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Manufacturing industry developments - 2006/07; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Manufacturing Industry Developments—2006/07

Strengthening Audit Integrity
Safeguarding Financial Reporting

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Notice to Readers

This Audit Risk Alert, prepared by the AICPA staff, is intended to help you identify the significant business risks that may result in the material misstatements of your manufacturing client's financial statements with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements you perform.

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

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

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How This Alert Helps You

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

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

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2006/07* (product no. 022336kk). You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this Alert.

When referring to the professional standards, this alert cites the applicable sections of the codification and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54 is referred to as AU section 317.

Economic and Industry Developments

AU section 311A, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), among other matters, provides guidance for auditors regarding the specific procedures that should be considered in planning an audit in accordance with generally accepted auditing standards (GAAS). AU section 311A states that the auditor should obtain knowledge of matters that relate to the nature of the entity's business, organization, and operating characteristics, and consider matters affecting the industry in which the entity operates, including economic conditions as they relate to the specific audit.

Current Manufacturing Economic and Industry Developments

The U.S. Manufacturing Environment

There are many competing and conflicting factors affecting the United States economy. The consensus is that the economy is still growing but not as quickly. That's good news for the Federal Reserve Board, which has increased the federal fund rate 75 basis points during the year to stabilize inflation and cool the economy. The U.S. Department of Commerce reported continued but smaller increases in real gross domestic product through third quarter of 2006.

The Institute for Supply Management (ISM) cites data that shows October 2006 as the 41st consecutive month of growth in the manufacturing sector of the economy. At current levels, the National Association of Manufacturers' (NAM) president, John Engler, says, "U.S. manufacturing output has never been higher. Overall, manufacturing continues to grow but at a slower pace and with some level of decline in sectors related to the motor vehicle and home construction industries."

According to a study conducted by Duke University, small business owners are concerned by slowing sales and rising labor and energy costs. As a result, many companies will be delaying capital spending and hiring plans. The NAM reported that labor, energy, and other structural costs are as much as 30 percent higher in the United States than those of foreign manufacturers, which serves to further squeeze profit margins.

With a midterm election in 2006 many consumer-impact items have shown some price softening. Gas prices have declined by 25 percent this year, mortgage interest rates edged back to March 2006 levels, and price forecasts for heating fuels such as natural gas and propane are down from last winter. These trends should increase consumer and business confidence during the fourth quarter and boost spending by year end.

Manufacturers face a variety of issues in this business environment. Some examples would include the shortage of skilled labor and the widening opportunities to outsource production design and processing. This in turn may give rise to concerns with supply chain security. New environmental regulations and enforcement efforts with regard to business practices may affect manufacturing throughout the world.

The Labor Pool and Why It Is Drying Up

There is a drought coming. Over the next 10 years, the baby boomer generation will begin to receive their Social Security checks, cash in their 401k accounts, and roll over their lump sum pension distributions. Who is going to fill those empty workstations? Educational institutions in the United States have not been turning out enough engineers, information technology specialists, chemists, or machinists to offset these vacancies. According to the Bureau of Labor Statistics, the unemployment rate has remained essentially flat at 4.7 percent in August 2006, compared to 4.9 percent in the previous year. Of those who were unemployed, 22 percent were not actively seeking employment. There is a small pool of qualified applicants for skilled jobs and a general low level of unemployment with demand ready to skyrocket. Recruiting costs can be expected to increase along with wage and benefits expenses as competition drives the market rate for these applicants up. Recently there has been an increase in skilled labor outside the United States, which has allowed manufacturers to combat the rising domestic labor costs by outsourcing to nations with developing economies.

The shrinking labor pool is also accompanied by an increase in the cost of providing employee benefits. According to a study released earlier this year by the U.S. Government Accountability Office (GAO), employee benefits costs have increased 18 percent while wages are up 10 percent from 1991 to 2005. The disparity in the increase between wages and benefits developed between 2002 and 2005. Prior to that time the growth rate was uniform. Since 2002, wages have shown no appreciable growth as a result of increased benefit costs.

For the purpose of the GAO study, employee benefits expense contained three components; health insurance cost, paid leave, and retirement income. Paid leave has historically been the largest piece of the benefit dollar, but in 2005, health care costs were on par with it. This equality is a result of a 28 percent increase in health care costs versus a 5 percent increase in paid leave costs during the period of the study. Health insurance cost increases were greatest for medium-sized companies, at 45 percent, while large companies saw increased costs of 34 percent and small company costs remained flat.

With global pricing competition causing shrinking profit margins, manufacturers have trended toward passing the cost of benefit increases through to employees in the forms of higher employee contributions to health insurance premiums, higher co-pay and deductible policies, and the shift from defined benefit pensions to defined contribution plans such as 401k or Simple IRA plans. For manufacturing clients with pension and postretirement benefits the Financial Accounting Standards Board (FASB) has recently issued Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R).*

Outsourcing to the Global Marketplace

The outsourcing of U.S. manufacturing production is picking up pace. The availability of skilled and unskilled labor at a discount in China, Thailand, India, Viet Nam, and Mexico is very attractive to U.S. manufacturers under pressure to reduce costs. While the desire to reduce labor and product cost is universal, the final destination varies according to the needs or requirements of the manufacturer. Each of the recent slate of assembly countries has its own skill set and advantages for the U.S. manufacturer.

China has the inexpensive labor to draw assembly business away from the United States and even other Asian countries. Now China is turning to creating competing products in the high tech, automotive, and value-added arenas based on the lessons learned. During 2006, China ousted the United States as the world's largest exporter. However, China does not have as much experience with U.S. quality and delivery standards, and the legal protection of a manufacturer's intellectual property is still a deep concern.

Thailand has been in the marketplace for decades. Its manufacturers are more familiar with U.S. quality expectations and have a legal system that addresses product counterfeiting laws. As is to be expected with any nation that is developing an economic base, wages have risen, making Thailand less of a bargain to U.S. manufacturers.

India has a cheap workforce and is comparable in size to that of China. India has taken a different tack with its economic development in that it is more focused on internal growth than imported jobs. The amount of paperwork required by foreign companies to operate in India could be described as daunting. India has a healthy workforce number. Most are primarily employed in the service sector, and most of the remainder, employed in the manufacturing sector, are employees of India-based companies.

Viet Nam is relatively new to this market and has wage rates similar to those in China. Similarly there is a lack of experience with U.S. manufacturers and a low level of legal protection for intellectual property. It may be possible that your client is the first foreign customer that a manufacturer has ever dealt with, which may lead to quality and U.S. import issues for your client.

Mexico has drawn the interest of a different type of manufacturer. U.S. companies are beginning to rely more heavily on our southern neighbor in two areas: large product manufacturing and design engineering. The advantage to manufacturers of large items such as autos and appliances is proximity. Products can be easily transported by truck or train, and production line visits are less cumbersome for U.S. personnel. An increasingly well-trained pool of engineers has allowed companies to outsource design work and more complex production processes as well. This makes Mexico more attractive for high tech manufacturers. While still less expensive than the United States, Mexican wages are being pushed up by an increasing standard of living, as in Thailand. Mexico has positioned itself well with the focus on skilled labor to maintain an advantage.

In general, the outsourcing trend continues as countries all over the world market the natural and human resources they have. Gaining an understanding of the risks and pitfalls of international commerce is as important as reaping the benefits.

Intellectual Property

In the United States, manufacturers expect intellectual property rights (IPR) to be honored. For generations U.S. courts have enforced product and process patent rights, copyrights, and trademarks. The same may not be true with global trading partners. According to Congressman Donald Manzullo, 70 percent of all counterfeit goods are produced in China. Idea theft has been going on for centuries, only the products and processes have changed. The most counterfeited products in recent years have been music CDs and movie DVDs. Manzullo stated that there has been a growing market in bogus auto and aircraft parts, pharmaceuticals, and software.

There are several types of theft, such as:

- An unauthorized sale of the genuine product.
- An unauthorized but functional copy of the product.
- An inferior copy of the product with the manufacturer's name or trademark affixed.

Within the last category are the possibilities of harm to the public either through the use of harmless but ineffective components or through the use of ingredients that may actually cause harm.

The concept of individual property is a fairly new one in China. Until recently, property, including IPR, belonged to the government. There are laws in place to protect IPR but they go largely unenforced, with the exception of domestically developed intellectual property.

In the past, the same could be said for India. However, India has begun to realize that to become a modern nation with cutting edge, globally competitive products, you must have innovation. There will be little interest in investing time or money in innovation to have ideas stolen and then be driven out of the market by your own product. It is the national interest of every developed nation to respect and enforce IPR laws. Hopefully, China will eventually realize its own stake in enforcing the laws it agreed to when it joined the World Trade Organization. You may want to discuss with your clients the possibility of stolen IPR and their plans to address the issue.

In the report produced by the National Intellectual Property Law Enforcement Coordination Council (NIPLECC), several government agencies in the commerce/trade and law enforcement areas outline actions to combat the theft of U.S. intellectual property. These measures include a Web site, www.stopfakes.gov, where companies can access information on protecting themselves when dealing with non-U.S. partners, with a special focus on China. The Department of Homeland Security and the Customs and Border Protection agency are working to intercept fake and counterfeit goods at the borders. Seizures of these goods have doubled since 2001.

Supply Chain Security

A recent report indicated that 73 percent of U.S. companies with greater than $1 billion in sales had a disruption primarily related to raw materials, natural disasters, or supply chain partners in the past five years, and 36 percent of those surveyed took more than a month to recover. How is your client going to handle supply chain disruptions? Over the past few years there have been events that have brought production to a halt. It happened after 9/11, it happened after Hurricane Katrina, and it could happen again. With just-in-time production (JIT), inventory levels have dropped to record low amounts as manufacturers streamline processes to reduce holding costs. Under normal operating conditions this system is beneficial, but what happens when there are no airlines operating for seven days, or an entire region of the country is under water, or 40 percent of the workforce is affected by pandemic flu? Planning for the worst case scenario could prevent your client from becoming one of the 40 percent of small businesses that do not reopen after a major disaster, according to the American Red Cross. Companies should be prepared for risks such as fire, natural disasters such as hurricanes, pandemic illness, communications failure, civil disturbance, terrorist action, or hazardous materials incidents.

A good plan may include:

- Maintaining a contact list of employees, suppliers, and customers.
- Establishing an emergency information number for employees.
- Storing a current back-up of computer data in a secure location off-site.
- A review of insurance coverage to establish appropriate coverage and address events that are excluded from coverage.

The plan should be reviewed and updated periodically.

Planning for major disasters will also address more localized or industry-specific disruptions, such as increases in fuel prices and raw materials, skilled labor shortages, changes in the competitive landscape, or the loss of a key supplier or customer. Use of multiple suppliers in a variety of geographic areas, identifying alternative raw materials, diversifying the customer base, and vertical integration of the supply chain are all solutions implemented by manufacturers.

Further information on disaster recovery plans can be obtained at www.fema.gov, www.redcross.org, and www.sba.gov and from most insurance carriers.

Regulatory and Legislative Issues

Pension Protection Act of 2006

On August 17, 2006, President Bush signed the Pension Protection Act. In addition to expanding and improving defined contribution plans such as IRAs and 401(k) plans, the purpose of the Act is to strengthen the federal pension insurance program. The provisions in the Act are effective for fiscal years beginning after December 31, 2007. The major provisions of this legislation that may affect manufacturers with pension plans are:

- Increased premiums and contributions required for under-funded plans and companies that terminate their plans.
- Requirements for accurate measurement and reporting of benefit obligation liabilities.
- A prohibition on promising additional benefits to employees until they are funded.
- Closure of loopholes that permitted companies to defer contributions to under-funded plans.

Included in the Act were several trade provision changes, such as the suspension or modification of tariffs on certain categories of imported goods and modification of specific trade agreements and regulations. For technical explanations of the provisions of the Pension Protection Act, see www.house.gov/jct/x-38-06.pdf.

National Ambient Air Quality Standards

The Environmental Protection Agency implemented new air quality standards that will require a nearly 50 percent reduction in particulate matter (PM) emissions. The National Ambient Air

Quality Standards (NAAQS) announced on September 21, 2006, address fine and coarse particle pollution. Research has linked significant health issues ranging from respiratory problems to heart and lung disease to this type of pollution. These standards must be met by 2015. If your manufacturer has emission concerns, it may need to consider these standards in the future. For more information on NAAQS see www.epa.gov/pm/naaqsrev2006.html.

Foreign Corrupt Practices Act

The past two years have been active for the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC), which are the primary enforcement organizations for the Foreign Corrupt Practices Act (FCPA). Since 2004, the DOJ and SEC reached settlements totaling $64 million for improper payments made to foreign officials. The largest penalty ever assessed was recently imposed as a result of improper payments and an insufficient corporate FCPA compliance policy. Ethics are on the front burner for American companies at least in part because they are on the front page of America's newspapers. Stepped-up FCPA enforcement efforts by DOJ and SEC can result in crippling fines and forfeiture of profits for those who violate the Act.

The FCPA was passed in 1977 in response to SEC investigations that determined that millions of dollars were being paid to foreign officials, politicians, and political parties. The purpose of this legislation is to help maintain the integrity of the American business system. The FCPA is written to acknowledge the fact that business practices and customs vary throughout the world. It is important to be aware of the provisions of this legislation in the age of the global economy.

The FCPA prohibits the payment, offer, or promise of payment to induce the recipient to influence any act or decision of a foreign official in his or her official capacity, to violate his or her lawful duty, or induce a foreign official to exercise his or her influence in an improper manner. The prohibition extends to payments or offers made through third parties and the business sought does not need to be with a foreign governmental entity.

Payments that are made to facilitate or expedite performance of a “routine governmental action” may be allowed. Examples provided by the U.S. DOJ include obtaining permits or licenses; processing visas; providing police protection, mail service, phone service, or utility service; and inspections associated with transit of goods.

Each violation of the FCPA can result in fines for corporations of up to $2 million and fines up to $100,000 and five years imprisonment for officers, directors, stockholders, employees, and other agents of the corporation. In certain circumstances, the Racketeer Influenced and Corrupt Organizations Act provisions may apply as well. For more information about the FCPA or to utilize the DOJ’s Foreign Corrupt Practices Act Opinion Procedure to predetermine compliance with the law see www.usdoj.gov.

An Update on European Hazardous Waste Regulations

Last year’s Alert discussed the Waste Electrical and Electronic Equipment (WEEE) and Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (RoHS) directives of the European Commission. The goals of these directives are the prevention of WEEE and to require environmentally friendly recovery and disposal of WEEE. The provisions of WEEE and RoHS are minimum standards required to be adopted by European Union (EU) members. Each member may impose more restrictive measures if it chooses. Fines and penalties for noncompliance will be established by individual nations. Regulations have been implemented in some nations with effective dates in 2006. Additional guidance in the form of questions and answers has been issued by the European Commission in an effort to clarify the application of these rules at http://ec.europa.eu/environment/waste/weee_index.htm. You may need to contact EU members to determine specific requirements for each nation.

Many manufacturers may find it difficult to comply with RoHS requirements. The directive provides for the removal of lead, mercury, cadmium, hexavalent chromium, polybrominated biphenyl, and polybrominated dipheyl ether from their electronic products and file the appropriate compliance documents with the EU or face having their products stopped at the border. You may consider inquiring of your client if any of its products contain the regulated compounds. Compliance records include certification of all raw materials and component parts and must be maintained for four years from the time the product is first sold. If the EU is a large part of your client's market, the use of a specialist to verify compliance may be in order. See AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1).

Energy Efficiency Action Plan

The European Commission has provided an overview of a plan to reduce energy consumption by EU members by 20 percent by 2020. During the next two years, the commission will be setting standards for minimum energy performance for appliances, equipment, buildings, and energy services. Some of the manufactured items that are specifically included in the plan are autos, refrigerators, water heaters, computers, televisions, heating and air conditioning systems, lighting, and washing machines. To be sold in the EU, these items will require special labeling that indicates that they meet the prescribed energy standards that are anticipated to be applied in 2009. The commission expects the plan to be fully implemented within six years. For more information see http://ec.europa.eu/index_en.htm.

U.S. Bureau of Customs and Border Protection

Since September 11, 2001, the U.S. Bureau of Customs and Border Protection (CBP) has played an increasing role in policing imports to the United States. To ease the daily burden on an organization that processes nearly 70 thousand truck, rail, and sea containers each day, CBP implemented a voluntary program to improve supply chain security. The Customs-Trade Partnership Against Terrorism (C-TPAT) and its subsidiary Free and Secure Trade (FAST) program include annual corporate self-assessments of supply chain security procedures in relation to C-TPAT criteria, including all outsourced elements such as foreign facilities or warehousing. Once these criteria are met and validated by CBP, there are substantial benefits for participants, including a reduced number of inspections, Front of the Line processing for inspections, and assignment of a CBP Supply Chain Security Specialist to assist with the process. For more information on these or other CBP programs or requirements, see www.cbp.gov.

Transportation Worker Identification Credential Program

Two Department of Homeland Security divisions are implementing a program that is part of the 2002 Maritime Transportation Security Act. The Transportation Worker Identification Credential (TWIC) program will require 850,000 port workers to prove legal citizenship and pass a background check to obtain an ID card. According to the Transportation Security Administration, the affected workers include 110,000 truck drivers and may include a substantial number of illegal immigrants. An article in the *Wall Street Journal* put the number between 20 percent and 50 percent of the truck drivers. The program is expected to begin by the end of 2006. There is a potential for major impact on the nation's goods flow from and to seaports. For more information, see www.tsa.gov.

Audit and Accounting Issues Arising From Current Risks

Related Party Transactions

The existence of related party transactions has always presented a concern for the auditor. There is a current trend toward vertical integration of the supply chain, as discussed in the "Supply Chain Security" section of this Alert, which may affect your manufacturing clients. The client often fails to understand the question fully when asked about the existence of related parties. The definition, according to FASB Statement No. 57, *Related Party Disclosures*, is as follows:

> Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts

> for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

One way that the existence of related parties can be established is through inquiry of management during the planning process. It is often helpful to provide the client with examples to help understand your query. Transactions that frequently occur between related parties could include:

- Borrowing or lending money at no or low interest
- Real estate transactions for amounts significantly different from appraised value
- Nonmonetary like-kind exchanges
- Loans made without repayment terms
- Related vendors or customers
- Use of company or personal property with or without payment
- Guarantees of indebtedness
- Other noncash activity with a related party

Once known, the auditor can evaluate the company's policies and procedures for identifying, recording, and disclosing related activity.

It is important to be alert for evidence of nondisclosed related parties throughout the audit. Some useful sources in a search for related parties are board of directors meeting minutes, conflict-of-interests disclosure forms, large unusual or nonrecurring accounting entries, legal invoices, bank confirmations, and vendors or customers that account for a large percentage of activity.

The fact that there are dealings with related parties does not indicate that they are not valid business transactions. Identifying such items is merely the first step. Material transactions may be tested to ensure that they are reasonable, have an appropriate business purpose and, where possible, were reviewed and approved by disinterested parties at the appropriate level. Documentation of the items should include names and relationships of the parties involved, amounts, and a description of the transactions for possible disclosure in the financial statements. Be sure to refer to FASB Statement No. 57 for complete disclosure criteria and requirements.

Management Override of Controls

As described in AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), the design, implementation, and monitoring of internal control are the responsibility of the entity's management. One of the most difficult types of fraud to detect is management override of internal control. Auditors often spend a good deal of time considering, documenting, and testing a client's controls. Within minutes, a supervisor in the accounts payable department can bypass one or more controls and establish a bogus vendor without a trace. The clerk that "just went ahead" and entered the vendor without the prerequisite background check is on the supervisor's bowling team and was just "helping him out." Now the groundwork has been laid for payments on fictitious invoices that will either fund the supervisor's retirement or allow him to spend it in state prison. The likelihood is that the clerk won't think twice about helping out a friend (the supervisor) because he doesn't realize the implications of overriding controls such as obtaining a credit report or references for potential vendors. He may not even understand why the controls exist in the first place.

How do you find out if it's likely that overrides are occurring? AU section 316A, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), has several things for you to think about:

- Brainstorming. Adopt the mindset of the potential fraudster. For example, if you were the accounts payable supervisor, how could you steal from the client? What if you were the accounts receivable supervisor, the purchasing manager, or even the CFO? Who has access to the accounting records? Use the required brainstorming session to get inside the organization's controls and look for holes and potential conflicts-of-interest. Which categories of accounts are most likely to have misstatements and which of those are lacking the controls to expose them in the normal course of business?
- Inquiring. Try to ask questions of the people that no one thinks to ask. You may be introduced to the department manager but also ask to interview one or two of the frontline employees. The people with their hands in the mix might just have the best vantage point. Be careful in the way you phase your questions and try to put the employee at ease. The least you will get is a better understanding that the controls are working as designed.
- Flowcharting. Consider the use of flowcharts to record the flow of documents and the approval/review process. A flowchart is a good way to visually identify control system overlaps and gaps. Microsoft Excel can be a valuable tool in this arena.

Once you have identified the potential problems, tailor your audit program to address those areas in your testing. In addition, AU section 316.57A provides guidance on procedures to address management override of controls. If you suspect management override of controls, you should document your findings and review them with the appropriate level of management.

You should also refer to AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), which addresses additional responsibilities of the auditor with regard to internal control issues discussed in the "Evaluating Control Deficiencies" section, which follows.

The AICPA Auditing Standards Board (ASB) has issued Statements on Auditing Standards (SASs) No. 104 through No. 111, referred to as the Risk Assessment Standards. A discussion of these standards and how they affect your audit can be found in the "Recent Auditing and Attestation Pronouncements and Related Guidance" section of this Alert.

Evaluating Control Deficiencies

In May 2006, the ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended. The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006.

The standard requires that auditors (1) evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses and (2) communicate, in writing, significant deficiencies and material weaknesses to management and those charged with governance. This communication includes significant deficiencies and material weaknesses identified and communicated to management and those charged with governance in prior audits but not yet remediated.

Some examples of potential control deficiencies that you might find in manufacturing companies are:

- Lack of segregation of duties in the cash management function due to a small number of administrative staff and without effective compensating controls
- Management override of controls by owners of privately held companies or by project managers in the invoice approval process
- Inadequate monitoring of the financial accounting process to detect deficiencies in internal control by management
- Inadequate controls that would prevent improper revenue recognition through recording change orders that have not been approved
- Ineffective perpetual inventory controls that do not detect a material misstatement of inventory
- Inadequate controls due to a lack of client expertise in preparing financial statements including the process for identification, consolidation, and disclosure of VIEs

The AICPA has published the Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in the implementation of this Standard.

Compliance With Laws and Regulations

While it is not a requirement under generally accepted audit standards to design procedures to detect illegal acts by clients, exercising professional skepticism and due diligence may bring issues to light. AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), discusses the responsibilities of the auditor when encountering questionable activity. Audit procedures that may highlight concerns could be reading of meeting minutes, obtaining a legal representation letter from the client's attorney, and substantive testing of transactions. As a step in understanding the client, AU section 317.08 recommends inquiry of management regarding the client's policies for the prevention of illegal acts to gain insight into the client's compliance with laws and regulations. Some examples provided of items that may warrant additional testing include:

- Unauthorized transactions, improperly recorded transactions, or transactions not recorded in a complete or timely manner in order to maintain accountability for assets
- Investigation by a governmental agency, an enforcement proceeding, or payment of unusual fines or penalties
- Large payments for unspecified services to consultants, affiliates, or employees
- Unusually large payments in cash, purchases of bank cashiers' checks in large amounts payable to bearer, transfers to numbered bank accounts, or similar transactions

It is important to consider the impact that illegal acts would have on your audit engagement and your client's financial statements. It may be necessary to take one or more of the following steps:

- Consider whether management needs to record or disclose a contingent liability (FASB Statement No. 5, *Accounting for Contingencies*)
- Consider the impact on the entity as a whole, including its ability to continue as a going concern (AU sec. 341A, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, AICPA, *Professional Standards*, vol. 1)
- Communicate with audit firm owners and legal counsel
- Communicate with the client's legal counsel
- Communicate with an appropriate level of management, the audit committee, or others of similar authority
- Express a qualified or adverse opinion (AU sec. 508, *Reports on Audited Financial Statements*, AICPA, *Professional Standards*, vol. 1)

- Withdraw from the engagement
- Document findings and steps taken to resolve the issues

Contingencies

FASB Statement No. 5 defines a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability." The purpose of gaining an understanding of contingencies is to properly reflect the financial position of an entity at the end of the reporting period.

The difficulty in recording or disclosing contingent events relates to the heavy reliance on estimates. When determining that a contingency should be accrued, the statement requires that as of the date of the financial statements, "it is probable that an asset has been impaired or a liability had been incurred." Further determinations are required regarding the reasonableness of the amount to be accrued and whether the loss will be substantiated by future events. The term *probable* is defined as "the future event or events are likely to occur." Events occurring subsequent to the financial statement date can provide a valuable resource in your search for contingent items. It is clear that a thorough reading of FASB Statement No. 5 is required to properly apply the rules. Appropriate documentation should be kept with regard to potential contingency accruals and disclosures.

Examples of items that may require accrual or disclosure are:

- Pending or threatened litigation, claims, or assessments, including those related to counterfeit products
- Defense of intellectual property rights
- Threat of expropriation of assets
- Environmental remediation
- Self-insurance

- Tax assessments
- Product warranties
- Guarantees of indebtedness

Sample disclosures for these events can be obtained in AICPA *Accounting Trends and Techniques*, 60th Edition (product no. 009898kk).

Items that are generally not accrued and may not require disclosure could include:

- Gain contingencies
- General business risks
- Appropriated retained earnings

The goal of accruing or disclosing contingencies is to provide users with financial statements that are not misleading.

Recent Auditing and Attestation Pronouncements and Related Guidance

Presented below is a list of auditing and attestation pronouncements, Guides, and other guidance. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. The PCAOB sets auditing and attestation standards for audits of public companies. See the PCAOB Web site at www.pcaobus.org for information about its activities. You may also look for announcements of newly issued standards in the *CPA Letter, Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org.

SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standard* SSAE No. 13, *Defining Professional Requirements in Statements on Standards for*	These standards established two categories of professional requirements that are identified by specific terms. The words *must* or *is required* are used to indicate an unconditional requirement. The word *should* is used to indicate a presumptively

(continued)

Attestation Engagements (December 2005)	mandatory requirement. (The words *may, might, could,* and *should consider* represent actions that auditors have a professional obligation to consider.) The provisions of SAS No. 102 and Statement on Standards for Attestation Engagements (SSAE) No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements*, were effective upon issuance. The ASB intends to make conforming changes to AICPA literature over the next several years to remove any language that would imply a professional requirement where none exists.
SAS No. 103, *Audit Documentation* (December 2005)	SAS No. 103 supersedes AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), and amends AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards,* vol. 1). Effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted. This SAS establishes standards and provides guidance to an auditor of a nonissuer on audit documentation.
SASs No. 104 through No. 111, Risk Assessment Standards	See the "Spotlight" section in this Alert.
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (May 2006)	The new standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. Effective for periods ending on or after December 15, 2006.
PCAOB Auditing Standard No. 4 (February 2006) (Applicable to audits conducted	*Reporting on Whether a Previously Reported Material Weakness Continues to Exist* This standard applies if auditors report on the elimination of a material weakness in a

in accordance with PCAOB standards only)	company's internal control over financial reporting. The standard establishes a voluntary engagement that would be performed at the election of the company.
PCAOB Conforming Amendment to AT 101.04f, *Attest Engagements* (February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	*Conforming Amendment to PCAOB Related Auditing and Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4* This states that Auditing Standard No. 4 must be used for reporting on whether a material weakness continues to exist for any purpose other than a company's internal use.

Spotlight on the AICPA Risk Assessment Standards

In March 2006, the ASB issued eight SASs that provide extensive guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. The following table lists the eight SASs and their effect on existing standards:

Statement on Auditing Standards	*Effect on Existing Standards*
SAS No. 104, *Amendment to Statement on Auditing Standards No. 1*, Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")*	Amends SAS No. 1, AU section 230, "Due Professional Care in the Performance of Work"
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards	Amends SAS No. 95, *Generally Accepted Auditing Standards* (AU sec. 150A)
SAS No. 106, *Audit Evidence*	Supersedes SAS No. 31, *Evidential Matter* (AU sec. 326A)
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*	Supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU sec. 312A)

(continued)

SAS No. 108, *Planning and Supervision*	Supersedes SAS No. 1, AU section 310, "Appointment of the Independent Auditor"; and supersedes SAS No. 22, *Planning and Supervision* (AU sec. 311A)
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*	Supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU sec. 319)
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*	Supersedes SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* (AU sec. 313); and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU sec. 319)
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling	Amends SAS No. 39, *Audit Sampling* (AU sec. 350A)

Key Provisions of the New Standards

The SASs emphasize the link between understanding the entity, assessing risks, and the design of further audit procedures. The SASs introduce the concept of risk assessment procedures, which are deemed necessary to provide a basis for assessing the risk of material misstatement. Risk assessment procedures, along with further audit procedures, which consist of tests of controls and substantive tests, provide the audit evidence to support the auditor's opinion of the financial statements. According to the SASs, the auditor should perform risk assessment procedures to gather information and gain an understanding of the entity and its environment, including its internal control. These procedures include inquiries, analytical procedures, and inspection and observation. Assessed risks and the basis for those assessments should be documented; therefore, auditors may no longer default to maximum control risk for an entity's risk assessment without documenting the basis for that assessment. The SASs also require auditors to consider and document how the risk assessment at the financial statement level affects individual financial statement assertions, so that auditors may tailor the nature, timing, and extent of their audit procedures to be responsive to their risk assessment. It is anticipated that generic audit programs will not be appropriate for all audit engagements, as risks vary between entities.

Effective Date and Implementation

The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. In some cases, implementation of the SASs may result in an overall increased work effort by the audit team, particularly in the year of implementation. It also is anticipated that to implement the SASs appropriately, some firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. Readers can obtain the SASs and the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessments* (product no. 022526kk) at www.cpa2biz.com.

New Companion Audit Guide

In December 2006, the AICPA published an Audit Guide titled *Assessing and Responding to Audit Risk in a Financial Statement Audit*. This guide will help practitioners understand and implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

SAS No. 103

The ASB has issued SAS No. 103, *Audit Documentation*, which supersedes SAS No. 96 of the same name (AICPA, *Professional Standards*, vol. 1, AU sec. 339) and amends AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1). Effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted. One key provision of this standard is the amendment of AU section 530.01 and 530.05, which requires that "the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion." The footnote to this section describes sufficient appropriate audit evidence as "evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them." Application of the rules may require revising the process used by your firm at the end of fieldwork to include a field review of audit working papers and financial statements. For some firms, an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

Staff Accounting Bulletin No. 108

On September 13, 2006, the SEC released Staff Accounting Bulletin (SAB) No. 108, Topic 1N, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements*. The issuance provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement.

There have been two common approaches used to quantify such errors. Using one approach, the error is quantified as the amount by which the current year income statement is misstated (rollover approach). The other common approach quantifies the error as the cumulative amount by which the current year balance sheet is misstated (iron curtain approach). Exclusive reliance on an income statement approach can result in a registrant accumulating errors on the balance sheet that may not have been material to any individual income statement, but that nonetheless may misstate one or more balance sheet accounts. Similarly, exclusive reliance on a balance sheet approach can result in a registrant disregarding the effects of errors in the current year income statement that result from the correction of an error existing in previously issued financial statements.

The SEC staff believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The SEC staff believes that this can be accomplished by quantifying errors under both a balance sheet and an income statement approach and by evaluating errors measured under each approach. Thus, a registrant's financial statements would require adjustment when either approach results in quantifying a material misstatement after considering all relevant quantitative and qualitative factors.

If, in correcting a prior year error in the current year, the amount is material to the current year's income statement, the prior year financial statements should be corrected, even though such a revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements. However, registrants electing not to restate prior periods should follow the disclosure requirements specified in the SAB. In general, SAB No. 108 is effective for financial statements for fiscal years ending after November 15, 2006, with earlier application encouraged in any report for an interim period of the first fiscal year ending after November 15, 2006, and filed after the SAB's publication date of September 13, 2006. For additional accounting and transition information, see the issuance at www.sec.gov/interps/account/sab108.pdf.

Recent AICPA Independence and Ethics Pronouncements

The AICPA *Independence and Ethics Alert—2006/07* (product no. 022477kk) contains a complete update on new independence and ethics pronouncements. This Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this Alert to be aware of independence and ethics matters that will affect their practice.

The AICPA general *Audit Risk Alert—2006/07* and other AICPA industry-specific Alerts contain summaries of recent pronouncements not included here. To obtain copies of AICPA standards and Guides, contact AICPA Service Center Operations at (888) 777-7077 or go online at www.cpa2biz.com.

Recent Accounting Pronouncements and Related Guidance

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 155	*Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*
FASB Statement No. 156	*Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*
FASB Statement No. 157	*Fair Value Measurements*
FASB Statement No. 158	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Interpretation No. 48	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB EITF Issues (Various dates)	Go to www.fasb.org/eitf/about_eitf.shtml for a complete list of EITF Issues.
FASB Staff Positions (Various dates)	Go to www.fasb.org/fasb_staff_positions/index.shtml for a complete list of FASB Staff Positions (FSP). Some of the recently issued FSPs address issues relating to FASB Statements No. 143 and No. 150, among others; and FASB Interpretation 46(R).
AICPA Technical Practice Aids 2130.09-.35 (December 2005) (Nonauthoritative)	Various topics on the application of Statement of Position (SOP) 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* to debt securities
AICPA Technical Practice Aids 5600.07-.17 (November 2005) (Nonauthoritative)	Various lease topics
AICPA Technical Practice Aid 6910.16-.20 (January 2006) (Nonauthoritative)	"Nonregistered Investment Partnerships"

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to the manufacturing industry or that may result in very significant changes. Read the AICPA general *Audit Risk Alert—2006/07* for a more extensive list of ongoing auditing and accounting projects. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing generally accepted accounting principles (GAAP) or GAAS.

The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org or www. pcaob.com
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm
Securities and Exchange Commission (SEC)	www.sec.gov

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to service@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message. The AICPA Web site also has connecting links to the other standard-setting bodies listed above.

Auditing Pipeline

Proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Over Financial Reporting* (AT section 501)

In January 2006, the ASB issued a revised exposure draft of a proposed SSAE that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE would establish standards and provide guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). Additionally, the new definitions of *significant deficiency* and *material weakness* provided by SAS No. 112 have been incorporated into AT section 501. In May 2006, the PCAOB announced plans to amend certain aspects of PCAOB Auditing Standard No. 2 to improve its implementation. Because the forthcoming changes to the PCAOB Standard will be relevant to the revision of AT section 501, the ASB has decided to defer the issuance of final revised AT section 501 until the PCAOB issues its amendments and the ASB has time to consider them.

Proposed *Amendment to SAS No. 69, The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, *for Nongovernmental Entities*

The ASB has issued an exposure draft introducing a proposed SAS entitled *Amendment to Statement on Auditing Standards No. 69, The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, *for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards entitled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69, AICPA, *Professional Standards*, vol. 1, AU sec. 411) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the FASB proposed statement, which can be obtained at www.fasb.org.

Proposed Statement on Auditing Standards, *The Auditor's Communication With Those Charged With Governance*

This proposed SAS would replace AU section 380, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1), and establish standards and provide guidance to an auditor on matters to be communicated with those charged with governance. Among other matters, the proposed SAS identifies specific matters to be communicated and also would amend AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AIPCA, *Professional Standards*, vol. 1). Readers should be alert for the issuance of a final standard.

Accounting Pipeline

Proposed FASB Statement *The Hierarchy of Generally Accepted Accounting Principles*

This proposed Statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, who is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final Statement.

Proposed FASB Statement *Accounting for Transfers of Financial Assets*

The exposure draft *Accounting for Transfers of Financial Assets* (Transfers Project) is a revision of a June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets*, and would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement seeks to (1) clearly specify the permitted activities of a qualifying special-purpose entity (QSPE), (2) address practice issues related to which arrangements should be considered and how they should be considered in the legal isolation analysis, (3) eliminate the prohibition on a QSPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor, (4) revise the methodology used to initially measure at fair value interests related to transferred financial assets held by a transferor, and (5) clarify guidance related to when rollovers of beneficial interests are permitted within a QSPE. At its July 26, 2006, meeting, the FASB decided to combine the servicer discretion project (which addressed issues relating to the waiver of due-on-sale, collateral substitution, and foreclosed asset activities) into the Transfers Project. The FASB expects to issue a final Statement, which would amend FASB Statement No. 140, in the second quarter of 2007. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement *The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115*

The fair value option project has two phases. This proposal represents Phase 1, which addresses the fair value option for certain financial assets and financial liabilities. Phase 2 will consider permitting the fair value option for certain nonfinancial assets and nonfinancial liabilities and some of the financial assets and financial liabilities excluded from the scope of Phase 1.

The proposed Statement would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur. The proposed Statement has specific financial presentation requirements to display fair values and those values that are measured using other measurement techniques. The proposed Statement would amend FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to require that securities reported at fair value in accordance with FASB Statement No. 115 satisfy the specific financial statement presentation requirements. Visit the FASB Website at www.fasb.org for additional information.

Proposed FASB Statements, *Business Combinations and Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*

In these proposed Statements, the FASB plans to revise the existing guidance on the application of the purchase method. The following are among the main proposals:

1. That all acquisitions of businesses be measured at the fair value of the business acquired.

2. That substantially all the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.

3. That entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

Exposure drafts on business combinations—purchase method procedures and noncontrolling interests—were issued on June 30, 2005. Visit the FASB Web site for further information.

FASB Project on Derivative Disclosures

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, has been criticized by certain analysts, auditors, investors, and others for lacking transparent disclosures, allowing a user of the financial statements to assess the overall risk of derivatives on a reporting entity from both a quantitative and qualitative perspective. An exposure draft on derivative disclosures is expected in the fourth quarter of 2006 or early 2007. The objective is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133. Additionally, the project is expected to reconsider the existing disclosure requirements under FASB Statement No. 133 for relevance and applicability. It is also expected that derivative loan commitments will fall under the scope of this project and could have a significant impact on the financial statements of entities with derivative loan commitments.

Proposed FASB EITF Issues

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

Proposed FASB Staff Positions

A number of proposed FASB Staff Positions are in progress addressing issues related to financial institutions. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

AICPA Resource Central

Educational courses, Web sites, publications, and other resources available to practitioners are listed here.

On the Bookshelf

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

- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012776kk). This Audit Guide is designed to provide guidance to auditors reporting on a service organization's controls. This Guide also provides guidance to auditors of companies that use service organizations. In addition, it has been revised as of May 1, 2006, to reflect certain changes necessary because of the issuance of authoritative pronouncements.
- Audit Guide *Analytical Procedures* (product no. 012556kk). Receive guidance on the effective use of analytical procedures with an emphasis on analytical procedures as substantive tests.
- *Accounting Trends & Techniques*, 60th Edition (product no. 009898kk). This is the must-have resource for any CPA who frequently creates or uses financial reports. Filled with current reporting techniques and methods used by the nation's top organizations, this 650-page AICPA bestseller will provide guidance you need to improve your accounting preparation and procedures.
- Audit Guide, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012526kk). This Guide has been updated with conforming changes as of May 1, 2006. In it you'll find an overview of derivatives and securities, in addition to case studies to help you better understand auditing derivative instruments.

- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012516kk). This publication, as of May 1, 2006, assists auditors in fulfilling their professional responsibilities with regard to auditing assertions about revenue.

- *Audit and Accounting Manual* (product no. 005136kk) is developed exclusively for small- and medium-size CPA practices. This unique manual explains and demonstrates useful techniques and procedures for conducting compilation, review, and audit engagements—from planning to internal control to accountants' reports.

AICPA reSOURCE: Online Accounting and Auditing Literature

AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library—that's available too! Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, Technical Practice Aids, Audit and Accounting Guides (more than 20!), Audit Risk Alerts (more than 15!), and *Accounting Trends & Techniques*. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Educational Courses

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

- *Auditing Inventory* (product no. 738340HSkk). This interactive CD-ROM course will teach you all you need to know to audit inventory effectively and efficiently. The course covers accounting principles, audit risks, performing an inventory observation, and reviewing the inventory amount. All this is taught with interactive exercises and a video inventory observation in which you participate.

- *Information Security: Critical Guidance for CPAs in Public Practice and Industry* (product no. 732451kk). This course informs participants about security for systems developed with new technology and what part the assessment of risk plays in developing controls to secure these systems.

- *SEC Reporting* (product no. 736773kk [text] and 186754kk [video]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance. Learn to apply Regulations S-X, S-K, and other SEC guidance, prepare or review financial statements and their related disclosures, and more. This course benefits financial reporting managers of registrants or companies planning to go public as well as managers and partners in public practice with SEC registrants as clients.

Accountants in the manufacturing industry, as well as in other industries, may also find the following courses helpful:

- *Accounting Update: A Review of Recent Activities* (2006 edition) (product no. 732762kk). This course keeps you current and shows you how to apply the most recent financial accounting and reporting standards. Highlights include FASB Statement No. 154 on accounting changes and error corrections, fair value concepts and measurements, and the revised FASB Statement No. 123 on share-based payment.
- *FASB Review for Industry* (2006-2007 edition) (product no. 730563kk). Comprehensive coverage of recent FASB, AcSEC, IASB, and EITF pronouncements is provided in this course geared to the specific interests of the CPA in corporate management.
- *AICPA's Annual Accounting and Auditing Update Workshop* (2006 edition) (product no. 736182kk, text; also available in video and DVD formats with a manual). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Accounting for Income Taxes: Applying SFAS No. 109/FIN 48: A Whole New Ballgame!* (product no. 732792kk). No

other area in accounting is as far reaching, and requires knowledge of a vast number of topics in financial and tax accounting, as accounting for deferred taxes. This course addresses the application of this complex standard to many common differences between financial accounting and tax compliance. You will gain a sound knowledge of the theory of deferred taxes and how this theory can be applied to practical situations. Many practical examples are included to illustrate the theory, and the information is presented so you will be able to apply this theory to any other situation that you may encounter.

- *The AICPA's Guide to Business Consolidations, Goodwill and Other Consolidation Issues* (product no. 735134kk). Learn how FASB Statements No. 141 and No. 142 have changed the rules for business combinations and goodwill accounting. Develop standards for applying purchase accounting and how to allocate the acquired entity now that it's the only game in town under FASB Statement No. 141. Identify variable interest entities' impact under FASB Interpretation No. 46(R). Learn how FASB Statement No. 142 deals with goodwill from initial recognition to the annual impairment review requirements.

For a listing of additional courses available, please download the *Fall/Winter 2006 AICPA CPE Catalog* at www.cpa2biz.com/CPE/default.htm.

Online CPE

AICPA CPExpress (formerly InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to construction company auditors are:

- *2006 Annual Update-A&A: Issues for Audits of Nonpublic Entities on the Horizon*
- *2006 Annual Update-A&A: Issues for Audits of Public Entities on the Horizon*
- *Just-in-Time Systems, Economic and Market-Value-Added*
- *Revenue Recognition: Income Statement Presentation and Disclosures*

To register or learn more, visit www.cpa2biz.com.

Webcasts

Stay plugged in to what's happening and earn CPE credit right from your desktop. AICPA webcasts are high-quality two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in on the discussion. If you can't make the live event, each webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

The CFO Roundtable Webcast Series—brought to you each calendar quarter—covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting, to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

The SEC Quarterly Update Webcast Series—brought to you each calendar quarter—showcases the profession's leading experts on what's "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and CorpFin activities, these hard-hitting sessions will keep you "plugged in" to what's important. A must for both preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

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Web Sites

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

This Audit Risk Alert replaces the *Manufacturing Industry Developments—2005/06 Audit Risk Alert*. The Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to ccole@aicpa.org, or write to:

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