decade by tightly managing inventories and costs. And, for the first time since the 1990 recession, retailers have reduced spending on equipment and software. Since profit projections remain poor, business investments, payroll expenses, and capital spending are being cut by retailers.

Store Closings. The cost cutting and restructurings undertaken by retailers have led to an increased number of store closings. In these circumstances, auditors should consider whether management has accounted for these store closings and restructurings appropriately. See the "Store Closings, Restructuring Charges, and Asset Impairments" section of this Alert for a discussion of a number of the accounting and auditing issues that result when a retail entity closes store locations.

Tough Competition Shaking Retailers Up. The difficult economic environment has resulted in some very tough competition among retailers. In response, retailers are focusing on new ideas to capitalize on sales opportunities. For example, retailers are putting an increased emphasis on tracking merchandise by analyzing what is not selling, allowing retailers to quickly react through promotions or the shifting of merchandise to other store locations. Also, retailers are reducing inventory levels (see the section of this Alert entitled "Helping Your Clients Manage Their Inventory During This Economic Downturn"), and retailers are simplifying trend and brand-name messages through clearer displays and more advertising.

Bankruptcies and Going Concern. Many retailers have filed for bankruptcy in the midst of the overall weak retail environment. The sluggish economy and not being able to keep up with the discount chains caused the majority of the bankruptcies. Auditors should be aware of their responsibility to evaluate whether there is substantial doubt about a retailer'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. See the "Going-Concern Issue" and "Troubled Debt Restructurings and Bankruptcy Reorganizations" sections of this Alert.

Electronic Commerce

Despite the economic downturn, established bricks-and-mortar retailers' online sales leaped to $5.3 billion in June 2001—a 71 percent increase from June 2000 according to Nielsen/NetRating. The increase in traffic on their e-commerce Web sites is attributable, in many cases, to their well-known name brands and

their customer relationships. Their customer base trusts them and knows what to expect from their products. The Internet is a cost-effective channel that allows these traditional retailers to extend their reach.

Many stand-alone Internet retailers are not doing well. Going out and about, roaming aisles, touching and feeling the products seems to appeal to most consumers. At least 232 e-commerce companies have gone out of business since January 2000, according to Webmergers.com.

> See the lengthy discussion of the current e-business economic environment in the AICPA Audit Risk Alert, *E-Business Industry Developments—2001/2002.* Call the AICPA Order Department at (888) 777-7077 to order. That Alert also contains detailed discussions about the unique accounting and auditing concerns prevalent in an e-business environment.

Regulatory and Legislative Issues

What recent actions has the IRS taken that possibly may affect your retail clients? What legislation is on the horizon that may affect your clients?

Large and Mid-Size Business Division of the IRS

As part of its modernization plan, the Internal Revenue Service (IRS) created the Large and Mid-Size Business (LMSB) Division organized around customer needs. The group includes corporations, Subchapter S corporations, and partnerships with assets over $5 million. The LMSB will be responsive to the needs of customers in a global environment and apply innovative approaches to customer service and compliance. The LMSB Division addresses key customer needs by improving tax administration in the following four areas:

- More consistent, timely, and direct responses from accountable industry managers through the LMSB Organizational Design

- Reduced examination duration, costs, and burden through enhanced prefiling guidance and issue resolution to resolve issues before forwarding the case to the United States Court of Appeals or the Tax Court
- Improved efficiency in examination cases through case planning and information management
- Reduced examination costs and burden through technology, such as electronic communication and data transfer, to reduce paper retention and exchange

The IRS continues to develop the structure of its LMSB Division. The Division includes a special industry section, headquartered in Chicago, devoted to retailers, food, and pharmaceutical industries with business dealings in beverages, tobacco, garments, small household appliances, hotels, agricultural commodities, and farms. The IRS Web site, www.irs.gov, provides contact information for the leadership of the LMSB Division and currently has a separate page to serve the customers of the Large to Mid-Size Business segment of the Division.

IRS Announcement 2001-82—Required Minimum Distributions

IRS Announcement 2001-82 establishes an alternative model amendment for all qualified stock bonus, pension and profit-sharing plan sponsors under Internal Revenue Code (IRC) Section 401 (a) to use with respect to required minimum distributions made for 2001 but before the date on which the plan began operating under 2001 proposed rules. The announcement was in response to concerns by plan sponsors that intended to use the 2001 proposed regulations for distributions for 2001 but that made required distributions for 2001 under the 1987 proposed regulations. Announcement 2001-82 allows qualified plan sponsors to use the alternative model amendment so that required minimum distributions made for 2001 (but before the date on which the plan began operating under the 2001 proposed rules) are deemed made under the 1987 proposed regulations.

For additional information on the announcement, go to www.irs.gov and see the Internal Revenue Bulletin.

IRS to Tax Stock Option Plans

The IRS has announced its intent to contemplate applying Social Security tax to stock option plans. A stock option purchase plan authorizes employees to purchase shares of their company stock at a discount generally around 15 percent below the market price.

The IRS has determined that it may possibly want to impose the Social Security tax (7.65 percent to the employee, matched by the employer) on the difference between the stock's market price and the discounted purchase price. The IRS maintains that the difference between the purchase price and the market price of the stock represents a type of compensation and therefore should be subject to the Social Security tax.

The IRS plans to impose this tax starting in January 2003 unless the IRS changes its position or Congress votes to block the tax.

Interest-Free Adjustments Under Section 6205

Final regulations under IRC Section 6205 were released by the IRS and the Treasury Department regarding the interest-free adjustment period for underpayment of employment taxes to reflect the changes made by the Taxpayer Relief Act of 1997 (1997 TRA). The final regulations issued and the proposed regulations issued in January 2001 are exactly alike. They affect employers that are the subject of IRS Examinations involving determinations by the IRS that workers are employees for purposes of subtitle C or that the employers are not entitled to relief from employment taxes under section 530 of the Revenue Act of 1978.

Section 6205

IRC Section 6205 allows employers that have paid less than the correct amount of employment taxes to make adjustments without interest, provided the error is reported and the taxes are paid by the last day for filing the return for the quarter in which the error was ascertained. However, no interest-free adjustments are permitted pursuant to IRC Section 6205 after receipt of notice and demand for payment thereof based upon an assessment.

Before the Taxpayer Relief Act of 1997

Section 6205 basically allowed an employer to pay employment taxes for disputed workers on an interest-free basis until the point in time that the IRS issued notice and demand for payment based on an assessment. The 1997 TRA added a new section 7436, which permits an employer to contest certain employment tax issues before the Tax Court. Consequently, the IRS cannot issue notice and demand for payment based on an assessment until after the taxpayer has received a "Notice of Determination Concerning Worker Classification Under Section 7436" and had the opportunity to petition the Tax Court contesting such determination.

Final Regulations

The final regulations provide that, in employment tax examinations involving worker classification or IRC Section 530 issues, as in other types of employment tax examinations, the error is ascertained for purposes of IRC Section 6205 when the employer has exhausted all internal appeals within the IRS. Accordingly, the regulations prohibit interest-free adjustments after a taxpayer receives a notice of determination. However, if, before receiving such notice, a taxpayer makes a remittance, the IRS will consider such remittance to be a payment of tax and assess it on an interest-free basis (and will issue a notice of determination only if some portion of the proposed liability remains).

Effective Date

The regulations are applicable with respect to notices of determination issued on or after March 19, 2001. For interest computation purposes, the final regulations will apply to claims for refund of interest pending on January 17, 2001.

Bankruptcy Legislation in Washington

The U.S. House of Representatives and the U.S. Senate have appointed conferees to draft a final version of the Bankruptcy Reform Act of 2001 to be sent to the President for his signature.

The National Retail Federation, long awaiting this action, claims that the absence of bankruptcy reform legislation costs retailers millions of dollars on a daily basis. Retailers are directly affected by this legislation since consumers more often than not finance highly priced items like televisions and furniture with installment debt. When consumers file for bankruptcy, retailers may be able to recover only some of the debt. This legislation is meant to protect the safety net of bankruptcy for those who really need it. Filing for bankruptcy, if this legislation is passed, will be more difficult if you have the means to repay your debt. The legislation will affect about 11 percent of those who file for bankruptcy with an estimated savings of $4 billion in debt annually that would currently be discharged—almost $11 million daily!

Debt Default and Delinquencies Rising—Bankruptcy Reform Needed Now

If the legislation is enacted, it comes at an opportune time for retailers since consumer debt is at an all-time high despite the slowing economy. Debt levels have risen due to substantial credit card account growth in 2000 and easier credit terms for consumers. According to the Federal Reserve Data, consumer debt in America now exceeds $1.5 trillion. Revolving debt jumped about 11 percent last year. Also, by the end of 2000, household debt service payments as a percentage of disposable personal income rose to more than 14 percent, the highest it has been since 1986.

Moody's Investor Services stated that the late payment and bad loan writeoff rate rose by over 13 percent from the prior year. Based on those statistics, consumer credit quality has not been this dismal since the negative credit cycle in 1995 to 1997. Moreover, Standard & Poor's found that credit card issuers wrote off uncollectible balances at an annual rate of 6.7 percent—also the highest rate loss since February 1997.

The disappointing economic outlook raises the specter of growing defaults and bankruptcies. Many retailers are already seeing increases in their credit card chargeoffs.

Taxation of Internet Sales: The Debate Continues

Will there be taxation of Internet sales?

For the past few years, we have been following the continuing debate over the taxation of Internet sales. State and local governments are concerned about losing sales and use tax revenue because of untaxed Internet sales. A recent estimate of the amount of sales tax revenue that will be lost in 2001 because of the nontaxation of Internet sales puts the amount at $2 billion.

During the saga of the taxation of Internet sales last year, the Advisory Commission on Electronic Commerce (ACEC) had just submitted its report to Congress. That report recommended that, among other actions, Congress (1) extend the existing ban (which is slated to expire in October 2001) on new taxes on Internet access and on multiple or discriminatory taxes on e-commerce, and (2) take steps to simplify state and local sales and use taxes. (Internet businesses claim that disparities in sales tax systems among the various jurisdictions are too burdensome to administer.) Despite the introduction of numerous bills, Congress was unable to pass Internet taxation legislation this year. However, the attempts continue.

Recent Developments

More recently, on July 18, 2001, the Internet Tax Moratorium and Equity Act (H.R. 1410) was introduced in Congress. The bill ostensibly seeks to simplify state and local governments' complex sales tax structures to establish a uniform streamlined sales tax system. In turn, bricks-and-mortar retailers and Internet retailers will treat all retail sales of tangible property in the same manner. The current moratorium, the Internet Tax Freedom Act of 1998 (IFTA), on access taxes and on new discriminatory taxes on the Internet, would be extended until December 31, 2005, however, Congress failed to pass new legislation and the moratorium on Internet taxes expired on October 21, 2001. Analysts and lawmakers say it is unlikely that state and local governments will rush to impose e-commerce sales taxes, but given enough time and an increasing need to raise revenues, that could change. There is

concern that tax officials around the country could begin interpreting a variety of their current tax laws as applying to the Internet. Observers say such a move would drag down a crucial engine of the U.S. economy, adding to the nation's economic woes.

State Sales Tax Simplification

Simplifying the tax code should help retailers. First, tax policy should not provide one retailer with an advantage over another. Since profit margins are often narrow in the retail industry, out-of-state retailers who do not have to charge sales tax have a significant pricing advantage over those that do. Second, it would make filing tax returns easier. Some multistate companies file as many as ten thousand different forms with taxing jurisdictions across the country. The states are attempting to address the issue of sales tax simplification. The District of Columbia, forty-five states, and thousands of local governments impose sales taxes. To address complaints about disparities among the jurisdictions, the National Governors Association created the streamlined sales tax project (SSTP). The SSTP, comprising tax administrators from thirty states, developed model legislation to unify and simplify sales and use tax administration among the states that adopt the legislation. The SSTP hopes that, by unifying and simplifying sales tax systems, Internet businesses will voluntarily collect sales taxes. The model legislation, entitled the Uniform Sales and Use Tax Administration Act (the Act), would authorize a state taxing authority to enter into an interstate contract, the Streamlined Sales and Use Tax Agreement (the Agreement). The Act and the related Agreement would, among other matters, establish more uniform administrative standards, and develop and adopt uniform definitions of sales and use tax terms.

Recently, the Act ran into a snag when a task force of the National Conference of State Legislatures (NCSL) took significant exception to some of its measures. The NCSL drafted and distributed its own version of model legislation to simplify sales tax. State legislatures are now considering whether to adopt legislation and, if so, which version.

> **Help Desk**—The Act is available on SSTP's Web site at www.streamlinedsalestax.org. The NCSL's version of the model legislation is available on the NCSL Web site at www.ncsl.org/programs/fiscal/tctelcom.htm. The NCSL site also includes a document that lists the amendments that the NCSL made to the SSTP Act.

Nevada Passes a Sales Tax Law

Nevada has enacted a law, A.B. 455, that requires out-of-state vendors that sell tangible personal property over the Internet or by other electronic means to Nevada customers to collect use tax on those sales. A.B. 455 has revised the definition of "a retailer maintaining a place of business" in the state to include the following.

> A retailer soliciting orders for tangible personal property ... through a Web site on the Internet or other means of electronic communication to provide solicitations to persons in this state.

Also effective June 13, 2001, retailers soliciting orders from persons located in Nevada via a Web site are treated as "maintaining a place of business" (defined to include not just maintaining an office, but also various other activities, including soliciting orders via television, Web sites, and a toll-free telephone number) in the state and are required to collect sales and use taxes.

New York State Ruling

The New York Department of Taxation and Finance also ruled earlier this year that the sale of music delivered electronically over the Internet is neither a taxable sale of tangible personal property nor the provision of a taxable information or entertainment service.

New York treats digitally downloaded music and digitally downloaded software differently. Digitally downloaded software is treated as a sale of tangible personal property, which is subject to sales tax in New York. Currently, some states treat the sales of digitally delivered software as sales of tangible personal property, others consider these sales of a taxable service, while still others deem them sales of intangible property that are exempt from sales tax.

Audit Issues and Developments

Collectibility of Receivables (Allowance for Doubtful Accounts)

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

With current high levels of consumer bankruptcies, the collectibility of receivables may be a more significant issue this year. Bankruptcies are discussed further in the section entitled "Bankruptcy Legislation in Washington" in the "Regulatory and Legislative Issues" section of the Audit Risk Alert.

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.) When auditing estimates, auditors should be familiar with Statement on Auditing Standards (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. Practitioners should also refer to the section, "Evaluating Accounting Estimates Relevant to Revenue Recognition," of this Alert for additional guidance. The guidelines set forth by SAS No. 57 include the following:

- Identify the circumstances that require accounting estimates.
- Consider internal control relating to developing accounting estimates.
- Evaluate 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, including chargebacks from credit card companies.

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

1. Obtain publicly available information on major customers to determine their ability to honor outstanding obligations to the company.
2. Investigate unusual credit limits or nonstandard payment terms granted to customers.
3. Test subsequent collections of receivables.

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

are examples of the ratios that auditors might use to evaluate collectibility of accounts receivable:

- *Accounts receivable turnover* indicates how well the company collects its receivables and is computed as net credit sales divided by average net accounts receivable.
- *Bad debts to net credit sales* indicates whether writeoffs 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 an allowance for doubtful accounts divided by accounts receivable.

The auditor may also review revenue and receivables transactions and fluctuations after the balance-sheet date for items such as sales and writeoffs. 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 of Financial Accounting Standards No. 125[1], *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.

1. This Statement was replaced by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, which is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. See the "New FASB Pronouncements" section of this Alert for more information on FASB Statement No. 140.

Going-Concern Issue

Why is going concern an important issue for the retail industry? What is the auditor's responsibility in addressing it?

Historically, the retail industry's sensitivity to negative changes in economic conditions, such as reductions in personal income, layoffs, higher unemployment levels, and decreases in consumer confidence, have resulted in high rates of business failures. Accordingly, auditors should be alert to conditions and events which, when considered in the aggregate, indicate that there could be substantial doubt about the retail entity's ability to continue as a going concern.

For example, such conditions and events could include (1) negative trends such as recurring operating losses or working capital deficiencies, (2) financial difficulties such as loan defaults or denial of trade credit from suppliers, (3) internal matters such as substantial dependence on the success of a particular product line, or (4) external matters such as legal proceedings or loss of a principal supplier. Another condition which may raise doubt about an entity's ability to continue as a going concern could be excessive and unusual reliance on external financing, rather than money generated from the companies' own operations as evidenced by many dot.com retailers that shut down or filed for bankruptcy this past year, including Pet.com, Quepasa.com, Mothernature.com, and Value America.com, just to name a few. In such circumstances, auditors will have to consider whether, based on such conditions and events, there is substantial doubt about the retailer's ability to continue as a going concern.

Auditor's Responsibilities Related to a Going-Concern Issue

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 in conducting an audit of financial statements in accordance with generally accepted auditing standards (GAAS) for evaluating whether there is substantial doubt about a client's ability to continue as a going concern for a period not to exceed one year from the date of the financial statements being audited.

Continuation of an entity as a going concern is generally assumed in the absence of significant information to the contrary. Information that significantly contradicts the going-concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions. SAS No. 59 does not require the auditor to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

If there is substantial doubt about the entity's ability to continue as a going concern, the auditor should consider whether it is likely that existing conditions and events can be mitigated by management plans and whether those plans can be effectively implemented. If the auditor obtains sufficient competent evidential matter to alleviate doubts about going-concern issues, then consideration should be given to the possible effects on the financial statements and the adequacy of the related disclosures. If, however, after considering identified conditions and events, along with management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern remains, the audit report should include an explanatory paragraph to reflect that conclusion. In these circumstances, auditors should refer to the specific guidance set forth under SAS No. 59.

Retailers in Bankruptcy Reorganization

For those retail entities that are under bankruptcy reorganization pursuant to chapter 11 of the Bankruptcy Code or emerging from it, the auditor should consider whether the company is following the accounting guidance of SOP 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*. Retail entities that filed for bankruptcy may have impairments that need to be recorded prior to fresh-start accounting under SOP 90-7.

Inventory

What are the risks in the area of inventory? What effect will they have on audits for retail entities?

Obsolete or Excess Inventory

Numerous retail companies were far too optimistic in their economic forecasts, resulting in overstocking, overexpansion, and warehouses bulging with inventory. Some retailers have sought out deep discounters, barter companies, and liquidators to help relieve excessive levels of inventory.

The primary literature on inventory accounting is Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins.* Chapter 4 of ARB No. 43 states:

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

The appendix to SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.26), lists the following substantive tests that the auditor might want to consider in identifying slow-moving, excess, defective, and obsolete items included in inventories:

1. Examine an analysis of inventory turnover.
2. Review industry experience and trends.
3. Analytically compare the relationship of inventory balances to anticipated sales volume. (The "Analytical Procedures" section below describes some of the ratios commonly used in a retail environment to evaluate the reasonableness of inventory valuation and to help identify the existence of obsolete inventory.)

4. Tour the facility.

5. Inquire of sales and other relevant personnel concerning possible excess or obsolete items.

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

Analytical Procedures

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

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

The following gives a brief description of some of the ratios commonly used in a retail environment for inventory valuation:

- The *gross profit ratio* indicates whether profit goals will be met and whether there are unusual variances in the 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 the 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.

- *Inventory shrinkage as a percentage of sales* indicates the percentage of inventory loss resulting from theft and/or bookkeeping errors. Many retailers look at the trend of inventory shrinkage as a percentage of sales from period to period and on a location-by-location basis. This is calculated by taking the book inventory minus the physical inventory divided by net sales.

- *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, dollar values, or quantities of inventory.

Help Desk—For additional guidance the auditor should refer to the new AICPA *Analytical Procedures Guide* (Product Number 012551). Call the AICPA at (888) 777-7077 to order.

Helping Your Client Manage Their Inventory During This Economic Downturn

Good inventory management has become an important determinant in the success of a business in the retail industry today. As the U.S. economy began to slow and demand began to weaken, retailers found themselves with surplus inventories. The stores that are thriving, such as Wal Mart and H & M clothing retailer, are less likely to maintain stale inventory. Inventories have climbed to $4 billion, up from just $250 million a year ago according to liquidation experts. Retailers are becoming averse to retaining mounds of inventory attributable to the lack of spending by consumers during this weak economy. Even the biggest retail giants, Wal Mart and Target, are being conservative in regard to the intake of inventory. Inventory levels fell for the fifth straight month in August 2001 according to the U.S. government. Retailers are being extremely cautious about future demand. In prior years, retailers have been in inventory building modes, and these days they must make the transition to the maintenance mode. Factory inventory levels are at their lowest in almost twenty years according to the National Association of Purchasing Management of Chicago. The U.S. Commerce Department reported that during the second quarter, businesses curtailed inventories at a rate of $38.4 billion per year and the gross domestic product grew at 0.2 percent annual rate.

Practitioners can assist their retail clients in establishing and maintaining effective controls over inventory during this economic downturn in some of the following areas:

- *Physical Inventory.* Practitioners can assist their clients in developing written instructions for taking inventory while highlighting the importance of good documentation during the physical inventory. AU Section 331, "Inventories" (AICPA, *Professional Standards,* vol. 1, AU sec. 331), discusses the requirements to observe inventories, periodic comparisons with physical counts, and inventory controls (including statistical sampling) on procedures used by the auditor.

- *Perpetual Inventory.* Practitioners can assist clients in optimizing the full potential of their perpetual inventory systems by helping their clients implement an inventory in transit procedure to ensure the proper recording of inventory shipped FOB shipping point along with the related accounts payable. You may suggest using a separate control account to record the inventory in transit, which would be reversed when the goods are received and entered into the perpetual inventory system. Also, by assisting the client in ensuring that all inventory that has been purchased has been included in inventory and accounts payable, the practitioner can help minimize inventory cutoff errors.
- *Markdowns.* Practitioners can help clients develop a procedure to monitor markdowns to confirm that only authorized markdowns are taken in order to control inventory levels and fulfill its planned profit expectations. The appropriate level of management should supervise markdowns closely, regardless of whether the cost or retail method is used in order to achieve those goals.
- *Shrinkage.* Practitioners can assist clients in implementing effective paperwork control by instituting internal controls to help prevent errors and to find them as they occur. The practitioner can also assist in minimizing the risk of loss from theft, both internal and external, by the means of setting up operating policies, practices, and procedures. For example, this can be done in areas such as store closings, transfers, store openings, and merchandise receiving operations (not all inclusive).
- *Employee Purchases.* Practitioners can assist clients in establishing procedures that keep track of employee purchases on an individual basis to monitor possible abuse so it may be detected and resolved in a more timely manner.
- *Open-to-Buy.* Practitioners can assist in instituting and supporting an open-to-buy (OTB) system to help ensure that inventory levels will be adequate to satisfy budgeted sales. It will also help retailers reduce the amount of re-

sources they tie up in slow-moving inventories, which during the current economic environment, can be devastating to retailers.

Inventory Fraud

What auditors should know to help uncover phony figures?

As the economy downshifts and management is under pressure, companies may be more prone to inventory fraud. Practitioners who are familiar with common methods for fraudulent inventory manipulations will be in a much better position to identify them.

There are many ways a dishonest client can attempt to manipulate inventory. Those clients usually use a combination of several methods to commit inventory fraud: fictitious inventory, the manipulation of inventory counts, the nonrecording of purchases, and fraudulent inventory capitalization. All these elaborate schemes have the same goal of illegally boosting inventory values.

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 misstatements, 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 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 attributable to fraud, and develop an appropriate audit response.
- Requires the auditor to make an assessment as to the risk of material misstatement attributable to fraud, from the perspective of the broad categories listed in the SAS. The as-

sessment 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.

Auditors must maintain an appropriate attitude of professional skepticism. This means assuming neither that the management is dishonest nor that it is unquestionably honest; 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 attributable 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, the examination of documentation, or discussions with others within or outside the entity.

Fraudulent Asset Valuations

Companies use five different techniques to illegally boost assets and profits:

1. Fictitious revenue
2. Fraudulent timing differences
3. Concealed liabilities and expenses

4. Fraudulent disclosures
5. Fraudulent asset valuations

The misstatement of asset valuations is the most common form of inventory fraud. Inventory overstatement makes up the majority of asset valuation frauds and is the focus of this section.

The valuation of inventory involves two separate elements: quantity and price. Goods are constantly being bought and sold, and transferred among locations. Figuring the unit cost of inventory can be problematic, too; FIFO, LIFO, average cost, and other valuation methods can routinely make a material difference in what the final inventory is worth. As a result, the complex inventory account is an attractive target for fraud.

The obvious way to increase inventory asset value is to create various records for items that do not exist, including unsupported journal entries, inflated inventory count sheets, bogus shipping and receiving reports, and fake purchase orders. Since it can be difficult for the auditor to spot such phony documents, he or she may use other means to substantiate the existence and value of inventory.

Auditing Procedures

Since the auditor relies heavily on observing the client's inventory, the auditor's taking and documenting of the test counts is important. During the observation of the physical inventory, the auditor should validate the inventory quantity by test counting. Even when this is done, inventory fraud can go undetected. The following are examples:

- Management representatives follow the auditor and record the test counts. Thereafter, the client can add phony inventory to the items not tested, in turn falsely increasing the total inventory values.
- Auditors announce when and where they will conduct their test counts. For companies with multiple inventory locations, this advance warning may permit management to conceal shortages at locations which auditors will not visit.

- Sometimes auditors do not take the extra step of examining packaged boxes. To inflate inventory, management may stack empty boxes or boxes may contain items other than inventory in the warehouse.

Practitioners can use analytical procedures to help detect ghost goods. *Ghost goods* are phantom inventories, which may throw off a company's books. For example, if the auditor compares the books with previous periods, the cost of sales will be too low; inventory and profits will be too high. There will be other signs, too. When analyzing a company's financial statement over time, the auditor can look for the following trends:

- Inventory increasing faster than sales
- Decreasing inventory turnover
- Shipping costs decreasing as a percentage of inventory
- Inventory rising faster than total assets move up
- Falling cost of sales as a percentage of sales
- Cost of goods sold on the books not agreeing with tax returns

An alert auditor may be able to detect inventory fraud schemes by any one of the above analytical methods. The auditor can also examine the cash disbursements subsequent to the end of the period. If the auditor finds payment made directly to vendors that were not recorded in the purchase journal, he or she should investigate further.

Assessing the Risk of Inventory Fraud

Practitioners should refer to SAS No. 82 for guidance. In evaluating the risks of inventory overstatements, the auditor may answer the following questions. Many *yes* answers to the following may indicate a greater risk of inventory fraud:

- Is inventory a significant balance-sheet item?
- Is the company attempting to obtain financing secured by inventory?
- Has the percentage of inventory to total assets increased over time?

- Has the ratio of cost of sales to total sales decreased over time?
- Have shipping costs fallen compared with total inventory?
- Has inventory turnover slowed over time?
- Have there been significant adjusting entries that have increased the inventory balance?
- After the close of an accounting period, have material reversing entries been made to the inventory account?

Auditors may need to adjust the scope of their audits if control risk, associated with inventory controls, is assessed as high. The auditor should document the understanding of the entity's internal control as required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended. If the understanding reveals weakness in inventory controls, there may be an increased risk of material misstatements and fraud in the financial statements. Also, reportable conditions, as defined in SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended, may exist.

Evaluating Accounting Estimates Relevant to Revenue Recognition

How practitioners can evaluate the reasonableness of accounting estimates?

In light of the current economic slump, management is under great pressure to show good results. Since revenue is an easy target to boost up profits, it may be inflated. So, auditors may need to pay particular attention to revenue recognition issues.

The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. The evaluation of estimates is always an area of auditing concern because the measurement of estimates is inherently uncertain and depends on the outcome of future events. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342.10), sets forth

guidance for auditing estimates. Refer to the "Collectibility of Receivables (Allowance for Doubtful Accounts)" section of this Alert for a description of those guidelines.

Estimates relevant to the retail industry that are significant to management's assertion about revenue include sales returns and the allowance for doubtful accounts. An adequate allowance for doubtful accounts assumes increasing importance in the face of today's slowing economy, abundance of store closings, consumer loan payment delinquencies, and bankruptcies. Auditors often use historical data to evaluate the reasonableness of such estimates as reserves for sales returns. Historical data may indicate client practices to take back inventory even when no contractual right of return exists. Analysis of the aging of the accounts receivable that reflects a "building up" of receivables may indicate contingent sales or concessions to customers regarding the return of goods. Auditors also should consider reviewing sales to major customers, particularly to distributors, to detect excess purchases (channel stuffing) that may be at greater risk of return in the subsequent period. A company's ability to make reasonable estimates of sales returns may be impaired if the company does not have sufficient visibility into what is going on in the sales channel. Reliance on solely historical averages may be insufficient, especially if the environment is somewhat volatile.

The ability to make reasonable estimates of future returns is one of the conditions that must be met for recognition of revenue at the time of sale, in accordance with FASB Statement No. 48, *Revenue Recognition When Right of Return Exists.* FASB Statement No. 48 establishes accounting and reporting standards for sales of a product when the buyer has the right to return the product. Paragraph 6 provides that, in such circumstances, revenues from the sales transactions should be recognized at the time of sale only if *all* of 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 the 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.
5. The seller does not have significant obligations for future performance to directly bring about the resale of the product by the buyer.
6. The amount of future returns[2] can be reasonably estimated (paragraph 8).

If the preceding conditions are not met, sales recognition should be postponed until the right of return substantially expires or until such time as the conditions are met.

If revenue is recognized at the time of sale because the above conditions are met, FASB Statement No. 48 requires that the costs or losses that may be expected in connection with returns must be accrued in accordance with FASB Statement No. 5, *Accounting for Contingencies*. The sales revenue and cost of sales reported in the income statement should be reduced to reflect estimated returns.

Paragraph 8 of FASB Statement No. 48 describes a number of factors that may impair (but not necessarily preclude) the ability to make a reasonable estimate of the amount of future returns. Among those factors are the susceptibility of the product to significant external factors (for example, obsolescence or changes in demand); the absence of or lack of relevance of historical experience to the circumstances (for example, if a product, market, or customer is new); the length of the return period; and the absence of a large volume of relatively homogeneous transactions.

In addition to analyzing historical data and the accounts receivable aging reports, auditors' should consider testing the company's estimate of the collectibility of receivables. Practitioners

2. 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 for purposes of this Statement.

should refer to the "Collectibility of Receivables" section of this Alert for the procedures to be followed.

Help Desk—For additional guidance, the auditor should refer to the AICPA Practice Aid *Auditing Estimates and Other Soft Accounting Information* (Product Number 010010kk) and the AICPA Audit Guide *Auditing Revenue in Certain Industries* (Product Number 012510). Call the AICPA at (888) 777-7077 to order.

Accounting Issues and Developments

Store Closings, Restructuring Charges, and Asset Impairments

What accounting issues arise with respect to store closings?

In this weak economic period and harsh retail climate, retailers are continually evaluating the performance of individual stores and considering whether it might be necessary to close those stores. In the past year, many retailers have had to close stores as a result of the adverse economic conditions. Retailers such as JC Penny, Sears Roebuck & Co., Saks Fifth Avenue, Krause's Furniture Inc., Albertson's Inc., Montgomery Ward, Bradlees Inc., Office Max, Office Depot, Lechters, Ames Department Stores, Dillards, and Sterns, just to name a few, have posted sizable charges related to shutdowns. As many retailers are closing stores, discount retailers such as Wal-Mart, Target, Costco, Kohls, and Family Dollar Stores are adding new stores in response to the slowing economy and bargain-oriented customers.

Also in the wake of this bleak economic picture and in response to intense competitive pressures, retailers such as Lechters Inc., Tupperware Corp., Albertsons Inc., and iGo Corp., have had huge nonrecurring charges as a part of their restructuring plans. Restructure costs may include store closings, job reductions, sale of business segments, reductions in the number of operating divisions, disposal of assets, asset impairment, and eliminating or combining certain functions or departments in an attempt to reduce the cost structure and spur future profitability and return of capital. Auditors need to address a number of issues concerning store closings.

Need to Accrue for the Costs of the Exit Plan

The auditor needs to determine whether management has properly addressed the requirements of EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, and, for Securities and Exchange Commission (SEC) clients, Staff Accounting Bulletin (SAB) No. 100, *Restructuring and Impairment Charges*. Auditors should 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 that are subsequently charged against such reserves, or the reversals of excess amounts of such liability reserves, should be clearly disclosed. For further guidance on disclosures, auditors should refer to EITF Issue No. 94-3 and SAB No. 100, as they both address disclosure requirements that must be followed by the organizations beginning with the period in which the exit plan is committed and ending with the point at which the exit plan is completed.

When evaluating the criteria necessary to accrue for the costs of an exit plan, auditors should be aware of restrictive standards set in EITF Issue No. 94-3 for plan specificity. It states that the exit plan should specifically identify all significant actions to be taken to complete the exit plan and the period of time to complete the plan should indicate that significant changes to the exit plan are not likely. In determining the specificity of a retailer's exit plan, the SEC staff suggests that auditors may wish to consider whether the exit plan is sufficiently detailed so 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. According to SAB No. 100, 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 circum-

stances 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 No. 94-3.

Finally, auditors should be aware that EITF Issue No. 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. SAB No. 100 discusses in further detail factors that need to be considered in evaluating the plan's specificity. Those factors include the reliability of estimated costs, the level of identification and the aggregation of costs, and the timetable within which the exit plan is expected to be completed.

According to SAB No. 100, after the exit plan is evaluated and the amount of accrual is determined, it is not final and might have to be adjusted because of a change in circumstances. The SAB states that at each balance-sheet date, exit costs accruals should be evaluated to ensure that any accrued amount no longer needed for its originally intended purposes is reversed in a timely manner. Reversal of the liability should be recorded through the same income statement line item that was used when the liability was initially recorded. Costs actually incurred in connection with an exit plan should be charged to the exit accrual only to the extent those costs were specifically included in the original estimation of the accrual. Costs incurred in connection with an exit plan but not specifically contemplated in the original estimate of the liability for exit costs should be charged to operating expense in the period incurred, or the period that the exit costs qualify for accrual under EITF Issue No. 94-3, with appropriate explanation presented in the Management's Discussion and Analysis.

Employee Termination Benefits

EITF No. 94-3 requires a liability to be recorded in the period that management approves a store closing for benefits paid to involuntarily terminated employees if the conditions are met to accrue the costs to exit an activity as well as meeting the conditions to record a liability for employee termination benefits according to EITF No. 94-3. Practitioners should refer to the EITF for the specific conditions.

EITF No. 94-3 also provides guidance for voluntary termination arrangements and when employees are required to work until they receive the benefits offered.

Practitioners should refer to EITF No. 94-3 for required disclosures related to employee termination costs.

Unusual and Infrequent Items

Unusual and infrequent (but not both) transactions or events are to be presented in the statement of income as separate elements of income from continuing operations as required by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.* The presentation should not imply that the amounts are extraordinary items since they do not meet the criteria of being both infrequent and unusual. Practitioners may present store closings on the face of the statement of income as a component of continuing operations such as provision for store closing.

Disclosures stating the effect and nature of the transaction or event can be made in the notes to the financial statements using captions such as unusual items or nonrecurring items, as well as on the face of the statement of income as stated above.

Inventory Markdowns

The auditor should determine 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 SAB No. 67, *Income Statement Presentation of Restructuring Charges,* has been followed regarding the classification as a component of cost of goods sold for markdowns associated with a restructuring.

Lease Modifications

The auditor needs to find out whether the client, as a result of the decision to close a store, 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.*

Other Concerns

Additional matters that may need to be addressed in light of store closings include the collectibility of accounts receivable and the accounting for handling and shipping costs when transferring merchandise to other stores.

Need to Accrue for Restructuring Charges

You should also consider whether management has appropriately accounted for restructuring costs. EITF Issue No. 94-3 also provides guidance on whether certain costs (such as employee severance and termination costs) should be accrued and classified as part of restructuring charges, or whether such costs would be more appropriately considered a recurring operational cost of the organization. The EITF provides guidance about the appropriate timing of recognition of restructuring charges and the related disclosures as well.

Management's Plan

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

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

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

Making Disclosures

When liabilities are accrued in accordance with the guidance in EITF Issue No. 94-3, certain disclosures are required. The thresh-

olds for making the required disclosures are related to the materiality of the amounts accrued or the significance of the activities that will not be continued. Therefore, when the disclosure thresholds have been met, all the disclosures are required, not just those that are individually material.

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

Making Sure Accruals Are Not "Cushions"

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

Impairment of Assets

Management is responsible for evaluating 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.

- *Old Guidance.* Auditors should evaluate management's consideration of FASB Statement No. 121, *Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* 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 No. 30. Assets covered by APB Opinion No. 30 will continue to be reported at the lower of the carrying amount or the net realizable value. The SEC's SAB No. 100, among other things, discusses the impairment of fixed assets and goodwill.

- *New Guidance.* The FASB has issued FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in August of 2001. The Statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. The Statement supersedes FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Disposed Of*, and the accounting and reporting provisions of APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, for the disposal of a *segment of a business* (as previously defined in that Opinion). FASB Statement No. 144 was issued because FASB Statement No. 121 did not address the accounting for a segment of a business accounted for as a discontinued operation under APB Opinion No. 30, two accounting models existed for long-lived assets to be disposed of. The Board decided to establish a single accounting model, based on the framework established in FASB Statement No. 121, for long-lived assets to be disposed of by sale. The Board also decided to resolve significant implementation issues related to FASB Statement No. 121. The provisions of FASB Statement No. 144 are effective for financial statements issued for the fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early application encouraged

- Also practitioners should refer to FASB Statement No. 142, *Goodwill and Other Intangible Assets*, issued in June 2001, for guidance on the recognition and measurement of impairment losses for goodwill and intangible assets. The Statement addresses financial accounting and reporting for acquired goodwill and

other intangible assets and supersedes APB Opinion No. 17, *Intangible Assets*. It addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. The Statement also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements. FASB Statement No 142 is effective starting with fiscal years beginning after December 15, 2001. Early application is permitted for entities with fiscal years beginning after March 15, 2001, provided that the first interim financial statements have not previously been issued. The Statement is required to be applied at the beginning of an entity's fiscal year and to be applied to all goodwill and other intangible assets recognized in its financial statements at that date. Impairment losses for goodwill and indefinite-lived intangible assets that arise due to the initial application of this Statement (resulting from a transitional impairment test) are to be reported as resulting from a change in accounting principle.

Multiple Leased Locations

How does the existence of multiple leased locations affect the auditor of retail entities?

Retailers often operate from multiple locations, including stores and warehouses, and these locations can change or can be eliminated 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 whether it has been properly accounted for in accordance with FASB Statement No. 13, *Accounting for Leases*, and the related interpretations and pronouncements (FASB, *Current Text*, vol. 2, sec. L10).

Some of the issues the auditor may encounter when evaluating the lease under these standards are:

1. The lease may only apply to a portion of a building.
2. Equipment may be included in the rental.
3. The fair market value of the leased property may not be easily determinable.
4. 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, *Accounting for Leases*, 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 FASB's EITF relating to leasing transactions. EITF Issue No. 98-9, *Accounting for Contingent Rent in Interim Financial Periods* addresses how lessors and lessees should account during interim periods for contingent rental income/expense that is based on future specified targets within the lessor's or lessee's fiscal year.

The auditor should also review leases for upcoming lease expiration dates, penalties for early terminations (especially with the large amount of recent store closings), 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 In-*

formation 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 SAS No. 45, *Related Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 334), and 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, as a result 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 FASB's EITF Issue No. 96-21, *Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities*, and EITF Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction.*

Troubled Debt Restructurings and Bankruptcy Reorganizations

Some retailers have been in the news lately announcing debt restructurings, and bankruptcy reorganizations. Given the occurrence of these events and their inherently complicated nature, we have provided information below to remind you of the accounting requirements for companies involved in troubled debt restructurings and bankruptcy reorganizations. Also presented are some useful disclosure examples.

Troubled Debt Restructurings

FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FASB, *Current Text*, vol. 1, sec. D22) as amended, provides the primary guidance on accounting for troubled debt restructurings. The debtor's accounting for a troubled debt restructuring depends upon the kind of restructuring. For example, the arrangement could be a transfer of assets, a grant of equity, a modification of terms, or a combination of those kinds. In addition to the accounting requirements, FASB Statement No. 15, as amended, mandates debtors to make certain disclosures about their troubled debt restructurings.

You may also need to be familiar with the guidance contained in EITF Issue No. 89-15, *Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties (FASB, EITF Abstracts)*, FASB Technical Bulletin 80-2, *Classification of Debt Restructurings by Debtors and Creditors* (FASB, *Current Text*, vol. 1, sec. D22), and FASB technical Bulletin 81-6, *Applicability of Statement 15 to Debtors in Bankruptcy Situations* (FASB, *Current Text*, vol. 1, sec. D22).

Bankruptcy Reorganizations

AICPA SOP 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code* (AICPA, *Technical Practice Aids*, vol. 2, sec. 10,460) provides guidance on financial reporting by entities that reorganize under Chapter 11 of title 11 of the U.S. Bankruptcy Code. SOP 90-7 distinguishes between financial reporting by the entity during the reorganization proceeding and financial reporting after the plan is confirmed by the court. The principal reporting problem during the proceeding is the measurement of liabilities subject to compromise. The principal reporting problem after the plan is confirmed is the allocation of the reorganization value to the assets of the entity. Determining the appropriate accounting in accordance with SOP 90-7 for entities in reorganization under the Bankruptcy Code requires considerable judgment. You should ensure that appropriate expertise is available in these situations.

Helpful Disclosure Examples

Presented below are examples of financial statement disclosures that concern entities involved with a bankruptcy reorganization.

Example of Financial Statement Disclosure of Reorganization.

On [*date*], the Company's Second Amended Plan of Reorganization (the Plan of Reorganization) was confirmed by the United States Bankruptcy Court for the District of [*place*] (Case No. xx-xxx) (the Bankruptcy Court). None of the Company's foreign-based subsidiaries were part of the chapter 11 filing.

By its terms, the Plan of Reorganization becomes effective (*the Effective Date*) on the first business day that is at least ten days after the Bankruptcy Court order confirming the Plan of Reorganization is entered and on which no stay of such order is then in effect. On [*date*], the Bankruptcy Court entered its order confirming the Plan of Reorganization. Accordingly, the Effective Date of the Plan of Reorganization is [*date*].

On [*date*] (*the Filing Date*) the Company filed a voluntary petition (*the Chapter 11 Case*) under chapter 11 of the United States Bankruptcy Code. On [*date*], the Company filed an amended plan of reorganization and related disclosure statement with the Bankruptcy Court. On [*date*], the Bankruptcy Court approved as adequate the Disclosure Statement, thereby enabling the Company to solicit votes on the Plan of Reorganization from the Company's secured lenders (collectively, *the Lender Group*) and stockholders. From the Filing Date until the Effective Date, the Company operated its business as a debtor-in-possession subject to the jurisdiction of the Bankruptcy Court. During such time, all claims against the Company in existence prior to the Filing Date were stayed and have been classified as "liabilities subject to compromise" in the consolidated balance sheet.

At [*date*], "liabilities subject to compromise" were comprised of the following:

[*list*]

Example of "Basis of Presentation" Disclosure in Significant Accounting Policies Footnote, Related to a Bankruptcy Reorganization.

On [*date*], with the approval of all voting classes of creditors and equity holders, the United States Bankruptcy Court for [*location*] confirmed the Debtor's Modified Amended Consolidated Plan of Reorganization dated [*date*] [*the plan*]. On [*date*], the plan became effective. For accounting purposes, the effective date of the plan is considered to be [*date*].

Upon emergence from its Chapter 11 proceedings, the Company issued new common stock, warrants to purchase common stock and senior notes, and created a newly formed liquidating subsidiary, [*name*], which issued certain asset proceeds notes to be redeemed from the proceeds of sales of noncore assets.

The Company adopted fresh-start reporting in accordance with AICPA Statement of Position No. 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*, as of [*date*]. The Company's emergence from its Chapter 11 proceedings resulted in a new reporting entity with no retained earnings or accumulated deficit as of [*date*]. Accordingly, the Company's consolidated financial statements for periods prior to [*date*] are not comparable to consolidated financial statements presented on or subsequent to [*date*]. A black line has been drawn on the accompanying consolidated financial statements to distinguish between the pre-reorganization and post-reorganization company.

Special Customer Programs

To confront dwindling consumer demand and the weak economy, many retailers are increasingly offering special incentives to customers. Auditors should inquire whether a client has offered any incentives. Recently, the FASB EITF has been discussing issues relating to certain sales incentives. The following EITF issues relate to the accounting for sales incentives and should be considered:

- EITF Issue No. 00-14, *Accounting for Certain Sales Incentives* (Consensuses were reached May 17-18, 2000, with revisions made to the EITF Abstracts at the September 20-21, 2000 meeting.)

- EITF Issue No. 00-21, *Accounting for Multiple-Element Revenue Arrangements* (Consensuses were reached July 19, 2001, with revisions to the EITF Abstracts at the July 19, 2001 meeting.)
- EITF Issue No. 00-22, *Accounting for "Points" and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future* (Originally discussed at the September 20-21, 2000 meeting, consensuses reached on Issue 3 January 17-18 2001, further discussion is planned at future meetings.)

Auditors should also consider the guidance in SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU secs. 310, 333, and 380), when evaluating whether such sales incentives have been properly accounted for. SAS No. 89 establishes audit requirements designed to encourage client management to record financial statement adjustments aggregated by the auditor.

Employee Layoffs

Many companies are instituting layoffs during this economic downturn. Since January 2001, announcements of job cuts just keep coming. U.S. companies have reported approximately 650,000 layoffs through May 2001. The trend is broad-based, affecting not just struggling industries like tech and telecom but also food and consumer products—both businesses once thought to be recession-proof. Healthy companies are also using layoffs as a tool to reduce costs and accumulate earnings as they maneuver through this economic downturn.

If the retailing entity you are auditing is experiencing layoffs, management will need to properly account for employee-related termination charges such as severance packages, restructuring charges, and voluntary separation. In addition, management may need to properly account for outplacement services, bonuses, and educational allowances to assist employees in contending with the loss of their jobs. The following accounting literature provides guidance on accounting issues related to layoffs:

- EITF Issue No. 94-3 addresses liability recognition for certain employee termination benefits. See the "Store Clos-

ings, Restructuring Charges, and Asset Impairment" section of this Alert for further information about the guidance in EITF Issue No. 94-3.

- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, establishes standards for accounting for curtailments and termination benefits among other issues. Practitioners should refer to paragraphs 6 to 14 for guidance on curtailment and paragraphs 15 to 17 for guidance on termination benefits. FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits other than Pensions*, requires the effect of the curtailment (for example, the termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a segment of a business) to be recorded as a loss. Practitioners should refer to paragraphs 96 to 99 for guidance on how to account for plan curtailment. The Statement also provides guidance on how to measure the effects of termination benefits in paragraphs 101 and 102.

- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, requires that entities providing postemployment benefits to their employees accrue the cost of such benefits. Inactive employees include those who have been laid-off, regardless of whether or not they are expected to return to work. Postemployement benefits that can be attributed to layoffs can include salary continuation, supplemental unemployment benefits, severance benefits, job training and counseling, and the continuation of benefits such as health care benefits and life insurance coverage.

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

- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, addresses disclosures

only and requires the disclosure of the amount of gain or loss recognized resulting from a settlement or curtailment. Additionally, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event is required to be disclosed.

Subsequent Events

Auditors should also refer to AU Section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560), for guidance on auditors' procedures relating to subsequent events. The following audit procedure should be applied to employee benefit plan engagements that include terminations. The auditor should inquire of and discuss with the plan administrator or other parties performing the plan's management function matters involving unusual terminations of participants, such as terminations arising from a sale of a division or layoffs.

Internal Control Deficiencies and Audit Processes

Significant layoffs can have a serious effect on a retailer's internal control and financial reporting and accounting systems. For instance, employees who remain at the company may be overwhelmed by their workloads, under pressure to complete their tasks with little or no time to consider their decisions, or performing too many tasks and functions. The auditor may need to consider whether these situations exist and what their effect is on internal control.

Additionally, the auditor may need to consider the possible effects that key unfilled positions can have on internal control. Retailers that have had strong financial reporting and accounting controls could see those controls deteriorate as a result of the lack of employees. Controls over inventory, purchasing, and receivable collections could also suffer. Layoffs can also create additional exposure to possible internal fraudulent activities (for example, when an employee performs job functions that otherwise would be segregated.)

You may want to consider these issues in planning and performing the audit and in assessing control risk. Remember that gaps in

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

Accounting for Advertising Costs

How should management account for advertising costs?

Retailers advertise through newspaper inserts, local television, circulars, magazines and radio spots, which can take a big chunk out of their budgets and bottom lines. In the beginning of the year and now, advertising has been used to help retailers with promoting markdowns for slow moving merchandise in an effort to keep inventory at a healthy level. Currently, retailers will use advertising to promote back-to-school sales, to target consumers receiving tax rebates, and to possibly develop a competitive edge in the upcoming holiday season. Practitioners should refer to SOP 93-7, *Reporting on Advertising Costs*, for guidance.

SOP 93-7 defines advertising as a customer acquisition activity involving the promotion of an industry, an entity, a brand, a product name, or specific products or services so as to create or stimulate a positive entity image, or to create or stimulate a desire to buy the entities' products or services. It also provides guidance on accounting for advertising costs in annual financial statements for the following:

1. Reporting the costs of advertising, which would be expensed either as incurred or the first time the advertising takes place, except for direct-response advertising:
    a. That is primarily intended to elicit sales to customers who could be shown to have responded specifically to the advertising.
    b. That results in probable future economic benefits.
2. For direct-response advertising that may result in reported assets (that is, capitalized pursuant to the criteria set forth in items a. and b. above) as follows:

a. How such assets should be measured initially

b. How the amounts ascribed to such assets should be amortized

c. How the realizability of such assets should be assessed

Additionally, SOP 93-7 requires that the notes to the financial statements should disclose the following:

1. The accounting policy for reporting advertising, indicating whether such costs are expensed as incurred or the first time the advertising takes place
2. A description of the direct-response advertising reported as assets (if any), the accounting policy for it, and the amortization period
3. The total amount charged to advertising expense for each income statement presented, with separate disclosure of amounts, if any, representing a write-down to net realizable value
4. The total amount of advertising reported as assets in each balance sheet presented

The following is an example of the disclosures required by the SOP:

> Note X. Advertising
>
> The Company expenses the production costs of advertising the first time the advertising takes place, except for direct-response advertising, which is capitalized and amortized over its expected period of future benefits.
>
> Direct-response advertising consists primarily of magazine advertisements that include order coupons for the Company's products. The capitalized costs of the advertising are amortized over the three-month period following the publication of the magazine in which it appears.
>
> At December 31, 20XX, $1,000,000 of advertising was reported as assets. Advertising expense was $10,000,000 in 20xx, including $500,000 for amounts written down to net realizable value.

Auditing and Attestation Pronouncements and Guidance Update

Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. The AICPA *Audit Risk Alert—2001/2002* (Product No. 022250kk) contains a summary explanation of all these issuances. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 94	*The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*
SOP 01-3	*Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*
SSAE No. 10	*Attestation Standards: Revision and Recodification*
Audit Guide	*Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*
Audit Guide	*Auditing Revenue in Certain Industries*
Audit Guide	*Audit Sampling*
Audit Guide	*Analytical Procedures*
Practice Alert 01-1	*Common Peer Review Recommendations*

Accounting Pronouncements and Guidance Update

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. The AICPA *Audit Risk Alert—2001/2002* (Product No. 022250kk) contains a summary explanation of all these issuances. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web

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

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

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is some brief information about some ongoing projects that are especially relevant to the Retail industry. Remember that exposure drafts are non-authoritative and cannot be used as a basis for changing GAAP or GAAS. The AICPA general *Audit Risk Alert—2001/2002* summarizes some of the more significant exposure drafts outstanding.

The following table lists the various standard-setting bodies' web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft.

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

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

New Framework for the Audit Process

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

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

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Among other things, this will im-

prove the auditor's assessment of inherent risk and eliminate the "default" to assess inherent risk at the maximum.

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

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

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

Resource Central

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

On the Book Shelf

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

- *Auditing Derivative Instruments, Hedging Activities and Investments in Securities* Audit Guide (Product No. 012520kk)
- *Revenue Recognition* Audit Guide (Product No. 012510kk)
- *Audit Sampling* Audit Guide (Product No. 012530kk)

- *Analytical Procedures* Audit Guide (Product No. 012551kk)
- *Auditing Estimates and Other Soft Accounting Information* Practice Aid (Product No. 010010kk)
- *Accounting Trends &Techniques* (2001)
- *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* Practice Aid (Product No. 006701kk)
- *Consideration of Internal Control in a Financial Statement Audit 1997* (Product No. 012451kk)
- *Use of Real Estate Appraisal Information 1997* (Product No. 013159kk)
- *Common Interest Realty Associations* Checklist (Product No. 008764kk)
- *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (008883kk)

Audit and Accounting Manual

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

CD-ROM

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

Educational Courses

The AICPA has developed a number of continuing professional education courses that are valuable to CPAs working in the specific industries. Those courses include:

- *AICPA's Annual Accounting and Auditing Workshop* (2000-2001 Edition) (Product No. 737061 (Text); 187078 (Video)). Whether you are in industry or public practice, this course keeps you current, informed, and shows you how to apply the most recent standards.
- *Independence* (Product No. 739035). This new interactive CD-ROM course will review the AICPA authoritative literature covering independence standards (including the newly issued SECPS independence requirements), SEC regulations on independence, and Independence Standards Board standards.
- *Internal Control Implications in a Computer Environment* (Product No. 730617). This practical course analyzes the effects of electronic technology on internal controls and provides a comprehensive examination of selected computer environments, from traditional mainframes to popular personal computer setups.

Online CPE

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

CPE CD-ROM

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

Member Satisfaction Center

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

Hotlines

Accounting and Auditing Technical Hotline

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

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Web Sites

AICPA Online

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

CPA2Biz.Com

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

Some features cpa2biz provides or will provide include:

- Online access to AICPA products like audit and accounting guides, and audit risk alerts
- News feeds each user can customize
- CPA "communities"
- Online CPE
- Web-site development and hosting
- Electronic procurement tools to buy goods and services online
- Electronic recruitment tools to attract potential employees online
- Links to a wider variety of professional literature
- Advanced professional research tools

Other Helpful Web Sites

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

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This Audit Risk Alert replaces *Retail Industry Developments—2000/2001*.

Practitioners should also be aware of the economic, regulatory, and professional developments described in *Audit Risk Alert—2001/2002* (Product No. 022260kk) and *Compilation and Review Alert—2001/2002* (Product No. 022270kk) which may be obtained by calling the AICPA Order Department at (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 e-mail these comments to lwest@aicpa.org or write to—

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Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

APPENDIX

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, IRS 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 as follows:

- 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. The reliability of the 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	www.aicpa.org
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
Securities and Exchange Commission	SEC Digest and Statements, EDGAR database, current SEC rulemaking	www.sec.gov
Independence Standards Board	Information on the activities of the Independence Standards Board	www.cpaindependence.org
The Electronic Accountant	*World Wide Web* magazine, which features up-to-the-minute news for accountants	www.electronicaccountant.com
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com/
Guide to WWW for Research and Auditing	Basic instructions on how to use the Web as an auditing research tool	www.tetranet.net/ users/gaostl/guide.htm
Accountants Home Page	Resources for accountants and financial and business professionals	www.computercpa.com
United States Department of Commerce	Various economic statistics about the U.S. economy	www.doc.gov www.bea.doc.gov
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/- ustax.html
Federal Reserve Bank of New York	Key interest rates	www.ny.frb.org/pihome/- statistics/dlyrates

Hoovers Online	Online information on various companies and industries	www.hoovers.com
Ask Jeeves	Search engine that utilizes a user-friendly question format. Provides simultaneous search results from other search engines as well (for example, Excite, Yahoo, AltaVista)	www.askjeeves.com
Chain Store Age	Industry periodical with retail news headlines	www.chainstoreage.com
About	Industry periodical with retail news, trends and statistics	retailindustry.about.com
Today's Retail News	Current events in the retail industry	biz.yahoo.com/news/retail.html

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