Finance companies industry developments - 1993; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

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Finance Companies
Industry Developments—1993

Complement to AICPA Audit and Accounting Guide
Audits of Finance Companies

AICPA
American Institute of Certified Public Accountants
NOTICE TO READERS

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

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Finance Companies
Industry Developments—1993

Industry and Economic Developments

Finance companies provide a wide variety of lending and financing services to both consumers and business enterprises. Some limit their lending activities to financing purchases of products produced by an affiliated company. Others concentrate on lending to consumers. Still others have diversified into higher risk lending to real estate and takeover ventures and have come to compete with banks and savings institutions.

Finance companies, along with most other lenders, are reaping the benefits of an economic environment characterized by a wide interest-rate spread—the differential between the rate paid to raise capital to lend and the rates charged to borrowers. The primary activity of finance companies is borrowing money at wholesale and lending it at retail. Thus, the ability to raise capital at some of the lowest rates in years and to lend that money out at relatively high rates has boosted earnings virtually throughout the industry to near-record levels.

Credit quality, while still a major concern for lenders of all sorts, has also taken a turn for the better. Delinquencies have continued on a downward trend for the first three quarters of the year and are expected to stay that course for the remainder of the year.

Loan volume, which became somewhat soft in recent years as consumers pared down their debt levels, is nevertheless expected to increase in response to developments such as increases in consumers’ disposable income and the improved affordability of housing. Loan demand at banks and savings institutions continues to be weak. Corporations have been implementing fundamental changes in financing policies. The policy changes include a drive by corporations to reduce debt, and greater use by medium-size corporations of nonbank borrowings such as leases, private placements of debt, and sales of corporate securities in the bond and commercial paper markets. As a result, corporations that formerly dealt only with banks are now turning to commercial finance companies.

The low-inflation, low-interest rate environment has also proved beneficial to companies with real-estate related activities such as mortgage origination, refinancing, and servicing.
Auditors of finance companies should fully understand the kinds of lending activities in which their clients are engaged and carefully consider the risks inherent in each. Auditors should also be alert to red flags that indicate areas of increased risk requiring particular audit consideration. Such red flags include—

- Changes in loan acceptance policies attributable to increased competition, possibly resulting in the acceptance of higher risk loans.

- Material changes in operations or operating performance that may indicate deteriorating financial strength. Such changes include increasing loan delinquencies or loss charge-offs, declining interest spreads, lower ratios of loan-loss allowances to nonperforming loans in comparison to industry averages, and practices that reflect a failure to consider changing economic conditions (for example, inappropriately heavy reliance on historical data in evaluating allowances for loan losses).

- Material, one-time transactions that may indicate attempts to realize large, short-term benefits, particularly when such transactions occur at or near the end of a reporting period or account for a material portion of reported income. Such transactions may include high-volume purchases or sales of assets (such as mortgage-servicing rights), speculative or unusual off-balance-sheet arrangements, and other high rates of asset growth or disposition. Auditors should give particular attention to the propriety of the accounting treatment of such transactions.

- Highly complex or speculative investments, such as complex mortgage derivatives, investments in noninvestment-grade securities, or complicated, multiple-step transactions involving real estate. Auditors should consider the propriety of management’s valuation of such investments and evaluate management’s assessment of their recoverability.

- Nontraditional or unusual loan transactions that may expose the company to increased risk. Such transactions include loans with unusual, questionable, or inadequate collateral; loans outside the company’s normal lending area; poorly documented loans; loans that pay interest from interest reserves; loans secured by collateral that has dramatically changed in value; significant concentrations of loans; loans to real estate ventures that represent equity investments (acquisition, development, and construction loans); and practices such as routine extension or modification of loan terms or lending activity inconsistent with the stated policies of management.
Regulatory Developments

AICPA Statement on Auditing Standards (SAS) No. 22, Planning and Supervision (AICPA, Professional Standards, vol. 1, AU sec. 311), requires that in planning their audits, auditors consider matters affecting the industry in which the entity operates including, among other things, government regulations. Auditors consider such regulations in light of their potential impact on the financial statements being audited. SAS No. 54, Illegal Acts by Clients (AICPA, Professional Standards, vol. 1, AU sec. 317), distinguishes between the following two types of laws and regulations:

1. Those that have a direct and material effect on the determination of financial statement amounts
2. Those that relate more to an entity’s operating aspects than to its financial and accounting aspects and, therefore, have only an indirect effect on the financial statements

Although auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts, an audit performed in accordance with generally accepted auditing standards does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

Finance companies and the transactions in which they engage have become the focus of increasing governmental regulation. Laws and regulations that affect the finance companies industry are discussed below and in the AICPA Audit and Accounting Guide Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies).

Regulation Z of the Consumer Credit Protection Act

Truth-in-lending laws can have a significant effect on the operations of financing transactions. Regulation Z prescribes requirements for both creditors and borrowers for full disclosure of credit costs and is applicable to all real estate transactions, regardless of amount, in which individual borrowers are involved in nonbusiness transactions.
Audit Issues and Developments

Credit Quality

Credit quality has begun to show signs of improvement for many finance companies. Nevertheless, credit quality and other asset quality issues associated with loans, real estate portfolios, troubled debt restructurings, foreclosures and in-substance foreclosures, off-balance-sheet financial instruments, and other assets require critical attention in audits of the financial statements of finance companies, especially those that have diversified into higher-risk lending activities. Auditors should obtain reasonable assurance that management has recorded adequate asset valuation allowances and liabilities for other credit exposures based on all relevant factors. The subjectivity of determining asset valuation allowances, combined with continued economic uncertainty, reinforces the need for careful planning and execution of audit procedures in this area.

Lack of an asset impairment evaluation system or failure of a finance company to document adequately its criteria and methods for determining asset valuation allowances may indicate a material weakness in the internal control structure and will generally increase the extent of judgment that must be applied by auditors in evaluating the adequacy of management’s allowances and will increase the likelihood that differences will result. The guidance in SAS No. 57, Auditing Accounting Estimates (AICPA, Professional Standards, vol. 1, AU sec. 342), should be followed in auditing asset valuation allowances. Other sources of information on auditing loan loss allowances include the AICPA Audit and Accounting Guides Audits of Savings Institutions and Audits of Credit Unions, the Industry Audit Guide Audits of Banks, and the Auditing Procedure Study, Auditing the Allowance for Credit Losses of Banks. The Audit and Accounting Guide Guide for the Use of Real Estate Appraisal Information provides guidance to help auditors understand real estate appraisal concepts and information.

As with credit risk, other valuation issues involve many subjective assumptions. For example, the expected effects of prepayments on loans in portfolios and the types of income and expense items included in valuations of loan servicing assets have a significant impact on the recorded values of those assets. High levels of prepayments of mortgage loans, for example, have resulted in the impairment of many assets, such as purchased mortgage servicing receivables and interest-only securities. Evaluation and recognition of impairment attributable to prepayments should include consideration of the entity’s aggregation policy, discount rates, and assumptions about the future prepayment rates.
Further, falling interest rates have created an environment in which transactions involving gains trading of securities, refinancing of loans, restructuring of nonperforming assets, origination of loans to facilitate the sale of real estate owned, and other asset dispositions all require specific attention. Such transactions require an understanding of the specific situations so that the auditor may carefully assess and control audit risk.

Derivatives and Other High-Risk Investments. In recent years there has been a growing use of innovative financial instruments that often are very complex and can involve a substantial risk of loss. Users and issuers of such instruments must have the expertise necessary to understand and manage the related risks. As discussed below, auditors should also be familiar with such instruments and the associated risks. One class of these instruments—derivatives—requires particular attention.

Derivatives are complex financial instruments whose values depend on the values of one or more underlying assets or financial indexes. Derivatives generally fall into at least two categories:

1. Asset-backed securities, which include mortgage-backed securities, interest-only and principal-only strips, and tranches of collateralized mortgage obligations.
2. Off-balance-sheet instruments such as forward contracts, interest-rate and currency swaps, futures, options, and other financial contracts.

By reconfiguring cash flows associated with underlying assets, an issuer can create asset-backed securities that meet the needs of, and are attractive to, various potential users by isolating, enhancing, or diluting one or more of credit, liquidity, interest-rate and other risks inherent in the underlying cash flows. For example, through mortgage-backed securities, the issuer can enhance the marketability of underlying mortgage loans by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those users willing to accept a higher concentration of the risks associated with specific collateral cash flows. Similarly, users find certain derivatives attractive because they can purchase the risks and rewards they desire most, or can synthetically create a security with the desired risk and reward characteristics.

Increased volatility of interest rates, foreign exchange rates, and commodity and other prices has also fostered tremendous innovation in financial products to meet the needs of users attempting to hedge or alter the related risks. Swaps, for example, are financial contracts in which two parties exchange streams of payments over a period of time.
An entity with debt that carries variable interest rates (such as an entity that has short-term certificates of deposit) might swap interest-rate payments on an agreed-upon principal amount with a counterparty by paying a fixed rate and receiving a variable rate. The entity locks into an interest rate for the term of the swap, reducing the risk that increases in interest rates will increase the entity's cost of funds as its liabilities are refunded or related interest rates are reset. The entity takes on other risks, however, such as the risk that the counterparty could default on its payments. By locking into fixed rates, the entity will no longer benefit from interest-rate decreases during the term of the swap, and it is often costly to terminate a swap. Further, the fair value of derivatives can be volatile in periods of changing market conditions.

**Accounting.** Accounting for derivatives is complex. Given the constant innovation and complexity of derivatives, accounting literature does not explicitly cover some derivatives; however, several related projects are under way. The Financial Accounting Standards Board (FASB) has been carrying out a major project on the recognition and measurement of financial instruments, which has already resulted in the issuance of FASB Statements of Financial Accounting Standards No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk; No. 107, Disclosures about Fair Value of Financial Instruments; No. 115, Accounting for Certain Investments in Debt and Equity Securities; and FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts, that address related issues. The FASB's project includes a comprehensive review of accounting for hedging and risk-adjusting derivatives. Also, the International Accounting Standards Committee is in the process of developing an international accounting standard for financial instruments.

Several accounting issues involving derivatives have also been addressed by the FASB's Emerging Issues Task Force (EITF). Other guidance is provided by FASB Statements No. 52, Foreign Currency Translation, and No. 80, Accounting for Futures Contracts. In addition, AICPA Issues Paper No. 86-2, Accounting for Options, discusses various matters relating to options.

**Auditing.** The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, as more and more financial institutions enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counterparties that have
higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used by the managements of finance companies to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. Understanding the substance of transactions in such instruments is important in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts.

SAS No. 22 requires that auditors understand the events, transactions, and practices that, in their judgment, may have a significant effect on the financial statements. Accordingly, auditors should carefully consider the various risks involved with investments in derivatives and other complex securities as they plan their audits and should—

1. Assess management's expertise in monitoring, evaluating, and accounting for the securities.

2. Ensure that the entity has set appropriate policies and procedures for investment in high-risk securities and that there is adequate oversight by the board of directors.

3. Involve specialists, when necessary, in valuing and auditing these investments.

Service-Center-Produced Records. Finance companies frequently operate in an environment in which service organizations play a critical role in the accounting function. In assessing control risk in such an environment, auditors must carefully consider the functions or processing of information performed by the service organizations. SAS No. 70, Reports on the Processing of Transactions by Service Organizations (AICPA, Professional Standards, vol. 1, AU sec. 324), which was issued in April 1992 and supersedes SAS No. 44, Special-Purpose Reports on Internal Accounting Control at Service Organizations, provides guidance to auditors performing audits of finance companies that use such organizations.

When a finance company uses a service organization, the functions or processing performed by the service organization may have a significant effect on the finance company's financial statements. Because the processing may be subjected to control policies and procedures that are physically and operationally separate from the finance company, the internal control structure of the finance company may include a component that is not directly under the control and monitoring of its management. SAS No. 55, Consideration of an Entity's Internal Control Structure in a Financial Statement Audit (AICPA, Professional Standards, vol. 1, AU sec. 319), requires an auditor to obtain a sufficient understanding of an entity's internal control structure to plan an audit. For this reason, planning the audit of a finance company may require that
the auditor gain an understanding of the control policies and procedures performed by service organizations. When a finance company relies on a service organization’s control policies and procedures over the processing of transactions that are material to the finance company’s financial statements, those control procedures should be considered by the auditor. One method of obtaining information about those policies and procedures is to obtain a service auditor’s report as described in SAS No. 70.

Auditors frequently inquire whether it is necessary to obtain a service auditor’s report when their clients use service organizations. The fact that an entity uses such an organization does not, in itself, require that such a report must be obtained. In certain situations, the finance company may implement control policies and procedures that will obviate the need for a service auditor’s report. For example, a finance company using a payroll service may routinely compare the data submitted to the service organization with reports received from the service organization to check the completeness and accuracy of the data processed. The finance company may also recompute a sample of the payroll checks for clerical accuracy and review the total payroll for reasonableness. In such circumstances, the finance company is not relying on the service organization’s controls.

Other factors that may be considered in determining whether to obtain a service auditor’s report are—

- Whether the transactions or accounts affected by the service organization are material to the finance company’s financial statements.
- The extent to which the user organization retains responsibility for authorizing the transactions and maintaining the related accountability.
- The availability of other information (for example, user manuals, system overviews, and technical manuals) at the finance company that may provide the auditor with sufficient information to plan the audit.

The AICPA’s Auditing Standards Division expects to issue an Auditing Procedure Study Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations, early in 1994.

Accounting Developments

FASB Financial Instruments Project

The FASB’s agenda continues to include a project on financial instruments that encompasses three primary segments: disclosures,
distinguishing between liabilities and equity, and recognition and measurement. In addition to these three primary segments, the FASB has addressed several narrower issues within the overall scope of the project. Some of the current developments of the project are described in the following sections.

**Impairment of a Loan.** In May 1993, the FASB issued FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, which addresses the accounting by creditors for impairment of certain loans. The Statement is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller balance homogeneous loans that are collectively valued for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115. It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

FASB Statement No. 114 requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent.

The Statement amends FASB Statement No. 5, *Accounting for Contingencies*, to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

The Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

Sources of guidance relevant to auditing loan loss allowances are described on page 8.

Some finance companies may adopt the provisions of the Statement prior to its effective date. Auditors of the financial statements of such finance companies should carefully consider the implications of applying the new provisions of the Statement on audit risk. Aspects of applying the new Statement that warrant particular consideration include—

- Proper identification of all loans to which the Statement should be applied.
- The reasonableness of estimates of future cash flows and interest rates used in discounting.
• The appropriateness of amounts used to measure impairment if alternatives to present value amounts, such as fair values of collateral or observable market prices, are used.

• The relationship between the identification of impaired loans under the Statement and the classification of loans under regulatory classification systems.

• The presentation of accrued interest receivable and its relationship to valuation allowances.

• The relevance of concepts of performing and nonperforming assets.

Investments in Debt and Equity Securities. In May 1993, the FASB issued FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, which addresses the accounting and reporting for investments in equity securities that have readily determinable fair values (previously addressed by FASB Statement No. 12, Accounting for Certain Marketable Equity Securities) and for all investments in debt securities. FASB Statement No. 115 does not cover securities accounted for by the equity method and investments in consolidated subsidiaries. FASB Statement No. 115 establishes three categories of reporting debt and marketable equity securities:

• Held-to-maturity securities (debt securities that the entity has the positive intent and ability to hold to maturity), to be reported at amortized cost

• Trading securities (debt and equity securities that are bought and held principally for the purpose of selling them in the near future), to be reported at fair value, with unrealized gains and losses included in earnings

• Available-for-sale securities (debt and equity securities not classified as either held-to-maturity or trading), to be reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of equity until realized

Mortgage-backed securities that are held for sale in conjunction with mortgage-banking activities (as described in FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities), are classified as trading securities. Mortgage-backed securities that are currently not held-for-sale in conjunction with mortgage-banking activities may be classified in one of the two other categories, as appropriate.

FASB Statement No. 115 also requires finance companies to determine whether declines in the fair value of individual securities classified as either held-to-maturity or available-for-sale below their amortized cost bases are other than temporary. For example, if it is probable that an
investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment is considered to have occurred. If such a decline is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as the new cost basis, with the amount of the write-down included in earnings (that is, accounted for as a realized loss).

The Statement also specifies the accounting treatment for transfers between categories.

The Statement (paragraph 8) indicates that certain changes in circumstances may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Such circumstances include evidence of a significant deterioration in the issuer’s creditworthiness or a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security. In addition, other events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated may cause an enterprise to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. Such sales and transfers of held-to-maturity securities are expected to be rare.

An entity shall not classify a debt security as held-to-maturity if it has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be classified as a held-to-maturity if the enterprise anticipates that the security would be available to be sold in response to changes in market interest rates and related changes in the security’s prepayment risk, needs for liquidity, changes in the availability of and the yield on alternative investments, changes in funding sources and terms, and changes in foreign-currency risk.

FASB Statement No. 115 is effective for fiscal years beginning after December 15, 1993. It specifically prohibits retroactive restatement of prior financial statements. Although typically FASB Statement No. 115 would be initially applied as of the beginning of a fiscal year (such as January 1, 1994), entities are permitted to initially apply the Statement as of the end of an earlier annual period for which financial statements have not been issued (with no restatement of interim periods).

Since all finance companies with a calendar fiscal year must classify their investments in securities in accordance with FASB Statement No. 115 as of January 1, 1994, those finance companies will also be able to apply the Statement as of December 31, 1993, if they wish to do so in their 1993 annual financial statements. Thus, auditors should be aware of some of the issues that are likely to arise when the Statement is applied. Auditing financial statements involving the classification of
investments in debt and equity securities pursuant to FASB Statement No. 115 may involve a high degree of judgment about such matters as the following:

- How auditors should evaluate subjective exceptions for sales of securities designated as held-to-maturity (including the interpretation of restrictive terms such as isolated, nonrecurring, and unusual)
- How auditors should evaluate the ability of a finance company to hold securities to maturity, particularly when going-concern issues arise
- Whether cash flow projections are needed in conjunction with assessing a finance company's ability to hold securities to maturity
- How to evaluate whether impairments of investments are other than temporary

Consensus Decisions of the FASB's Emerging Issues Task Force

The FASB's EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to finance companies.

In Issue No. 93-1, Accounting for Individual Credit Card Acquisitions, the EITF reached a consensus that credit card accounts acquired individually should be accounted for as originations under FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs for Leases, and EITF Issue 92-5 (see the following discussion).

In Issue No. 92-10, Loan Acquisitions Involving Table Funding Arrangements, the EITF reached a consensus that a mortgage loan acquired by a mortgage banking enterprise in a table funding arrangement should be accounted for as a purchase of the loan if the loan is legally structured as an origination by the correspondent and if the correspondent is independent of the mortgage banking enterprise. If any criterion set forth in the consensus is not met, the loan should be accounted for by the mortgage banking enterprise as an originated loan.

In Issue No. 92-5, Amortization Period for Net Deferred Credit Card Origination Costs, the EITF reached a consensus that credit card origination costs that qualify for deferral pursuant to paragraph 6 of FASB Statement No. 91 should be netted against the related credit card fee, if any, and the net amount should be amortized on a straight-line basis over the privilege period. If a significant fee (relative to the related costs) is charged, the privilege period is the period during which the fee entitles the cardholder to use the card. If there is no significant fee, the privilege period should be one year.
In addition, the EITF reached a consensus that for both purchased and originated credit cards, an entity should disclose its accounting policy, the net amount capitalized at the balance sheet date, and the amortization period(s) of credit card fees and costs.

In Issue No. 92-2, *Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse*, the EITF reached a consensus that the obligation recorded at the date of sale in connection with the recourse provisions of a transfer of receivables should include all probable losses over the life of the receivables transferred and not only those measured in conformity with FASB Statement No. 5 prior to the date of transfer. The EITF also reached a consensus that recognition of the recourse obligation on a present value basis, as defined, would be acceptable if the timing of the estimated cash flows can be reasonably estimated.

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This Audit Risk Alert replaces *Finance Companies Industry Developments—1992.*

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Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1993,* which may be obtained by calling the AICPA Order Department at the number below and asking for product number 022099.

Copies of AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.