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AUDIT RISK ALERTS

Retail Industry Developments—2000/01

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

Yelena Mishkevich
Technical Manager
Accounting and Auditing Publications

Special thanks to David J. Middendorf, CPA, Ted Shapiro, CPA, and Richard Donlon, CPA, for their assistance in development and review of this Alert.

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Retail Industry Developments—2000/01

Economic and Industry Developments

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

U.S. economic expansion, now in its tenth year, continued in 2000. Gross domestic product (GDP) grew at an annual rate of 4.8 percent in the first quarter and 5.6 percent in the second quarter. Estimates for third-quarter GDP suggest that the economy has slowed to a growth rate in the 3 percent range. Estimated annualized GDP for 2000 is 4.5 percent. Our economy has grown at an average annual rate of 4.08 percent over the past five years, almost a full percentage point higher than the average since 1970. The biggest surprise at this point is not that the economy grew at such a fast pace for so long, but that it managed to do so without sparking inflation. These phenomena can be explained by gains in productivity due to widespread use of technology. After growing at 1.6 percent annually between 1990 and 1994, productivity has been rising at almost 2.4 percent since 1995.

In 2000, retail entities continued to invest heavily in technology to increase worker productivity. Spending on equipment and software nationwide increased by 20.6 percent in the first quarter and 21 percent in the second quarter. See the "New or Upgraded Computer Systems" section of this Alert for a discussion of new technology and its effect on the audit of retail entities.

Consumer spending, a key determinant of retail sales, rose at a 7.6 percent annual rate in the first quarter and a 3 percent annual rate in the second, the slowest pace since 1997. The second quarter increase in consumer spending was disappointing for retailers, as retail sales are a significant component of consumer spending.

Risks for Retailers

Despite the strength of the overall economy, it was a rather difficult year for most of the retail industry. This year's sales were negatively affected by a number of factors. In the first quarter, sales were hampered by lower demand for items that were stockpiled in preparation for Y2K problems. These problems never materialized to any significant extent. Sales were also hampered by the fact that this year's Easter shopping season fell in the second quarter vs. the first quarter last year (due to a late Easter). Poor results continued in the second quarter, attributable to such factors as unseasonably cold and rainy weather, lack of fashion direction, higher interest rates, and rising gas prices. Back-to-school sales were disappointing for many of the same reasons. Sales were also dampened by the fact that fashions that appealed to kids this year were viewed as inappropriate for academic environments, and therefore were unacceptable to most parents. The biggest concern at this point is that weak back-to-school sales may indicate decreased shopper interest for the rest of the year, particularly the Christmas holiday season.

The apparel and department store sectors of the retail industry were hurt the most by the factors described above. Many retailers held clearance sales throughout the summer to get rid of unwanted merchandise. However, in some cases this sales strategy did not help. These retailers were stuck with inventory levels significantly higher than last year. As a result, auditors of retail entities in this industry sector should be alert to issues such as obsolete and excess inventories. See the "Inventory" section of this Alert for a further discussion of inventory obsolescence and other issues affecting this significant retail asset.

Weak sales negatively affected the stock performance of many retail entities. As a result, retailers are more frequently being confronted with stock compensation issues such as repricing (that is, reducing the exercise price of fixed stock option awards). As an auditor of a retail entity, you should be aware that accounting for various changes to stock option plans has changed as a result of Financial Accounting Standards Board (FASB) Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*, an interpretation of Accounting Principles Board (APB) Opinion No. 25. We will discuss this issue in further detail in the "Repricing of Employee Stock Options" section of this Alert.

Traditionally, the retail industry has experienced a proportionally greater number of bankruptcies compared to many other industries. Small and medium-size retailers, for example, do not have the capital base or cost structure to effectively compete against the retail giants. This year the situation worsened with the wave of failures that swept away many dot-com retailers. (See the "Electronic Commerce" section of this Alert for more information on this topic.) These developments are likely to make it more difficult for retailers to obtain new debt or equity financing. This, in turn, may result in negative trends, or other conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern. Auditors should be aware of their responsibility to evaluate whether there is a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. See the "Going Concern Issue" section of this Alert. Also, see the "Store Closings and Asset Impairments" section of this Alert for a discussion of some of the accounting and auditing issues that result when a retail entity closes store locations.

Electronic Commerce

The astounding growth rate of e-commerce presents retailers with many risks and opportunities. E-commerce, or online retailing, is growing and thriving, according to a recent study conducted by the Boston Consulting Group (BCG). Based on data collected from more than 400 electronic retailers (also known as *online retailers* or *e-tailers*), the BCG study provides a comprehensive picture of actual online retail revenues for 1999, along with estimates of future growth. The study notes that total online business-to-consumer (B2C) revenues across all categories grew by 120 percent to $33.1 billion in 1999. It is interesting to note that this amount, though sizeable, represents only 1.4 percent of all retail sales, which provides a great opportunity for growth in the

B2C market. For 2000, online retail transactions are expected to grow 85 percent, reaching $61 billion in revenues.

According to the BCG report, the continued growth of the online retail market is a result of the boom in the online population, an increasing number of off-line retailers establishing a strong presence online, and the emergence of new nontraditional retail business models. The study goes on to predict that by the end of 2000, a number of categories—computers, books, music, and videos—will have nearly met, or surpassed, 10 percent market penetration, posing a very real threat to "brick and mortar" retailers. Many retailers that have no online presence may soon have to consider reducing the number or size of their physical outlets to compensate for the loss in sales.

The U.S. Department of Commerce did not begin tracking e-commerce sales until the fourth quarter of 1999, when it reported $5.198 billion for that period. For 2000, the Department of Commerce reported retail e-commerce sales of $5.240 billion in the first quarter and an estimated $5.518 billion in the second quarter. Furthermore, Forrester Research predicts that online spending this holiday season will reach $10 billion, doubling last year's figure. These numbers demonstrate that online retail sales, especially after adjusting 1999 totals for holiday sales, continue to grow at a phenomenal rate.

However, despite strong trends and a positive outlook for the whole industry, some individual online retailers did not fair well this year. Investors and lenders have finally come to realize that an entity showing continually increasing losses on its financial statements is not worth much. This point was further reinforced by the *Wall Street Journal* in an article by Burton G. Malkiel entitled "Nasdaq: What Goes Up...." This publication brought out into the open what all professional investors learned in business school, but chose to ignore for Internet stocks, that "eventually every stock can only be worth the value of the cash flow it is able to earn for the benefit of investors." In June, Lehman Brothers Inc. released a report about Amazon's deteriorating credit situation. Among other things, the report questioned Amazon.com's business model, on which most other e-tailers are based, by saying that it may be flawed. On June 4, 2000, the *New York Times* reported in an article titled "E-Tailers Countdown to Mid-year 2001" that

TheStreet.com's index of twenty stocks was down 51.2 percent for the year. The article predicted that ten of the thirty-two most prominent Internet retailers would have to increase their cash reserves by mid-2001. The failure of several prominent dot-com retailers like ToySmart.com, Boo.com, and ToyTime.com did not help to improve the mood of the investment community. As a result of these developments, companies requiring cash are likely to have difficulty raising it as investors are now taking a closer look at return on investment and cost savings. In the meantime, increasing sales, low operating margins, and excessive operating losses cannot fund continuing operations. Auditors of online retailers need to look at the short-term cash requirements and cash generating ability of their clients. Auditors should consider if clients that require additional equity investments in the next twelve months to maintain operations have the ability to continue as going concerns. See the "Going Concern Issue" section of this Alert for further discussion.

Current conditions regarding cash reserves and other market challenges may prompt Internet retailers to manipulate sales, expenses, and income. Many online retailers are fighting for survival, and a good survival tactic might be to present investors with financial statements that show increasing sales, decreasing costs, and profits. Auditors should also consider the variety of unique accounting issues that may confront e-tailers. The "Revenue Recognition in Financial Statements – SEC Staff Accounting Bulletin" section of this Alert discusses some of the issues that are relevant to e-tailers.

> **Help Desk**—To find out more about what's happening in the realm of e-business and how it will affect your audits, order the new "E-business" Alert (022273kk). See the "AICPA—At Your Service" section of this Alert for order information.

Executive Summary—Economic and Industry Developments

- The U.S. economic expansion is continuing.
- Many retailers did not perform as well this year as one might have expected in this strong economy.
- Retailers may be facing significant changes as a result of e-commerce, including increased competition and the need to have a presence on the World Wide Web.

Audit Issues and Developments

Auditing in an Electronic Commerce Environment

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

Before discussing the effect of e-commerce on the auditor, it may be helpful to provide a definition: The term *electronic commerce* (e-commerce) simply refers to those transactions between businesses and consumers that are conducted in an electronic environment. E-commerce has a number of significant audit and accounting implications, including the following:

- In the not-too-distant past, investors demonstrated a great tolerance for dot-com retailers with limited revenues and a lack of profitability. There seemed to be few misgivings on their part about providing additional cash infusions to keep these entities solvent. The focus of the investment community was on the future potential for earnings. In those circumstances it was appropriate for auditors to conclude that the going concern assumption was valid. However, the stock collapse of some of the prominent e-tailers earlier in the year has ushered in greater skepticism on the part of investors. Given this change in circumstances, auditors may have to reassess the going concern assumption for some of their dot-com clients in accordance with Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341). See the "Going Concern Issue" section of this Alert for further discussion.

- In addition to performing the audit, some CPA firms may provide nonattest services to a retailer involved in Internet transactions that will require consideration of independence issues. For example, designing, implementing, or integrating information systems for your audit client may impair independence. In such circumstances, the auditor should consider Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101). Auditors of publicly held entities should of course also consider Securities and Exchange

Commission (SEC) and, where applicable, Independent Standards Board (ISB) independence standards.

- The technological skills required to fully understand the operations of an e-business and the manner in which business is transacted may be highly specialized. Having a sound understanding of these matters may therefore present a formidable challenge to the uninitiated. This is further complicated by the rapid change in technology, which may mean that you're chasing a moving target. While auditors are likely to have the requisite skill set to address many of the issues that arise in an e-business environment, some additional training may be required. In some cases the use of a technology specialist may be advisable. If the auditor decides to use the specialist, he or she should consider SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).
- E-commerce will result in the increased use by retailers of electronic data to transact business, and to record, update, and maintain records. As a result, auditors of retail companies increasingly will be confronted with evaluating evidential matter that may exist only in electronic format. SAS No. 80, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326), provides guidance to auditors who have been engaged to audit the financial statements of an entity that transmits, processes, maintains, or accesses significant information electronically. One of the issues addressed by SAS No. 80 is the timing of the audit. Electronic evidence exists only for a limited amount of time and it may not be retrievable later if files are changed and backup files do not exist. Consequently, waiting until after fiscal year end to begin auditing procedures may be too late to obtain competent sufficient evidence. The AICPA Auditing Practice Release *The Information Technology Age: Evidential Matter in the Electronic Environment* (Product No. 021068kk) is designed to provide nonauthoritative guidance to auditors in applying SAS No. 80.
- The auditor also may be more likely to see prepackaged or customized computer systems used by retail clients. In such

circumstances, the auditor should evaluate management's consideration of Statement of Position (SOP) 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.* SOP 98-1 is discussed in further detail in the "New or Upgraded Computer Systems" section of this Alert.

- The cost of developing a Web site is one of the key issues identified by the SEC staff. It is often one of the largest costs for a retailer conducting business over the Internet. The SEC staff believes that a large portion of these costs should be accounted for according to SOP 98-1. This year, FASB issued Emerging Issues Task Force (EITF) Issue No. 00-2, *Accounting for Web Site Development Costs.* The auditor should ensure that management accounted for the costs of developing a Web site in accordance with the above-mentioned guidance.

- Accounts receivable are a hot topic for e-tailers because of the high incidence of fraud on the Internet. Auditors should evaluate the collectibility of accounts receivable and the adequacy of bad debt reserve. See the "Collectibility of Receivables (Allowance for Doubtful Accounts)" section of this Alert for procedures that auditors might consider using to audit this area.

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

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

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

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

- Some retailers are outsourcing the entire fulfillment and information technology functions, becoming "virtual" stores. Auditors of entities that use such services should be familiar with the requirements of SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324). However, in some cases auditors might not be able to obtain a SAS No. 70 letter. For example, a number of retailers use an Internet Service Provider (ISP) to host their Web sites, including the databases used to initially record sales and credit card receivables. Unfortunately, because of the newness of e-business, an auditor is unlikely to obtain a SAS No. 70 letter from an ISP. For those audit clients that host their sites at an ISP, lacking a SAS No. 70 letter or access to the ISP to gain an understanding and test internal control, the auditor will be faced with a scope limitation.

- E-commerce may result in rapid changes in the way transactions are processed, possibly without adequate consideration of the effect on internal control. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the auditor's consideration of an entity's internal control in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).
- Retailers may organize their e-commerce operations as a separate business segment. For a public business enterprise, this may result in an operating segment subject to the disclosure requirements of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*. In such circumstances, auditors should consider the guidance set forth under auditing Interpretation No. 4, "Applying Auditing Procedures to Segment Disclosures in Financial Statements," of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 9326.22).
- Electronic Data Interchange (EDI) is also a type of electronic commerce that is often used by retailers to interact via computer with suppliers and customers. The Auditing Practice Release *Audit Implications of EDI* addresses the opportunities and challenges that EDI presents, including issues such as the internal controls that are important in EDI systems, and the audit and business risks associated with using the technology.

When auditing the financial statements of retailers that engage in e-commerce, auditors should gain an understanding of the retailers' accounting models used for their e-commerce activities, and should ensure that transactions that retailers enter into through their e-commerce operations are accounted for using the established accounting models for similar transactions entered into through the retailers' traditional business operations, when such models exist.

Executive Summary—Auditing in an Electronic Commerce Environment

- The growth of the Internet has led many retailers to make an initial venture into electronic commerce. Auditors need to consider how these ventures will affect the audit.
- Increasingly, auditors are faced with auditing in an environment where a significant amount of business is transacted electronically.
- Among the many accounting and auditing implications of the retailer's use of e-commerce are going concern and independence issues, determining the need to involve the technical specialist in the audit, accounting for software developed or purchased for internal use, accounting for costs of developing a Web site, use of service organizations, and the effect of e-commerce on internal control.

Collectibility of Receivables (Allowance for Doubtful Accounts)

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

One of the most significant differences between a credit card purchase made in a traditional brick-and-mortar store and the one made over the Internet is the existence of the customer's signature acknowledging the purchase. A traditional retailer will have it while an e-tailer will not. It may not seem like much of an issue, but it makes the world of difference when a customer disputes the transaction. In the off-line retail environment, charges for disputed transactions are normally absorbed by the credit card company. However, if the sale is made over the Internet, the retailer is usually the one losing the money. The problem is that without the customer's signature, a retailer cannot prove that merchandise was sold to the cardholder and not to someone else who is using the customer's stolen credit card number.

But fraud has expanded beyond stolen credit cards. Customers have become comfortable with the notion that they are always right in the world of Internet retailing. It is not uncommon nowadays for people to order the goods, dispute the transaction, and at the end keep the merchandise without paying anything for it. Because more people are ordering over the Internet, retailers may be more likely to experience an increased number of fraudulent transactions. As a result, retailers may experience an increase in uncollectible receivables. Additionally, because this is a rapidly evolving area, the retailer may not have an adequate history of bad debts resulting from Internet sales on which to estimate the level of uncollectible accounts, making the determination more difficult.

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

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

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

1. Review and test the process used by management to develop the estimate.

2. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.

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

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

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

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

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

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

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

Also, auditors of retail entities that have transferred receivables should evaluate whether management has properly implemented FASB Statement No. 125[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.

Going Concern Issue

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

The retail industry's sensitivity to changes in economic conditions (such as interest rates, personal income, unemployment levels, and consumer confidence) and its intense competition have resulted in a historically high rate of business failure. And, despite the current favorable economic environment, the retail industry experienced a disproportionately high rate of bankruptcies this year. 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 deficien-

1. This Statement was replaced by FASB Statement No. 140, 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.

cies, (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 line of product, or (4) external matters such as legal proceedings or loss of a principal supplier. In such circumstances auditors will have to consider whether, based on such conditions and events, there is substantial doubt about the retailer's ability to continue as a going concern.

Auditors should be aware of their responsibilities pursuant to SAS No. 59. SAS No. 59 provides guidance to auditors in conducting an audit of financial statements in accordance with 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.

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. The auditor should be aware that in November 1999 the SEC staff released SAB No. 100, *Restructuring and Impairment Charges,* which affects accounting for impairments. SAB No. 100 can be found on the SEC Web site at www.sec.gov/rules/acctreps/sab100.htm.

Auditing Derivatives

What guidance is available for auditing derivative instruments?

The topic of derivatives takes center stage this year, from both the accounting and auditing perspectives. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (as amended), issued in June 1998, became effective for all fiscal quarters of all fiscal years beginning after June 15, 2000. Many retailers are likely to be affected by FASB Statement No. 133 because they might have financial instruments that now should be accounted for as derivatives. In September of this year, the Auditing Standards Board (ASB) issued SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards,* vol. 1, AU sec. 391). SAS No. 92, which will supersede SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards,* vol. 1, AU sec. 332), is effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Early application of the SAS is permitted.

Guidance for Auditors

SAS No. 92 provides guidance for auditors in planning and performing auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities. The guidance in the SAS applies to (1) derivative instruments, as defined by FASB Statement No. 133; (2) hedging activities in which the entity designates a derivative or a non-derivative financial instrument as a hedge of exposure for which FASB Statement No. 133 permits hedge accounting; and (3) *debt and equity securities*, as those terms are defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The matters addressed by SAS No. 92 include—

- *The need for special skills or knowledge.* Auditors may need special skills or knowledge to plan and perform procedures for certain assertions about derivatives and securities, such as the ability to identify a derivative that is embedded in a contract or agreement.
- *Consideration of audit risk and materiality.* SAS No. 92 offers examples of factors that affect inherent risk (that is, the susceptibility of an assertion to a material misstatement, assuming there are no related controls) for assertions about derivatives or securities. Such factors include the complexity of the features of the derivative or security and the entity's experience with the derivative or security. The SAS also discusses control risk (that is, the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control) assessment.
- *Designing substantive procedures based on risk assessment.* Auditors assess inherent and control risk for assertions about derivatives and securities to determine the nature, timing, and extent of the substantive procedures to be performed. Substantive procedures for derivatives and securities should address the five categories of assertions presented in SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326):

  1. *Existence or occurrence*—Existence assertions address whether the derivatives and securities reported in the financial statements exist at the balance sheet date. Occur-

rence assertions address whether derivatives and securities transactions reported in the financial statements (as a part of earnings, other comprehensive income, or cash flows) occurred.

2. *Completeness*—Completeness assertions address whether all of the entity's derivatives and securities and the related transactions are reported in the financial statements.
3. *Rights and obligations*—Assertions about rights and obligations address whether the entity has the rights and obligations associated with derivatives and securities reported in the financial statements.
4. *Valuation*—Assertions about the valuation of derivatives and securities address whether the amounts reported in the financial statements were determined in conformity with generally accepted accounting principles (GAAP). GAAP may require that a derivative or security be valued based on cost, the investee's financial results, or fair value. Also, GAAP for securities may vary depending on the type of security, the nature of the transaction, management's objectives related to the security, and the type of entity.
5. *Presentation and disclosure*—Assertions about presentation and disclosure address whether the classification, description, and disclosure of derivatives and securities in the entity's financial statements are in conformity with GAAP.

SAS No. 92 also discusses hedging activities and management representation issues.

Audit Guide to Complement SAS No. 92

An Audit Guide to complement the SAS has been developed by the ASB and will be available in January 2001. The Guide provides practical guidance for implementing the SAS in all types of audit engagements. The objective of the Guide is both to explain SAS No. 92 and to provide practical illustrations through the use of case studies.

The Guide will include an overview of derivatives and securities and the general accounting considerations for them, as well as case studies that address topics such as the use of interest rate futures contracts to hedge the forecasted issuance of debt, the use of put options to hedge available-for-sale securities, separately accounting for a derivative embedded in a bond, the use of interest rate swaps to hedge existing debt, the use of foreign-currency put options to hedge a forecasted sale denominated in a foreign currency, changing the classification of a security to held-to-maturity, control risk considerations when service organizations provide securities services, inherent and control risk assessment, and designing substantive procedures based on risk assessments.

Executive Summary—Auditing Derivatives

- The topic of derivatives takes center stage this year, from both the accounting and auditing perspectives.
- Auditing guidance is available to auditors in the form of SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities.*
- Further, more detailed guidance will be available in a related ASB audit Guide that has been designed to complement the new SAS.

Repricing of Employee Stock Options

Will repricing of employee stock options be a significant issue for retail entities this year? What practical guidance has the FASB issued recently to clarify accounting for this type of transaction?

As we briefly mentioned in the "Economic and Industry Developments" section, retail entities may choose to reduce the exercise price of fixed stock option awards (a practice commonly referred to as *repricing*) due to tumbling stock prices. In today's job market, where intense competition for employees exists, stock options often play a significant role in attracting and retaining talented people. Declines in stock prices can often reduce the value of stock options or render some of them worthless. In these cases companies often reprice the options close to current market value so that they remain an incentive for employees.

In March 2000, FASB issued Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation* (an interpretation of APB Opinion 25). The Interpretation does not amend APB Opinion 25 but instead clarifies some of the issues addressed in it. In this Alert we will discuss only the guidance provided in FASB Interpretation No. 44 with respect to accounting for repricing because this topic is the one most likely to be relevant to retail entities this year.

Before the issuance of this Interpretation, repricing was basically "free"—that is, it did not affect net income. But with this new guidance, repricing most likely will have a negative impact on the bottom line. According to this Interpretation, if the exercise price of a fixed stock option award is reduced, the award shall be accounted for as variable from the date of the modification to the date the award is exercised, is forfeited, or expires unexercised. Subsequent to modification, additional compensation cost is calculated as the intrinsic value of the modified (or variable) award to the extent that it exceeds the lesser of the intrinsic value of the original award (1) at the original measurement date or (2) immediately prior to the modification. The remaining unrecognized original intrinsic value, if any, plus any additional compensation cost measured as described above shall be recognized over the remaining vesting (service) period, if any. If the modified award is fully vested at the date of the modification, any additional compensation cost to be recognized shall be recognized immediately. Also, under variable accounting, compensation cost shall be adjusted for increases or decreases in the intrinsic value of the modified award in subsequent periods until that award is exercised, is forfeited, or expires unexercised. However, compensation cost shall not be adjusted below the intrinsic value (if any) of the modified stock option or award at the original measurement date unless that award is forfeited because the employee fails to fulfill an obligation.

The effective date of FASB Interpretation No. 44 is July 1, 2000. However, modifications to fixed stock option awards that directly or indirectly reduce the exercise price of an award apply to modifications made after December 15, 1998. The effects of applying this Interpretation shall be recognized only on a prospective basis.

Accordingly, no adjustments shall be made on initial application of this Interpretation to financial statements for periods prior to July 1, 2000. Additional compensation cost measured on initial application of this Interpretation that is attributable to periods prior to July 1, 2000, shall not be recognized.

Auditors should ensure that management of their retail clients properly account for repricing of their stock option awards. Auditors also should be alert to the potential effect that this Interpretation may have on internal control. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319.29), identifies new accounting pronouncements as one of the circumstances that may increase risk relevant to the preparation of the financial statements.

Help Desk—This section presents only one aspect of FASB Interpretation No. 44 that is most likely to affect retail entities. Readers of this Alert are strongly encouraged to refer to the full text of FASB Interpretation No. 44, which can be found in the most recent edition of FASB *Original Pronouncements*, volume 3. See the FASB Web site at www.rutgers.edu/Accounting/raw/fasb/public/index.html for order information.

New or Upgraded Computer Systems

What is the proper accounting for new or upgraded software to be used internally? How does new technology affect the audit?

In the "Economic and Industry Developments" section we discussed the increase in technology spending by retailers seeking to boost workers' productivity. This is not the only reason that retailers have invested heavily in technology this year. A lot of big retail entities are focusing on cutting their costs along the supply chain by requiring their suppliers to monitor inventory levels at the stores and replenish stock as necessary. This can be accomplished by having a special computer link that connects the supplier to the retailer and allows the supplier to access individual stores' inventory data. New and improved technology is needed for this complex arrangement to work. Many big retailers that have not done so already plan to spend significant amounts of money over the next couple of years to improve technology that will allow for better coordination with suppliers. Rapid replacement of capital assets triggers the need for reassessment of depreciation lives of all assets. Auditors of retail entities need to ensure that their clients considered FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of.*

This year, many retailers did not spend significant amounts on hardware. Most had already upgraded their hardware last year in anticipation of the Y2K computer crisis. Therefore, in this Alert we will focus on issues related to computer software acquired or developed by the entity for internal use. Auditors of retail organizations should ensure that their clients have properly accounted for such software in accordance with SOP 98-1, *Accounting for Costs of Computer Software Developed or Obtained for Internal Use.* The SOP defines internal-use software as having the following characteristics:

1. The software is acquired, internally developed, or modified solely to meet the entity's internal needs.
2. During the software's development or modification, no substantive plan exists or is being developed to market the software externally.

SOP 98-1 defines three stages of computer software development: preliminary project stage, application development stage, and postimplementation/operation stage. The SOP provides the following guidelines on whether the computer software costs should be expensed or capitalized:

1. Internal and external costs incurred during the preliminary project stage should be expensed as incurred.
2. Internal and external costs incurred to develop internal-use computer software during the application development stage should be capitalized. Therefore, external direct costs of materials and services consumed in developing or obtaining internal-use computer software; payroll and payroll-related costs for employees who are directly associated with and who devoted time to the internal-use computer software project; and interest costs incurred when develop-

ing computer software for internal use should be capitalized. Data conversion costs should be expensed as incurred. However, costs to develop or obtain software that allows for access or conversion of old data by new systems should be capitalized.

3. Internal and external training and maintenance costs incurred during post-implementation/operation stage should be expensed as incurred.

4. Internal costs incurred for upgrades and enhancements should be expensed or capitalized in accordance with the criteria described above.

5. External costs incurred under agreements related to specified upgrades and enhancements should be expensed or capitalized in accordance with the criteria described above. However, external costs related to maintenance, unspecified upgrades and enhancements, and costs under agreements that combine the costs of maintenance and unspecified upgrades and enhancements should be recognized in expense over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the service received.

The SOP goes on to say that impairment should be recognized and measured in accordance with the provision of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* The capitalized costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software's use.

Auditors should also consider implications of a new or upgraded system on internal controls. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319.19), requires auditors to obtain a sufficient understanding of internal control. One of the key components of internal control is the assessment of risk relevant to the preparation of the financial statements. You, as an auditor, should understand the processes through which management identifies and addresses risks relevant to financial reporting. The SAS identifies certain circumstances in which risks can arise or change. Among those circumstances are new or revamped information systems and new technology. Given the current environment, auditors should be alert to the potential impact of these circumstances on their assessment of internal control.

Help Desk—This section presents only a brief summary of SOP 98-1. Readers of this Alert are strongly encouraged to refer to the full text of SOP 98-1, which can be ordered from the AICPA (Product No. 014905kk). See the "Resource Central" section later in this Alert.

Inventory

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

Obsolete or Excess Inventory

As discussed in the "Economic and Industry Developments" section, a number of retail companies are likely to end up with high inventory levels due to weak sales. The primary literature on inventory accounting is ARB 43, *Restatement and Revision of Accounting Research Bulletins.* Chapter 4 of ARB 43 states that "in keeping with the principle that accounting is primarily based on cost, there is a presumption that inventories shall be stated at cost... A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. If the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes, a loss [shall] be reflected as a charge against the revenues of the period in which it occurs. The measurement of such losses shall be accomplished by applying the rule of pricing inventories at cost or market, whichever is lower."

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. Examining an analysis of inventory turnover
2. Reviewing industry experience and trends
3. Analytically comparing 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. Touring the facility
5. Inquiring of sales and other relevant personnel concerning possible excess or obsolete items

When 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."

Inventory Observation

According to SAS No. 1, *Codification of Auditing Standards and Procedures*, as amended by SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 331.01), observation of inventories is a generally accepted auditing procedure. The independent auditor issuing an opinion without employing generally accepted auditing procedures must bear in mind that he or she has the burden of justifying the opinion expressed. The SAS states that when inventory quantities are determined solely by means of physical count, and all counts are made as of the balance-sheet date or as of a single date within a reasonable time before or after the balance-sheet date, it is ordinarily necessary for the auditor to be present at the time of count and, by suitable observation, tests, and inquiries, to satisfy himself or herself respecting the effectiveness of the methods of inventory-taking and the measure of reliance that may be placed on the client's representations about the quantities and physical condition of the inventories. The SAS goes on to describe two variations of that procedure when the client has well-kept perpetual records that are checked periodically by comparisons with physical counts or when the client uses statistical sampling to determine inventories. In such instances, the auditor may vary the timing of his or her observation of physical count, but "must be present to observe such counts as he deems necessary and must satisfy himself or herself about the effectiveness of the counting procedures used."

According to SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.24), the inability to observe physical inventories is one of the common restrictions on the scope of the audit. Some circumstances—for example, hiring the auditor near or after year end—may make it impossible for the auditor to observe physical inventory. According to AU section 331.12, it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions. If this cannot be accomplished, the auditor may be required to qualify his or her opinion or to disclaim an opinion because of an inability to observe the taking of the physical inventory. AU section 331.13 states that the auditor may be asked to audit financial statements covering the current period and one or more periods for which he or she had not observed or made some physical count of prior inventories. The auditor may, nevertheless, be able to become satisfied as to such prior inventories through appropriate procedures, such as tests of prior transactions, reviews of the records of prior counts, and the application of gross profit tests, provided that he or she has been able to become satisfied as to the current inventory.

According to the Appendix to SAS No. 31, *Evidential Matter*, observation of the physical inventory in combination with other procedures helps to accomplish the following audit objectives with respect to inventory:

1. Inventories included in the balance sheet physically exist.

2. Inventory quantities include all products, materials, and supplies on hand.

3. The entity has legal title or similar rights of ownership to the inventories.

4. Slow-moving, excess, defective, and obsolete items included in inventories are properly identified.

The process of observing physical inventory in a retail entity is not unique when compared to other industries. However, differences may arise when the retail method of inventory is used. In this case, the aggregate retail value of the inventory is often the only information that is documented during the inventory taking. The auditor should find out what kind of information will be documented prior to physical inventory and plan observation accordingly. In addition to that, some retailers use portable computerized devices that utilize SKU (stock keeping unit) numbers as a means of tracking inventory levels. In such cases the traditional evidential matter available to auditors may be limited. For example, count sheets often used in manually conducted physical inventories may not exist. When inventory is taken this way, the auditor may wish to consider utilizing procedures such as the following:

- Ensure that the facilities have been divided into small sections. This will help make the control and test counts easier. A section might also be set aside for questionable merchandise that is untagged and cannot be scanned by computer.

- Become satisfied as to the adequacy of physical inventory instructions and procedures to produce a complete and accurate count.

- Ensure the accuracy and completeness of the physical counts by—

    1. Recounting a minimum of one section per each person taking the inventory by having that person recall each SKU and price for that section and comparing it to the merchandise price tags.

    2. Using a calculator to come up with the total retail value for each section and comparing it to the amount produced by the inventory counter.

- Determine whether additional recounts are necessary based on the outcome of the procedures described above.
- Ensure that all sections are counted and all questions and problems are resolved prior to completion of the physical inventory.

In some cases retailers use an outside firm of nonaccountants specializing in the taking of physical inventories to determine the inventory on hand at the date of the physical count. In such circumstances the auditor must still perform some tests to satisfy himself as to the effectiveness of the procedures used by the outside firm. According to auditing Interpretation No. 1, "Report of an Outside Inventory-Taking Firm as an Alternative Procedure for Observing Inventories," of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 9508.06), the auditor would examine the outside firm's program, observe its procedures and controls, make or observe some physical counts of the inventory, recompute calculations of the submitted inventory on a test basis, and apply appropriate tests to the intervening transactions. The Interpretation goes on to say that the auditor ordinarily may reduce the extent of his or her work on the physical count of inventory because of the work of an outside inventory firm, but any restriction on the auditor's judgment concerning the extent of his or her contact with the inventory would be a scope restriction.

It is not uncommon for a retail entity to have inventory in several locations. Among the factors that should be considered by the auditor when selecting sites to observe are: (1) the amount of inventory at each location, (2) the effectiveness of control environment and monitoring activities at each site and in the organization as a whole, (3) the method of information processing—is it centralized or handled locally by each site.

Valuation

It is very important to ensure that inventory is properly stated for two reasons: (1) inventory is generally one of the biggest assets on most retailers' balance sheets, and (2) inventory amounts enter into the determination of net income and cash flows. ARB 43, chapter 4, provides that inventory shall be stated at the lower of cost or market except in certain exceptional cases when it may be stated above cost. *Cost* is defined as the sum of the applicable expenditures and charges directly or indirectly incurred in bringing inventories to their existing condition and location. Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as first-in, first-out [FIFO]; average; and last-in, first-out [LIFO]).

The ARB also provides guidance on applying the lower of cost or market rule, as well as the definition of those terms. For example, footnote 2 of ARB 43, chapter 4, explains that in the case of goods that have been written down below cost at the close of a fiscal period, such reduced amounts shall be considered the cost for subsequent accounting purposes.

Retailers generally use one of two methods for determining inventory cost—the cost method and the retail method. Using the cost method, the retailer would keep track of the cost of the various items in inventory and use this information to determine the cost value of the inventory, allocating it between cost of goods sold and ending inventory.

Because it is difficult to maintain cost information for more than a few items but relatively easy to maintain retail information, and because a physical inventory count is needed to determine the inventory value under the cost method, the retail method is still used by many retailers. Although more and more retailers are moving toward the cost method because it has been made easier through the use of computers, many retailers still use the retail method. In such circumstances auditors need to be familiar with the accounting issues specific to the retail method.

Under the retail method, cost of goods sold and ending inventory are determined at retail and reduced to cost value by using a cost-to-retail ratio. To understand the specifics of how the ratio is developed, you need to be familiar with the following concepts:

1. Original retail—the originally assigned selling price

2. Cost—the retailer's purchase price

3. Markon—the difference between the original retail and the cost
4. Markup—an increase in the selling price over the original retail price
5. Markup cancellation—a reduction in the markup, but not yet reducing the markon
6. Markdown—a reduction to the markon
7. Markdown cancellation—a reversal of the markdown

As an example, if a toy is purchased for $10 and originally offered for sale at $15, the markon is $5. If the price is increased to $18, the markup is $3. If the price is then reduced to $13, the markup cancellation is $3, and the markdown is $2. If it is then offered for sale at $14, the markdown cancellation is $1.

The proper classification of these changes is important in the retail method because of how they affect the cost-to-retail ratio. Markups and markup cancellations are included in determining the ratio, whereas markdowns and markdown cancellations are not.

To calculate ending inventory, goods available for sale (beginning inventory, plus purchases less purchase discounts, net markups [markups net of markup cancellations], and incidental costs) is determined at cost and retail (retail value does not apply to purchase discounts and incidental costs, and cost value does not apply to net markups). Cost would then be divided by retail to determine the cost to retail percentage. Sales, markdowns (net of cancellations) and shrinkage at retail would then be subtracted from goods available at retail to get ending inventory at retail. The cost to retail percentage would then be applied to ending inventory at retail to get ending inventory at cost.

The starting point for the preceding formula is the determination of goods available for sale at cost and at retail. This is determined by adding, as applicable, beginning inventory, purchases net of discount, incidental costs, and net markups, but not net markdowns. If net markdowns were deducted from the retail amount of goods available for sale (the denominator in the above ratio), the cost to retail ratio would be greater. As a result, when this larger percentage is applied to the value of ending inventory at retail, ending inventory at cost would be increased. Other variations, such as excluding both net markups and net markdowns from the ratio calculation would also distort ending inventory results. Therefore, it is customary to include net markups and exclude net markdowns in the calculation of the cost to retail ratio, which will approximate lower of cost or market valuation.

Because the retail method is an averaging method, the results can be distorted when not applied to reasonably homogeneous groups. Factors that can lead to distortion in the calculation of the inventory balance include applying the retail method to a group of products that is not fairly uniform in terms of its cost and selling price relationship and turnover, and applying the retail method to transactions over a period of time that includes different rates of gross profit, such as those occurring during various seasons.

The retail method uses a perpetual inventory system in that the stock ledger records all inventory changes. Among the items recorded are data on purchases (at cost and retail), sales and returns, markups and markdowns, markup and markdown cancellations, sales discounts, shrinkage, and transfers between departments. It is necessary to perform a physical count at year end to verify the balances and determine shrinkage.

Many retailers use the LIFO retail method. Because items are not specifically identified in the retail method, the dollar value approach, commonly referred to as the retail dollar value LIFO method, is used. The dollar value LIFO approach is much more complex than the conventional retail method. When applying dollar value LIFO method, both the markups and the markdowns must be considered in obtaining the proper cost to retail percentage. This is because the LIFO method is a cost method, not a cost or market approach. Furthermore, the beginning inventory should be excluded when calculating the cost to retail percentage since the LIFO method is concerned only with the additional layer or the decrement to the previous layer. Such treatment of the beginning inventory is based on the assumption of the LIFO retail method that the markups and markdowns apply only to the goods purchased during the current period and not to the beginning inventory. The first step in computing the LIFO inventory under a dollar value LIFO approach is to find the dollar increase in inventory and deflate it to beginning-of-the-year prices by using price indexes. The indexes may be either internally generated or obtained from reliable industry publications or government published indexes. The next step is to determine whether actual increase or decrease in quantity has occurred. An increase in quantities is multiplied by the current year's price index to compute the new layer. A decrease in quantities is subtracted from the most recent layers at the prices in existence when the layers were added. After determining the increment or decrement at retail value, it is necessary to reduce such value to cost. The current-year cost complement is applied to an increment, whereas the cost complement for the appropriate year would be used for a decrement. If LIFO is used for tax purposes, it must be used for financial reporting as well.

One of the areas where tax and accounting rules differ is with respect to the capitalization of cost in inventory. EITF Issue No. 86-46, *Uniform Capitalization for Inventory Under the Tax Reform Act of 1986*, discusses this issue.

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 is 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 cost of sales and inventory, and is computed as gross margin divided by net sales.

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

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

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

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

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

Accounting Issues and Developments

Revenue Recognition in Financial Statements—SEC Staff Accounting Bulletin

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

On December 3, 1999, the SEC staff released Staff Accounting Bulletin (SAB) No. 101.[2] This SAB addresses the application of generally accepted accounting principles to revenue recognition in financial statements. It applies to entities subject to SEC regulations. Initially, SAB No. 101 was required to be applied no later than the first fiscal quarter of the fiscal year beginning after December 15, 1999. However, subsequently the effective date was amended twice by SAB No. 101A and SAB No. 101B. The most recent effective date according to SAB No.101B is no later than the fourth fiscal quarter of the fiscal year beginning after December 15, 1999.

The SAB lists and explains four critical criteria needed for revenue recognition. All of the following criteria must be met for revenue to be recognized:

1. Persuasive evidence of an arrangement exists.
2. Delivery has occurred or services have been rendered.
3. The seller's price to the buyer is fixed or determinable
4. Collectibility is reasonably assured

The SAB addresses a number of revenue recognition topics. In this Alert we will discuss only those that are most relevant to retail entities. These topics are as follows:

1. Accounting for layaways
2. Accounting for refundable membership fees
3. Income statement presentation—gross vs. net

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

4. Accounting for sales of leased or licensed departments

Accounting for Layaways

Layaway sales can be a significant source of revenue for some retail entities. The SAB addresses layaway sales by stating that if the other criteria for revenue recognition are met, the company should recognize revenue from sales made under its layaway program upon delivery of the merchandise to the customer. Until then, the amount of cash received should be recognized as a liability entitled "deposits received from customers for layaway sales" or a similarly descriptive caption. Because the company retains the risks of ownership of the merchandise, receives only a deposit from the customer, and does not have an enforceable right to the remainder of the purchase price, the SAB states that the SEC staff would object to the company recognizing any revenue on receipt of the cash deposit.

The auditor has to ensure that the management properly handles the transition to SAB No. 101 with respect to layaway sales by reporting a change in accounting principle in accordance with APB Opinion 20, *Accounting Changes.*

Accounting for Refundable Membership Fees

Some discount retailers charge their customers annual membership fees to shop at their stores. The SAB addresses the timing of revenue recognition in a situation in which the customers are required to pay the entire membership fee at the outset of the arrangement and in which the customers have the unilateral right to cancel the arrangement at any time during its term and receive a full refund of the initial fee. In this situation, the SEC staff believes that revenue should not be recognized in earnings prior to the refund privileges expiring. The amounts received from customers or subscribers should be credited to a monetary liability account such as "customers' refundable fees" in accordance with FASB Statement No. 125[3], *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* paragraph 16.

3. This Statement was replaced by FASB Statement No. 140, 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.

This conclusion is based on the retailer's remaining and unfulfilled contractual obligation to perform services (that is, make available and offer products for sale at a discounted price) throughout the membership period. Therefore, the earnings process, irrespective of whether a cancellation clause exists, is not complete. In addition, the ability of the member to receive a full refund of the membership fee up to the last day of the membership term raises an uncertainty as to whether the fee is fixed or determinable at any point before the end of the term.

Nonetheless, the SEC staff recognizes that over the years the accounting for membership refunds evolved based on analogy to FASB Statement No. 48, *Revenue Recognition when Right of Return Exists*, despite the fact that FASB Statement No. 48 expressly does not apply to the accounting for service revenue if part or all of the service fee is refundable under cancellation privileges granted to the buyer. Companies following this practice recognize refundable membership fees, net of estimated refunds, as earned revenue over the membership term. That practice did not change when FASB Statement No. 125[4] became effective.

The SAB states that pending further action in this area by the FASB, the SEC staff will not object to this practice in the limited circumstances where all of the following criteria have been met:

1. The estimates of terminations or cancellations and refunded revenues are being made for a large pool of homogeneous items.
2. Reliable estimates of the expected refunds can be made on a timely basis.
3. There is a sufficient company-specific historical basis upon which to estimate the refunds, and the company believes that such historical experience is predictive of future events.
4. The amount of the membership fee specified in the agreement at the outset of the arrangement is fixed, other than the customer's right to request a refund.

4. See footnote 3.

If the company does not meet all of the foregoing criteria, the SEC staff believes that it should not recognize in earnings any revenue for the membership fee until the cancellation privileges and refund rights expire.

According to the SAB, if revenue is recognized in earnings over the membership period pursuant to the above criteria, the initial amounts received from customer or subscribers should be allocated to two liability accounts. The amount of the fee representing estimated refunds should be credited to a monetary liability account, such as "customers' refundable fees," and the remaining amount of the fee representing unearned revenue should be credited to a nonmonetary liability account, such as "unearned revenues." For each income statement presented, registrants should disclose in the footnotes to the financial statements the amounts of (1) the unearned revenue and (2) refund obligations as of the beginning of each period, the amount of cash received from customers, the amount of revenue recognized in earnings, the amount of refunds paid, other adjustments (with an explanation thereof), and the ending balance of (a) unearned revenue and (b) refund obligations.

If revenue is recognized in earnings over the membership period pursuant to the above criteria, the staff believes that adjustments for changes in estimated refunds should be recorded using a retrospective approach whereby the unearned revenue and refund obligations are remeasured and adjusted at each balance sheet date with the offset being recorded as earned revenue.

Income Statement Presentation

Gross vs. net—Prior to the advent of the "new economy," stock prices were generally determined by the company's bottom line. In today's dot-com world many Internet companies, including e-tailers, report net losses and yet are still doing very well in the stock market. The stock price for those companies is often affected more by the size of their revenue than by the size of their net income or loss. That is why it is extremely important to ensure that revenue is properly stated. The SAB gives an example of a company that operates an Internet site from which it sells products of another company. Customers place their orders for the product by making a product selection directly from the Internet site and providing a credit card number for the payment. The company operating the Internet site receives the order and authorization from the credit card company, and passes the order on to the company whose product it sells so that it can ship the product directly to the customer. The company operating the Internet site does not take title to the product and has no risk of loss or other responsibility for the product. The company whose product is sold is responsible for all product returns, defects, and disputed credit card charges. In the event a credit card transaction is rejected, the company operating the Internet site loses only its margin on the sale. In this situation, it is the SEC staff's view that the company operating the Internet site should report the revenue from the product on a net basis.

In assessing whether revenue should be reported gross with separate display of cost of sales to arrive at gross profit or on a net basis, the staff considers whether the registrant—

1. Acts as principal in the transaction.
2. Takes title to the products.
3. Has risks and rewards of ownership, such as the risk of loss for collection, delivery, or returns.
4. Acts as an agent or broker (including performing services, in substance, as an agent or broker) with compensation on a commission or fee basis.

If the company performs as an agent or broker without assuming the risks and rewards of ownership of the goods, sales should be reported on a net basis.

EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent,* provides additional guidance in determining whether to recognize revenue on gross or net basis. It lists the following factors that should be considered:

Indicators of Gross Revenue Reporting—

- The company is the primary obligor in the arrangement

- The company has general inventory risk (before customer order is placed or upon customer return).
- The company has latitude in establishing price.
- The company adds meaningful value to the product or service.
- The company has discretion in supplier selection.
- The company is involved in the determination of product or service specifications.
- The company has physical loss inventory risk (after customer order or during shipping).
- The company has credit risk.

Indicators of Net Revenue Reporting—

- The supplier (not the company) is the primary obligor in the arrangement.
- The amount the company earns is fixed.
- The supplier (and not the company) has credit risk.

Accounting for Sales of Leased or Licensed Departments

It is a common practice among retailers to lease or license departments within their store to a third party. According to SAB No. 101, department stores and other retailers customarily include the sales of leased or licensed departments in the amount reported as "total revenues." In November 1975 the SEC staff issued SAB No. 1, which addressed this issue. In that bulletin the staff did not object to retailers presenting sales of leased or licensed departments in the amount reported as "total revenues" because of industry practice. Subsequently, in November 1976 the FASB issued FASB Statement No. 13. In June 1995, the AICPA staff amended its *Technical Practice Aid* (TPA) section 5100.16, *Rental Revenue Based on Percentage of Sales*, based on an interpretation of FASB Statement No. 13 that leases of departments within a retail establishment are leases of tangible assets within the scope of FASB Statement No. 13. Consistent with the interpretation in TPA section 5100.16, the staff believes that FASB Statement No. 13 requires department stores and other retailers that lease or license store space to account for rental income from leased departments in accordance with FASB Statement No. 13. Accordingly, it would be inappropriate for a department store or other retailer to include in its revenue the sales of the leased or licensed departments. Rather, the department store or other retailer should include the rental income as part of its gross revenue. The SAB indicated that the staff would not object to disclosure in the footnotes to the financial statements of the amount of the lessee's sales from leased departments. If the arrangement is not a lease but rather a service arrangement that provides for payment of a fee or commission, the retailer should recognize the fee or commission as revenue when earned. If the retailer assumes the risk of bad debts associated with the lessee's merchandise sales, the retailer generally should present bad debt expense in accordance with Regulation S-X article 5-03 (b)(5).

Conclusion

As auditor of an SEC registrant, you should ensure that management has properly applied the accounting and disclosure requirements described in SAB No. 1. The SEC staff will not object if registrants that have not applied this accounting in the past do not restate prior financial statements, provided they report a change in accounting principle in accordance with APB Opinion 20, *Accounting Changes*. However, registrants that have not previously complied with generally accepted accounting principles should apply the guidance in APB Opinion 20 for the correction of an error.

Auditors might find helpful guidance recently issued by SEC staff on implementation of SAB No. 101. This guidance, in the form of a Frequently Asked Questions document, is available on the SEC's Web site at www.sec.gov/offices/account/sab101fq.htm.

Additional Issues Related to Revenue Recognition

You should also be aware of EITF Issue No. 00-10, *Accounting for Shipping and Handling Fees and Costs*, and EITF Issue No. 00-14, *Accounting for Certain Sales Incentives*, which address certain aspects of revenue recognition. EITF Issue No. 00-10 discusses income statement classification of shipping and handling costs. The EITF reached a consensus that all amounts billed to a customer in a sale transaction related to shipping and handling, if any, represent revenues earned for the goods provided and should be classified as revenue. With respect to shipping and handling costs, EITF reached a consensus stating that it is an accounting policy decision that should be disclosed pursuant to APB Opinion 22. A company may adopt a policy of including shipping and handling costs in cost of sales. However, if shipping or handling costs are significant and are not included in cost of sales, a company should disclose both the amount(s) of such costs and the line item(s) on the income statement that include them.

EITF Issue No. 00-14 addresses the recognition, measurement, and income statement classification for sales incentives offered voluntarily by a vendor without charge to customers that can be used in, or that are exercisable by a customer as a result of, a single exchange transaction. The EITF reached consensus on the following issues:

1. For sales incentives that will not result in a loss on the sale of a product or service, a vendor should recognize the "cost" of the sales incentive at the latter of the following:
   a. The date at which the related revenue is recorded by the vendor
   b. The date at which the sales incentive is offered
2. For sales incentives that will result in a loss on the sale of a product or service, a vendor should not recognize a liability for the sales incentive prior to the date at which the related revenue is recognized by the vendor. However, the EITF observed that the offer of a sales incentive that will result in a loss on the sale of a product may indicate an impairment of existing inventory under ARB 43.
3. If the sales incentive is a reduction in or refund of the selling price of the product or service, then its cost should be classified as a reduction of revenue. If the sales incentive is a free product or service delivered at the time of sale, the cost of the free product or service should be classified as an expense.

There are numerous issues on EITF's agenda dealing with revenue recognition. Auditors should be aware of final consensuses reached to ensure that, where applicable, their clients have properly applied these standards.

> **Help Desk**—This section presents only a summary of items from SAB No. 101 that are most likely to affect retail entities. Readers of this Alert are strongly encouraged to refer to the full text of SAB No. 101, which can be viewed at the SEC Web site www.sec.gov/rules/acctreps/sab101.htm.

Executive Summary—Revenue Recognition in Financial Statements

- SAB No. 101 lists four critical criteria needed for revenue recognition.
- The SAB states that revenue from layaway sales should be recognized only on delivery of the merchandise to the customer.
- The SAB addresses the issue of refundable membership fees by stating that the revenue from those fees should not be recognized in earnings prior to the refund privileges expiring. However, if certain criteria are met, different treatment might be acceptable.
- The SAB discusses issues related to income statement presentation of revenue. It lists factors that should be considered when deciding if revenue should be recognized on a gross or net basis. Additional guidance on this topic is provided in EITF Issue No. 99-19.
- The SAB states that it is inappropriate for a retailer to include in its revenue the sales from the leased or licensed department. Rather, the retailer should include rental income as part of its gross revenue.
- Additional revenue recognition issues are addressed by EITF Issue Nos. 00-10 and 00-14.

Store Closings and Asset Impairments

What accounting issues arise with respect to store closings?

Closing particular stores is often a normal part of a retailer's operations. A number of issues need to be considered.

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. 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 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. Assets covered by APB Opinion 30 will continue to be reported at the lower of the carrying amount or the net realizable value. In November 1999, the SEC staff released SAB No. 100, *Restructuring and Impairment Charges*, which, among other things, discusses the impairment of fixed assets and goodwill.

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 SEC clients, SAB No. 100. This has been an area of concern by SEC staff. Auditors of SEC registrants should, therefore, pay particular attention to the accrual of estimated liabilities, the criteria necessary to accrue for the costs of the exit plan, and the disclosures that should be provided. In particular, the reasons for such accruals, and the incurrence of the costs 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 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 the 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 circumstances that are likely to occur. If so, the exit plan may not be sufficiently detailed and thus not meet the criteria for accrual of related costs under EITF Issue 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 reliability of estimated costs, level of identification and aggregation of costs, and 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 in the "Management's Discussion and Analysis" section.

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, has been followed regarding the classification as a component of costs 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.*

New FASB Pronouncements

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

In this section we present brief summaries of accounting pronouncements issued since the publication of last year's Alert. The summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standard. For information on accounting standards issued subsequently to the writing of this Alert, please refer to the Web sites provided throughout this section. You may also look for announcements of newly issued standards in the *CPA Letter* and the *Journal of Accountancy*.

FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, an amendment of FASB Statement No. 133

FASB Statement No. 138 addresses a limited number of issues causing implementation difficulties for numerous entities that apply FASB Statement No. 133. This Statement amends the accounting and reporting standards of FASB Statement No. 133 for certain derivative instruments and certain hedging activities as indicated in the following paragraphs.

1. The normal purchases and normal sales exception in paragraph 10(b) may be applied to contracts that implicitly or explicitly permit net settlement, as discussed in paragraphs 9(a) and 57(c)(1), and contracts that have a market mechanism to facilitate net settlement, as discussed in paragraphs 9(b) and 57(c)(2).

2. The specific risks that can be identified as the hedged risk are redefined so that in a hedge of interest rate risk, the risk of changes in the benchmark interest rate (*benchmark interest rate* is defined in paragraph 4(jj) of FASB Statement No. 138) would be the hedged risk.

3. Recognized foreign-currency-denominated assets and liabilities for which a foreign currency transaction gain or loss is recognized in earnings under the provisions of paragraph 15 of FASB Statement No. 52, *Foreign Currency Translation*, may be the hedged item in fair value hedges or cash flow hedges.

4. Certain intercompany derivatives may be designated as the hedging instruments in cash flow hedges of foreign currency risk in the consolidated financial statements if those intercompany derivatives are offset by unrelated third-party contracts on a net basis.

FASB Statement No. 138 also amends FASB Statement No. 133 for decisions made by the FASB relating to the Derivatives Implementation Group (DIG) process. Certain decisions arising from the DIG process that required specific amendments to FASB Statement No. 133 are incorporated into FASB Statement No. 138.

FASB Statement No. 139, *Recission of FASB Statement No. 53 and Amendments to FASB Statements No. 63, 89, and 121*

FASB Statement No. 139 rescinds FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films.* An entity that previously was subject to the requirements of Statement 53 shall follow the guidance in AICPA SOP 00-2, *Accounting by Producers or Distributors of Films.* This Statement also amends FASB Statement Nos. 63, *Financial Reporting by Broadcasters,* 89, *Financial Reporting and Changing Prices,* and 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.*

Statement No. 139 is effective for financial statements for fiscal years beginning after December 15, 2000. Earlier application is permitted only upon early adoption of the SOP.

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* a replacement of FASB Statement No. 125

Issued in September 2000, FASB Statement No. 140 replaces FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* It revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures, but it carries over most of FASB Statement No. 125's provisions without reconsideration.

The Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. Those standards are based on consistent application of a *financial-components approach* that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. FASB Statement No. 140 provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

1. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
2. Each transferee (or, if the transferee is a qualifying special-purpose entity (SPE), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.
3. The transferor does not maintain effective control over the transferred assets through either (a) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (b) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.

The Statement requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interests in the transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

The Statement requires that servicing assets and liabilities be subsequently measured by (a) amortization in proportion to and over the period of estimated net servicing income or loss and (b) assessment for asset impairment or increased obligation based on their fair values.

The Statement requires that a liability be derecognized if and only if either (a) the debtor pays the creditor and is relieved of its obligation for the liability or (b) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

The Statement provides implementation guidance for assessing isolation of transferred assets; conditions that constrain a transferee; conditions for an entity to be a qualifying SPE; accounting for transfers of partial interests; measurement of retained interests; servicing of financial assets; securitizations, transfers of sales-type and direct financing lease receivables; securities lending transactions; repurchase agreements, including "dollar rolls," "wash sales," loan syndications, and participations; risk participations in banker's acceptances; factoring arrangements; transfers of receivables with recourse; and extinguishments of liabilities. The Statement also provides guidance about whether a transferor has retained effective control over assets transferred to qualifying SPEs through removal-of-accounts provisions, liquidation provisions, or other arrangements.

The Statement requires a debtor to (a) reclassify financial assets pledged as collateral and report those assets in its statement of financial position separately from other assets not so encumbered if the secured party has the right by contract or custom to sell or repledge the collateral and (b) disclose assets pledged as collateral that have not been reclassified and separately reported in the statement of financial position. The Statement also requires a secured party to disclose information about collateral that it has accepted and is permitted by contract or custom to sell or repledge. The required disclosure includes the fair value at the end of the period of that collateral, and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral.

The Statement requires an entity that has securitized financial assets to disclose information about accounting policies, volume, cash flows, key assumptions made in determining fair values of retained interests, and sensitivity of those fair values to changes in key assumptions. It also requires that entities that securitize assets disclose for the securitized assets and any other financial assets it manages together with them (a) the total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period; (b) delinquencies at the end of the period; and (c) credit losses during the period.

In addition to replacing FASB Statement No. 125 and rescinding FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*, FASB Statement No. 140 carries forward the actions taken by FASB Statement No. 125. FASB Statement No. 125 superseded FASB Statement Nos. 76, *Extinguishment of Debt*, and 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. FASB Statement No. 125 amended FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to clarify that a debt security may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. FASB Statement No. 125 amended and extended to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, and superseded FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*. FASB Statement No. 125 also superseded FASB Technical Bulletins Nos. 84-4, *In-Substance Defeasance of Debt*, and 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*, and amended FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights.*

FASB Statement No. 125 was effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996, and on or before March 31, 2001, except for certain provisions. FASB Statement No. 127 deferred until December 31, 1997, the effective date (a) of paragraph 15 of FASB Statement No. 125 and (b) for repurchase agreement, dollar-roll, securities lending, and similar transactions, of paragraphs 9 through 12 and 237(b) of FASB Statement No. 125.

FASB Statement No. 140 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. The Statement is effective for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral for fiscal years ending after December 15, 2000. Disclosures about securitization and collateral accepted need not be reported for periods ending on or before December 15, 2000, for which financial statements are presented for comparative purposes.

The Statement is to be applied prospectively with certain exceptions. Other than those exceptions, earlier or retroactive application of its accounting provisions is not permitted.

FASB Interpretation 44, *Accounting for Certain Transactions Involving Stock Compensation*, an interpretation of APB Opinion No. 25[5]

APB Opinion 25, *Accounting for Stock Issued to Employees*, was issued in October 1972. Since its issuance, questions have been raised about its application and diversity in practice has developed. During its consideration of the accounting for stock-based compensation, which led to the issuance of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, the FASB decided not to address practice issues related to APB Opinion 25 because it had planned to supersede the Opinion. However, FASB Statement No. 123 permits entities to continue applying APB Opinion 25 to stock compensation involving employees. Consequently, questions remain about the application of APB Opinion 25 in a number of different circumstances.

Interpretation No. 44 clarifies the application of APB Opinion 25 for only certain issues. It does not address any issues related to the

5. Certain implementation issues regarding FASB Interpretation No. 44, as well as certain issues regarding the application of APB Opinion 25 that are not addressed by Interpretation No. 44, are being addressed by the EITF in Issue No. 00-23.

application of the fair value method in FASB Statement No. 123. The issues addressed herein were selected after receiving input from members of both the FASB EITF and the task force on stock compensation that assisted in the development of FASB Statement No. 123. Among other issues, Interpretation No. 44 clarifies (a) the definition of employee for purposes of applying APB Opinion 25, (b) the criteria for determining whether a plan qualifies as a noncompensatory plan, (c) the accounting consequence of various modifications to the terms of a previously fixed stock option or award, and (d) the accounting for an exchange of stock compensation awards in a business combination.

In considering those issues, the FASB focused on interpreting APB Opinion 25. The FASB decided not to amend the APB Opinion 25 framework because most of the problems inherent in the APB Opinion 25 intrinsic value method are addressed in Statement 123 through that Statement's recommended fair value method. Consequently, in determining the guidance in this Interpretation, the FASB reached its conclusions within the framework of APB Opinion 25 and did not refer to concepts underlying the fair value method described in FASB Statement No. 123.

Interpretation No. 44 is effective July 1, 2000, but certain conclusions in the Interpretation cover specific events that occur after either December 15, 1998, or January 12, 2000. To the extent that the Interpretation covers events occurring during the period after December 15, 1998, or January 12, 2000, but before the effective date of July 1, 2000, the effects of applying the Interpretation are recognized on a prospective basis from July 1, 2000.

EITF Consensus Positions

The status of issues considered recently by the EITF of the FASB can be found in *Audit Risk Alert—2000/01.*

New SOPs

A complete listing of all SOPs issued this year by the AICPA can be found in *Audit Risk Alert—2000/2001.*

Executive Summary—New FASB Pronouncements

- FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, an amendment of FASB Statement No. 133
- FASB Statement No. 139, *Recission of FASB Statement No. 53 and amendments to FASB Statements No. 63, 89, and 121*
- FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, a replacement of FASB Statement No. 125
- FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*—an interpretation of APB Opinion No. 25
- The status of issues considered recently by EITF of the FASB can be found in *Audit Risk Alert—2000/01* or on the FASB Web site
- A list of new SOPs can be found in *Audit Risk Alert—2000/01*

New Auditing and Attestation Pronouncements

What new auditing and attestation pronouncements have been issued this year?

In this section we present brief summaries of auditing pronouncements issued since the publication of last year's Alert. The summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standard. For information on auditing pronouncements 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*.

Auditing Standards

SAS No. 88, *Service Organizations and Reporting on Consistency*

In December 1999, the AICPA Auditing Standards Board (ASB) issued SAS No. 88, *Service Organizations and Reporting on Consistency* (AICPA, *Professional Standards*, vol. 1, AU secs. 324 and 420). Part

1, "Service Organizations," amends SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU secs. 324.03 and 324.06–.10), to—

1. Clarify the applicability of SAS No. 70 by stating that the SAS is applicable if an entity obtains services from another organization that are part of the entity's information system. It also provides guidance on the types of services that would be considered part of an entity's information system.
2. Revise and clarify the factors a user auditor should consider in determining the significance of a service organization's controls to a user organization's controls.
3. Clarify the guidance on determining whether information about a service organization's controls is necessary to plan the audit.
4. Clarify that information about a service organization's controls may be obtained from a variety of sources.
5. Change the title of SAS No. 70 from *Reports on the Processing of Transactions by Service Organizations* to *Service Organizations.*

Part 2, "Reporting on Consistency," amends SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 420, "Consistency of Application of Generally Accepted Accounting Principles"), to—

1. Conform the list of changes that constitute a change in the reporting entity (AU sec. 420.07) to the guidance in paragraph 12 of APB Opinion 20, *Accounting Changes.*
2. Clarify that the auditor need not add a consistency explanatory paragraph to the auditor's report when a change in the reporting entity results from a transaction or event.
3. Eliminate the requirement for a consistency explanatory paragraph in the auditor's report if a pooling of interests is not accounted for retroactively in comparative financial statements.
4. Eliminate the requirement to qualify the auditor's report and consider adding a consistency explanatory paragraph to the

report if single-year financial statements that report a pooling of interests do not disclose combined information for the prior year.

All of the amendments contained in SAS No. 88 were effective upon issuance.

SAS No. 89, *Audit Adjustments*

In December 1999, the ASB issued SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU secs. 310, 333, and 380), which amends three SASs to establish audit requirements designed to encourage client management to record financial statement adjustments aggregated by the auditor. It also clarifies management's responsibility for the disposition of financial statement misstatements brought to its attention. SAS No. 89 amends SAS No. 83, *Establishing an Understanding With the Client*; SAS No. 85, *Management Representations*; and SAS No. 61, *Communication With Audit Committees*, as follows:

1. SAS No. 83 is amended to include, in the understanding with the client, management's responsibility for determining the appropriate disposition of financial statement misstatements aggregated by the auditor. Specifically, SAS No. 89 adds the following to the list of matters that generally are included in the understanding with the client:

    > Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

2. SAS No. 85 is amended to require that the management representation letter include an acknowledgment by management that the effects of any uncorrected financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the ag-

gregate, to the financial statements taken as a whole. It also requires that a summary of the uncorrected misstatements be included in or attached to the representation letter.

3. SAS No. 61 is amended to require the auditor to inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, whose effects management believes are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

These amendments are effective for audits of financial statements for periods beginning on or after December 15, 1999, with early adoption permitted.

SAS No. 90, *Audit Committee Communications*

SAS No. 90, *Audit Committee Communications* (AICPA, *Professional Standards*, vol. 1, AU secs. 380 and 722), issued by the ASB in December 1999, amends SAS No. 61 and SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722). SAS No. 90 was issued in response to recommendation numbers 8 and 10 of the report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which suggest changes to GAAS.

Among other things, the amendment to SAS No. 61 requires an auditor to discuss with the audit committees of SEC clients certain information relating to the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles and underlying estimates in its financial statements. It also encourages a three-way discussion among the auditor, management, and the audit committee. This amendment is effective for audits of financial statements for periods ending on or after December 15, 2000, with earlier application permitted.

The amendment to SAS No. 71 clarifies that the accountant should communicate to the audit committee or be satisfied, through discussions with the audit committee, that matters described in SAS No. 61 have been communicated to the audit committee by management when they have been identified in the conduct of interim financial reporting. This amendment also requires the accountant of an SEC client to attempt to discuss with the audit committee the matters described in SAS No. 61 prior to the filing of the Form 10-Q. This amendment is effective for reviews of interim financial information for interim periods ending on or after March 15, 2000, with earlier application permitted.

SAS No. 91, *Federal GAAP Hierarchy*

At its October 1999 meeting, the AICPA Council adopted a resolution recognizing the Federal Accounting Standards Advisory Board (FASAB) as the body designated to establish GAAP for federal government entities under Rule 203 of the AICPA's Code of Conduct. Pursuant to that resolution, Statements of Federal Financial Accounting Standards issued by the FASAB since March 1993 are recognized as GAAP for applicable federal governmental entities. At its February 2000 meeting, the ASB voted to issue SAS No. 91, *Federal GAAP Hierarchy* (AICPA, *Professional Standards*, vol. 1, sec. 411), which amends SAS No. 69, *The Meaning* of Present Fairly in Conformity with Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), to recognize FASAB statements as "level A" GAAP and to establish a hierarchy for other FASAB guidance and general accounting literature. SAS N0. 91 became effective upon its issuance in April 2000.

SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

In September 2000 the ASB issued SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities.* SAS No. 92 will help auditors plan and perform auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities. SAS No. 92 will supersede SAS No. 81, Auditing Investments. The guidance in the SAS applies to—

- Derivative instruments, as that term is defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

- Hedging activities in which the entity designates a derivative or a nonderivative financial instrument as a hedge of exposure for which FASB Statement No. 133 permits hedge accounting.
- Debt and equity securities, as those terms are defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.*

SAS No. 92 is effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Early application of the SAS is permitted. The ASB also has developed a companion audit Guide to help practitioners implement the new SAS. See the "Auditing Derivatives" section of this Alert for a more detailed discussion of the new SAS and companion Guide.

SAS No. 93, *Omnibus Statement on Auditing Standards—2000*

Issued by the ASB in October 2000, SAS No. 93—

1. Withdraws SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622). The guidance in SAS No. 75 will be incorporated in Statement on Standards for Attestation Engagements (SSAE) No. 4, *Agreed-Upon Procedures Agreements* (AICPA, *Professional Standards*, vol. 1, AT sec. 600) to consolidate the guidance on agreed-upon procedures engagements in professional standards. The withdrawal of SAS No. 75 is concurrent with the effective date of SSAE No. 10, *Attestation Standards: Revision and Recodification*, scheduled to be issued in January 2001. SSAE No. 10 will be effective for agreed-upon procedures engagements for which the subject matter or assertion is as of or for a period ending on or after June 1, 2001, with earlier application permitted.
2. Amends SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), to include an identification in the auditor's report of the country of origin of the accounting principles used to prepare the financial statements and the auditing standards that

the auditor followed in performing the audit. This amendment withdraws Auditing Interpretation No. 13, "Reference to Country of Origin in the Auditor's Standard Report," of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.53-.55). This amendment is effective for reports issued or reissued on or after June 30, 2001. Earlier application is permitted.

3. Amends SAS No. 84, *Communications Between Predecessor and Successor Auditors*, to clarify the definition of a predecessor auditor. This amendment is effective for audits of financial statements for periods ending on or after June 30, 2001. Earlier application is permitted.

Auditing Interpretations

Auditing Interpretations are issued by the Audit Issues Task Force of the ASB to provide timely guidance on the application of auditing pronouncements. Interpretations are reviewed by the ASB. An Interpretation is not as authoritative as a pronouncement of the ASB, but members should be aware that they may have to justify a departure from an interpretation if the quality of their work is questioned. The following Auditing Interpretations have been issued since our last Alert:

1. Interpretation No. 3, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls," of SAS No. 70 (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.19–.31)

2. Interpretation No. 13, "Reference to Country of Origin in the Auditor's Standard Report," of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.53–55)[6]

3. Interpretation No. 7, "Management's and Auditor's Responsibilities With Regard to Related Party Disclosures Prefaced

6. Withdrawn by SAS No. 93. See the New Auditing and Attestation Pronouncements section of this Alert for further information.

by Terminology Such As Management Believes That," of SAS No. 45, *Related Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 9334.22–.23)

4. Interpretation "The Meaning of the Term *Misstatement*" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.01-.04)

5. Interpretation "Evaluating Differences in Estimates" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.05-.09)

6. Interpretation "Quantitative Measures of Materiality in Evaluating Audit Findings" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.10-.14)

7. Interpretation "Considering the Qualitative Characteristics of Misstatements" of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.15-.17)

Help Desk—The full text of these Interpretations can be obtained at the AICPA Web site at www.aicpa.org/members/div/auditstd/announce/index.htm.

New Attestation Standard

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

The ASB expects to issue SSAE No. 10, *Attestation Standards: Revision and Recodification* in January 2001. SSAE No. 10 does the following:

- Changes the title of AT section 101 to *Attest Engagements*
- Changes the definition of an attest engagement into a statement of applicability of the standard, as follows:

> This statement applies to engagements in which a certified public accountant in the practice of public accounting (hereinafter referred to as a *practitioner*) is engaged to

issue or does issue an examination, a review or an agreed-upon procedures report on subject matter, or an assertion about the subject matter, that is the responsibility of another party.

- Revises the third general standard to focus on the essential elements of criteria: the criteria must be suitable and must be available to users. The subject matter also must be capable of reasonably consistent evaluation against the criteria.
- Enables true direct reporting on subject matter by eliminating the requirement to make reference to the assertion in the practitioner's report.
- Provides expanded guidance on the circumstances in which the use of attest reports should be restricted to specified parties.
- Supersedes SSAE Nos. 1 through 9.

The new standard also revises and renumbers the AT sections as follows:

	New AT section	*Existing AT section*
Attest Engagements	101	100
Agreed-Upon Procedures Engagements	201	600
Financial Forecasts and Projections	301	200
Reporting on Pro Forma Financial Information	401	300
Reporting on an Entity's Internal Control Over Financial Reporting	501	400
Compliance Attestation	601	500
Management's Discussion and Analysis	701	700

The new SSAE also eliminates the requirement in AT section 201, Agreed-Upon Procedures Engagements, for the practitioner to obtain a written assertion in an agreed-upon procedures attest engagement. It also incorporates changes needed as a result of the withdrawal of SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement.* That withdrawal is reflected in SAS No. 93, *Omnibus Statement on Auditing Standards—2000.*

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

Help Desk—Look for a new AICPA Practice Aid on how to understand and apply the provisions of SSAE No. 10. It is expected to become available during the first quarter of 2001.

New SOPs

A complete listing of all SOPs issued this year by the AICPA can be found in *Audit Risk Alert—2000/2001.*

Executive Summary—New Auditing and Attestation Pronouncements

- SAS No. 88, *Service Organizations and Reporting on Consistency,* issued in December 1999 and was effective upon issuance.
- SAS No. 89, *Audit Adjustments, issued in December 1999* and is effective for audits of financial statements for periods beginning on or after December 15, 1999, with earlier adoption permitted.
- SAS No. 90, *Audit Committee Communications,* issued in December 1999. The amendment to SAS No. 61 is effective for audits of financial statements for periods ending on or after December 15, 2000, with earlier application permitted. The amendment to SAS No. 71 is effective for reviews of interim financial information for interim periods ending on or after March 15, 2000, with earlier application permitted.
- SAS No. 91, *Federal GAAP Hierarchy,* issued in April 2000, this amendment to SAS No. 69, was effective upon issuance.
- SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities,* was issued in September 2000 and is effective for audits of financial statements for fiscal years ending on or after June 30, 2001.
- SAS No. 93, *Omnibus Statement on Auditing Standards—2000,* was issued in October 2000.
- New Auditing Interpretations were issued this year.
- SSAE No. 10, *Attestation Standards: Revision and Recodification,* is expected to be issued in January 2001.
- A list of new SOPs can be found in *Audit Risk Alert—2000/2001.*

On the Horizon

What exposure drafts are currently outstanding?

Practitioners should note that the purpose of exposure drafts is to solicit comments from preparers, auditors, users of financial statements, and other interested parties. They are nonauthoritative and cannot be used as a basis for changing GAAS or GAAP. The following is a listing of some of the more significant exposure drafts outstanding at the time this Alert was written. Please note that AICPA standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA's Web site.

ASB Exposure Draft

Issued in October 2000, the proposed SAS amends SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319) to provide guidance to auditors about the effect of information technology (IT) on internal control, and on the auditor's understanding of internal control and assessment of control risk. The ASB believes the guidance is needed because entities of all sizes increasingly are using IT in ways that affect their internal control and the auditor's consideration of internal control in a financial statement audit. Consequently, in some circumstances, auditors may need to perform tests of controls to perform effective audits.

This proposed SAS amends SAS No. 55, as amended by SAS No. 78, to—

1. Incorporate and expand on the concept from SAS No. 80, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU sec. 326.14), that in circumstances where a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, and reported, the auditor may determine that it is

not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk.

2. Describe how IT may affect internal control, evidential matter, and the auditor's understanding of internal control and assessment of control risk.

3. Describe both benefits and risks of IT to internal control, and how IT affects the components of internal control, particularly the control activities and information and communication components.

4. Provide guidance to help auditors determine whether specialized skills are needed to consider the effect of computer processing on the audit, to understand the controls, or to design and perform audit procedures.

5. Clarify that in obtaining an understanding of the entity's financial reporting process, the auditor should understand how both standard, recurring entries and nonstandard, nonrecurring entries are initiated and recorded, and the auditor should also understand the controls that have been placed in operation to ensure that such entries are authorized, complete, and correctly recorded.

6. Update terminology and references to IT systems and controls.

The proposed SAS does not—

1. Eliminate the alternative of assessing control risk at the maximum level and performing a substantive audit, if that is an effective approach.

2. Change the requirement to perform substantive tests for significant account balances and transaction classes.

Help Desk—See the ASB Exposure Drafts Web site at www.aicpa.org/members/div/auditstd/drafts.htm for information on the status of these and other exposure drafts issued by the ASB. Note that 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 email 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.

AcSEC Exposure Drafts

- Proposed Statement of Position—*Accounting for Discounts Related to Credit Quality* (The final SOP is expected to be titled "Accounting for Certain Purchased Loans.") December 30, 1998
- Proposed Statement of *Position—Amendment to Scope of Statement of Position 95-2,* Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools; August 15, 2000*
- Proposed Statement of Position—*Accounting by Certain Financial Institutions and Entities That Lend to or Finance the Activities of Others*; May 30, 2000
- Proposed Statement of Position—*Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*; April 3, 2000
- Proposed Statement of Position—*Accounting for and Reporting of Certain Health and Welfare Benefit Plan Transactions*; March 22, 2000

Help Desk—See the AcSEC Exposure Drafts Web site at www.aicpa.org/members/div/acctstd/edo/index.htm for information on the status of these and other exposure drafts issued by AcSEC.

Professional Ethics Executive Committee Exposure Draft

On April 15, 2000, the Professional Ethics Division issued an exposure draft, *Omnibus Proposal of Professional Ethics Division Interpretations and Rulings*, containing proposed revisions to four ethics pronouncements:

1. Interpretation No. 101-11, "Independence and the Performance of Professional Services Under the Statements on Standards for Attestation Engagements and Statement on Auditing Standards No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*" of ET section 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101.13).
2. Ruling 100 under rule 101: *Actions Permitted When Independence Is Impaired*
3. Ruling 108 under rule 101: *Participation of Member, Spouse or Dependent in Retirement, Savings, or Similar Plan Sponsored by, or That Invest in, Client*[7]
4. Interpretation No. 501-5, "*Failure to Follow Requirements of Government Bodies, Commissions, or Other Regulatory Agencies in Performing Attest or Similar Services,*" of ET section 501 (AICPA, *Professional Standards*, vol. 2, ET sec. 501.06)[8]

Help Desk—See the AICPA Professional Ethics section of the AICPA Web site, www.aicpa.org/members/div/ethics/index.htm for information on the status of these and other exposure drafts, along with other ethics-related matters.

FASB Statement Exposure Drafts

- Proposed Statement of Financial Accounting Standards—*Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities*; July 12, 2000

7. Adopted in October 2000. See the "AICPA Professional Ethics Rulings and Interpretations" subsection of this Alert.

8. See footnote 7.

- Proposed Statement of Financial Accounting Standards—*Accounting for Obligations Associated with the Retirement of Long-Lived Assets; February 17, 2000*
- Proposed Statement of Financial Accounting Standards—*Business Combinations and Intangible Assets*; September 7, 1999
- Proposed Statement of Financial Accounting Standards—*Consolidated Financial Statements: Purpose and Policy*; February 23, 1999

Help Desk—See the FASB Web site www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html for information on the status of these and other exposure drafts issued by the FASB.

Beyond the Audit

WebTrust℠

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

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

WebTrust℠ is an electronic commerce assurance service. It was developed jointly by the AICPA and the Canadian Institute of Chartered Accountants. The WebTrust℠ Seal, which is placed directly onto the online business' Web site, is issued to those sites that have been shown to be in compliance with the WebTrust℠ Principles and Criteria.[9] Online customers can click on the Seal and gain access to a CPA-issued report about the site. The WebTrust^{SM} Seal can be issued only by CPAs certified to conduct WebTrust^{SM} engagements. That certification is obtained by completing specialized training and entering into a licensing arrangement with the AICPA. The training, certification, and licensing process that CPAs undergo, along with a mandatory WebTrust^{SM} quality review program, ensure the consistent application of the WebTrust^{SM} Principles and Criteria.

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

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

The CPA's focus on internal control in financial statement audits also provides a competitive advantage because most non-CPA competitors lack the CPA's knowledge and experience of internal control and assessment techniques. The competencies required

9. Further information on the WebTrust^{SM} Principles and Criteria can be found in the Assurance Services Alert *WebTrust^{SM}—2000* (Product No. 022249kk).

for control assessment relative to historical financial statements are very similar to those required for assurance services. There is a natural extension of these into electronic commerce assurance services such as WebTrust℠.

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

A new competency model for WebTrust℠ practitioners is currently being developed by the AICPA's Electronic Commerce Task Force. This model—which will define core competencies and proficiencies and tie the competencies as defined to a training curriculum, activities, tools, research, and information—as well as other information regarding the WebTrust℠ service are discussed further in the Assurance Services Alert *WebTrust℠—2000* (Product No. 022249kk). The AICPA has also published CPA WebTrust Practitioners Guide (Product No. 006604kk), a nonauthoritative guide to assist practitioners in performing WebTrust℠ services. It includes guidance on all of the steps a practitioner takes in carrying out the WebTrust℠ engagement, from the marketing stage all the way through to the ninety-day examination updates.

SysTrust℠

What is SysTrust℠?

The AICPA and the CICA have introduced a new professional service to provide assurance on the reliability of systems. SysTrust℠ is an assurance service developed by the Assurance Services Executive Committee (ASEC) of the AICPA and the Assurance Services Development Board (ASDB) of the CICA to be provided by public accountants. It is designed to increase the comfort of management, customers, and business partners with the systems that support a business or a particular activity. Potential users of this service are shareholders, creditors, bankers, business partners, third-party users who outsource functions to other entities, stakeholders, and anyone who in some way relies on the continued availability, integrity, security, and maintainability of a system. The SysTrust service will help differentiate entities from their competitors because entities that undergo the rigors of a SysTrust engagement will presumably be better service providers— attuned to the risks posed by their environment and equipped with the controls that address those risks.

The SysTrust service entails the public accountant providing an assurance service in which he or she evaluates and tests whether a system is reliable when measured against four essential reliability principles. A reliable system is one that is capable of operating without material error, fault, or failure during a specified period in a specified environment. The following four principles are used to evaluate whether a system is reliable:

1. *Availability*—The system is available for operation and use at times set forth in service-level statements or agreements.

2. *Security*—The system is protected against unauthorized physical and logical access.

3. *Integrity*—System processing is complete, accurate, timely, and authorized.

4. *Maintainability*—The system can be updated, when required, in a manner that continues to provide for system availability, security, and integrity.

For each of the four principles, criteria have been established against which a system can be evaluated. The SysTrust criteria are designed to be complete, relevant, objective, and measurable and to address all of the system components (infrastructure, software, people, procedures, and data) and their relationship among them. All of the SysTrust criteria must be satisfied for a system to be deemed reliable. In determining whether a deviation from a specified criterion is material to that criterion, due consideration should be given to the anticipated users of the information and the types of decisions they are expected to make based on the information provided by the system.

The objective of a systems reliability engagement is for the practitioner to issue an attestation/assurance report on whether management maintained effective controls over its system to enable the system to function reliably. The system is evaluated against the SysTrust principles and criteria. The practitioner determines whether controls over the system exist and performs tests to determine whether those controls were operating effectively during the period covered by the attestation/assurance report. Management must provide the practitioner with an assertion regarding the availability, security, integrity, and maintainability of the system.

The practitioner may report on either of the following:

1. Management's assertion that it maintained effective controls over the reliability of the system during the period covered by the report

2. The subject matter—that is, the effectiveness of the controls over the reliability of the system during the period covered by the report

If one or more criteria have not been achieved, the practitioner can issue a qualified or adverse report. However, when issuing a qualified or adverse report the practitioner should report directly on the subject matter rather than on the assertion. Since the concept of system reliability is dynamic rather than static, SysTrust reports will always cover a historical period of time as opposed to a point in time. Although the determination of an appropriate period should be at the discretion of the practitioner and the reporting entity, reporting periods of less than three months generally would not be deemed meaningful. SysTrust is discussed further in the Assurance Services Alert *CPA SysTrust—2000* (Product No. 022253kk).

Help Desk—For more information about this new assurance service, and the availability of additional guidance, contact Erin Mackler, AICPA technical manager, Assurance Services, at (212) 596-6149 or emackler@aicpa.org.

Independence and Other Ethics Standards

What new independence and ethics standards have been issued?

In this section we present brief summaries of independence and other ethics standards issued since the publication of last year's Alert. The summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standard. For information on standards issued subsequent to the writing of this Alert, please refer to the Web sites provided throughout this section. You may also look for announcements of newly issued standards in the *CPA Letter* and the *Journal of Accountancy*.

New ISB Standards

The Independence Standards Board (ISB) was established in May 1997 as part of an agreement between the AICPA and the SEC. Its charge is to establish, maintain, and improve independence standards for external auditors of SEC registrants. Although the SEC retains its statutory authority to define independence, it recognizes the responsibility of the ISB in establishing independence standards and interpretations for auditors of public entities. The SEC also considers principles, standards, interpretations, and practices issued by the ISB as having substantial authoritative support. Note that the pronouncements of the ISB apply to auditors of publicly held entities only. The functioning of the ISB does not affect the authority of state licensing or disciplinary authorities regarding auditor independence. Also, it does not affect the AICPA's rules on independence as they relate to auditors of nonpublic entities.

Following is a summary of the independence standards issued by the ISB since our last Alert.

ISB Standard No. 2, *Certain Independence Implications of Audits of Mutual Funds and Related Entities*

This standard relates to audit of mutual fund and therefore is not related to the retail industry. If you would like to see the summary of this standard, refer to *Audit Risk Alert 2000/2001*.

ISB Standard No. 3, *Employment with Audit Clients*

Issued in July 2000, this standard describes safeguards that firms should implement when their professionals join firm audit clients. These safeguards are designed to assist in ensuring that—

1. Professionals who are broadly evaluating their career options will exercise an appropriate level of skepticism while performing audits prior to their departure from the firm.
2. A former firm professional now employed by the client cannot circumvent the audit because of familiarity with its design, approach, or testing strategy.
3. The remaining members of the audit team maintain objectivity when evaluating the work and representations of a former firm professional now employed by the audit client.

The procedures should be adapted depending on several factors, including whether the professional served as a member of the audit team, the positions he or she held at the firm and has accepted at the client, the length of time that has elapsed since the professional left the firm, and the circumstances of his or her departure. The standard also specifies the circumstances under which capital and retirement balances owed to the departing professional should be liquidated or settled to preserve the firm's independence. The standard's requirements are effective for employment with audit client situations arising after December 31, 2000.

The following Interpretations were issued by the ISB during 2000:

1. ISB Interpretation 00-1, *ISB No. 1 and Secondary Auditors*
2. ISB Interpretation 00-2, *An Amendment of Interpretation 00-1*

Help Desk—The full text of these standards and Interpretations, along with information about other ISB publications and exposure drafts, are posted on the ISB's Web site at www.cpaindependence.org/pubs_db.php3.

AICPA Professional Ethics Rulings and Interpretations

Ethics Interpretations and rulings are promulgated by the executive committee of the professional ethics division of the AICPA to provide Guidelines on the scope and application of ethics rules but are not intended to limit such scope or application. Publication of an Interpretation or ethics ruling in the *Journal of Accountancy* constitutes notice to members. Once published, pronouncements become effective on the last day of the month in which they appear in the *Journal of Accountancy*, except as may otherwise be stated in the pronouncements. A member who departs from Interpretations or rulings shall have the burden of justifying such departure in any disciplinary hearing. The full text of the interpretations and rules presented here can be found in their entirety in the *Journal of Accountancy*. The month of their publication is provided for reference.

The Professional Ethics Executive Committee has adopted revisions to two interpretations under the Code of Professional Conduct: Interpretation No. 101-3, "Performance of Other Services," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05), and Interpretation No. 501-1, "Retention of Client Records," of ET section 501, *Acts Discreditable* (AICPA, *Professional Standards*, vol. 2, ET section 501.02). The committee has adopted a new ethics ruling under the Code of Professional Conduct, Ruling No. 111, "Employee Benefit Plan Sponsored by Client" of ET section 101 (AICPA, *Professional Standards*, ET sec. 101.05). (April 2000, *Journal of Accountancy*)

The committee has made editorial revisions to Interpretation No. 101-9, "The Meaning of Certain Independence Terminology and the Effect of Family Relationships on Independence," of ET section 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101.11). "Member or Member's Firm" has been revised. The remainder of the interpretation is unchanged except for a renumber of footnotes following the added material. (May 2000, *Journal of Accountancy*)

The committee has made editorial revisions to the paragraph preceding the interpretations under rule 101 of the Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.01). (July 2000, *Journal of Accountancy*)

The committee has revised the following ruling and interpretation under the Code of Professional Conduct:

- Ruling No. 108 under Rule of Conduct 101, Participation of Member, Spouse or Dependent in Retirement, Savings, or Similar Plan Sponsored by, or That Invests in, Client. (October 2000, *Journal of Accountancy*)
- Interpretation 501-5, "Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies." of ET section 501. (October 2000, *Journal of Accountancy*)

Help Desk—For more information about the interpretations and rulings discussed above, visit the Professional Ethics Team Web page at www.aicpa.org/members/div/ethics/index.htm. You can also call the Professional Ethics Team at (888) 777-7077, menu option 3, followed by menu option 2.

Resource Central

On the Book Shelf

What other AICPA publications may be of value to my practice?

This section discusses AICPA publications that may be of interest to auditors of retail organizations.

General Audit Guides

- *Consideration of Internal Control in a Financial Statement Audit 1997*—(Product No. 012451kk)
- NEW GUIDE—expected publication date January 2001! *Auditing Derivative Instruments, Hedging Activities and Investments in Securities—Practical Guidance for Applying SAS No. 92*—(Product No. 012520kk)

Audit Risk Alerts

- *The ABCs of Independence*—(Product No. 022271kk) A must-read basic primer on the fundamentals of independence. Whether you're unfamiliar with the standards or need a user-friendly refresher course, this Alert is for you.

- *SEC Alert*—(Product No. 011172kk) Developed in conjunction with SEC staff, this Alert provides valuable insights into the staff perspectives on numerous accounting and auditing issues. The Alert also includes updates on recent SEC activities.

- *E-Business*—(Product No. 022273kk) The e-world awaits. Are you ready? Find out what's happening in the realm of E-business and how it will affect your audits in this new Alert.

Audit and Accounting Manual

The *Audit and Accounting Manual* (Product No. 007258kk) 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; sample opinions; checklists; and sample engagement, management representation, and confirmation letters.

AICPA Practice Aid Series

The publications that constitute the AICPA Practice Aid Series have been designed to address a broad range of topics that affect today's CPA. From enhancing the efficiency of your practice to developing the new skill sets required for a successful transition to meet the challenges of the new millennium, this series provides practical guidance and information to assist in making sense out of a changing and complex business environment. The series includes the following:

- *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883kk)

- NEW! *CPA WebTrust℠ Practitioners Guide* (Product No. 006604kk)

Assurance Services Alerts

The newly introduced Assurance Services Alerts series provides practitioners with information about the emerging practice areas. These Alerts provide both an introduction to those who are unfamiliar with assurance services and an update of important new developments for those who have expanded their practice to include these assurance services. Auditors of retail entities considering expanding the scope of their services might find the following publications helpful:

- *WebTrust*[SM]*—2000* (Product No. 022249kk)
- *CPA SysTrust*[SM]*—2000* (Product No. 022253kk)

Financial Statement Preparation Manual/Disclosure Checklists

This manual (Product No. G01027kk) is a loose-leaf service consisting of nineteen industry-specific disclosure checklists and includes sample financial statements. It is updated annually to reflect the issuance of new authoritative guidance. Most of the checklists are also available in individual paperback versions.

Accounting Trends and Techniques—2000

This publication (Product No. 009892kk) offers highlights of the latest trends in corporate financial statements, presented for practitioners in industry and public practice. The publication, which is based on a survey of over six hundred public companies, illustrates accounting practices and trends, including presentations and disclosures.

Auditing Practice Releases

Auditing Practice Releases provide auditors of financial statements with practical guidance on specific subject areas. These nonauthoritative publications help auditors understand complex issues encountered and suggest procedures to accomplish audit objectives.

- *Audit Implications of Electronic Data Interchange* (Product No. 021060kk)
- *The Information Technology Age: Evidential Matter in the Electronic Environment* (Product No. 021068kk)
- *Confirmation of Accounts Receivable* (Product No. 021064kk)
- *Audit Implications of Electronic Document Management* (Product No. 021066kk)
- *Service Organizations: Applying SAS No. 70* (Product No. 021056kk)

- *Analytical Procedures* (Product No. 021069kk)
- *Auditing in Common Computer Environments* (Product No. 021059kk)
- *Auditing With Computers* (Product No. 021057kk)
- *Consideration of the Internal Control Structure in a Computer Environment: A Case Study* (Product No. 021055kk)
- *Audits of Inventories* (Product No. 021045kk)
- *Audit Sampling* (Product No. 021061kk)

AICPA—At Your Service

How can I order AICPA products? What other AICPA services may be of interest to me?

Order Department (Member Satisfaction)

To order AICPA products, call (888) 777-7077; write AICPA Order Department, CLA10, P.O. Box 2209, Jersey City, NJ 07303-2209; fax (800) 362-5066. For best results, call Monday through Friday between 8:30 a.m. and 7:30 p.m. EST. You can obtain product information and place online orders at the AICPA's Web site, www.aicpa.org.

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 Site

The AICPA has a home page on the Web. AICPA Online (www.aicpa.org) offers CPAs the unique opportunity to stay abreast of developments in accounting and auditing, including exposure drafts. The Web site includes *In Our Opinion,* the newsletter of the AICPA Audit and Attest Standards Team. The newsletter provides valuable and timely information on technical activities and developments in auditing and attestation standard setting.

New! Online CPE Offer!

The AICPA has launched a new 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.

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This Audit Risk Alert replaces *Retail Industry Developments—1999/2000.*

Practitioners should also be aware of the economic, regulatory, and professional developments described in *Audit Risk Alert—2000/2001* (Product No. 022260kk) and *Compilation and Review Alert—2000/2001* (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 ymishkevich@aicpa.org or write to—

Yelena Mishkevich, CPA
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

Or email to Gdietz@aicpa.org

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, Internal Revenue Service information, software downloads, university research materials, currency exchange rates, stock prices, annual reports, and legislative and regulatory initiatives. Not only are such materials accessible from the computer, but they are available at any time, and are generally free of charge.

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

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

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

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

Name of Site	*Content*	*Internet Address*
American Institute of CPAs	Summaries of recent auditing and other professional standards as well as other AICPA activities	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.electronic accountant.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 (e.g., 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