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Securities industry developments - 2001/02; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Securities Industry Developments—2001/02

Complement to AICPA
Audit and Accounting Guide
Audits of Brokers and Dealers in Securities

American Institute of Certified Public Accountants

AICPA

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of broker-dealers in securities with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. Because securities broker-dealers often deal in commodity futures or function as commodity pool operators, this Audit Risk Alert expands the discussions of recent developments to include matters that may affect the audits of commodity entities as well. This document has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA.

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1 2 3 4 5 6 7 8 9 0 AAG 0 9 8 7 6 5 4 3 2

Table of Contents

How This Alert Helps You

This Audit Risk Alert helps you plan and perform the audits of your securities industry clients. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment your clients operate in. This Alert is an important tool in helping you identify the significant business risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and regulatory developments.

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

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2001/02* (product no. 022280kk).

Economic and Industry Developments

What are the industry and economic conditions facing broker-dealers and commodity entities in the current year?

The Weakened Economy

Through the first three quarters of 2001, the downward slide of the Dow Jones Industrial Average (DJIA) and the National Association of Securities Dealers Automated Quotation (NASDAQ) composite that began in 2000 continued, including steep declines following the events of September 11. The DJIA ended the third quarter of 2001 below 9000, and the NASDAQ ended below 1500. Through the first six weeks of the fourth quarter, both the DJIA and

NASDAQ regained the losses experienced after the markets reopened on September 18. The Federal Reserve Board cut the federal funds rate on separate occasions during the past year to 1.75 percent, bringing it to its lowest level in about 40 years. Corporate earnings reports through the first three quarters of 2001 were weak in many sectors. Consumer confidence also showed signs of weakening. The unemployment rate is expected to surpass 6 percent by the end of 2001, up from 4.9 percent in August and 3.9 percent last fall.

Nascent signs of economic recovery are appearing however. Many economists expect the business environment to turn around during the beginning of 2002. For a thorough discussion of the economic and business environment, see the AICPA general *Audit Risk Alert 2001/02*.

Even before the terrorist attacks, securities firms were experiencing financial difficulty. With a declining stock market and business dwindling in such profitable areas as underwriting initial public stock offerings and mergers and acquisitions, investment bank earnings for the first two quarters of 2001 were significantly lower than last year. Some analysts hoped that the situation would improve in the fourth quarter. But those hopes were dimmed on September 11.

September 11 Impact

When terrorists attacked the World Trade Center, they did much more than kill innocent people and destroy the buildings. They destroyed the symbol of financial prosperity, the symbol of capitalism itself. Since a number of investment banks and brokerage houses were located in the World Trade Center or very close to it, the securities industry was hit hard by the attack. The industry that relies heavily on personal relationships lost a number of professionals who will be hard to replace. Costs associated with the attacks are going to be enormous. Securities firms incurred significant expenses related to relocating from their damaged or destroyed offices and rebuilding computer systems. While those expenses should be covered by "business interruption" insurance, trading losses will have to be absorbed by the firms. Analysts estimate that the four-day trading halt due to the attacks will cost from 1 percent to 2 percent of brokerage firms' quarterly net revenue. In addition to that, securities firms are taking measures to increase security in the workplace, such as installing mail censors, securing ventilation systems, and using bomb-sniffing dogs. Those initiatives do not come cheap: analysts estimate that the cost of added security at investment banks could lead to a 1 percent reduction in return on equity. Therefore, it was no surprise when securities firms announced that their third-quarter earnings declined significantly from year-earlier levels, for some of them by more than 50 percent.

As you prepare to conduct audits of firms affected by the events centered on the terrorist attacks, you need to realize that your clients may be working in a new business environment. You must gain an understanding of this new environment in order to adequately plan and perform the audit. Although in certain instances the implications to the client's business environment may be temporary, auditors also need to consider the potential for any ongoing, longer-lasting implications.

In addition to the obvious economic implications, a number of accounting and auditing issues are raised as a result of the September 11 terrorist attacks and related subsequent events. These issues affect those businesses and auditors directly affected by the attacks and those businesses and auditors who were not directly affected, but whose clients, vendors, suppliers, and others were directly affected.

Emerging Issues Task Force (EITF) Issue No. 01-10, *Accounting for the Impact of the September 11, 2001 Terrorist Acts*, addresses the proper accounting treatment for matters related to the terrorist attacks. EITF Issue No. 01-10 states that the economic effects of the events were so extensive and pervasive that it would be impossible to capture them in any one financial statement line item and decided against extraordinary treatment for any of the costs attributable to the terrorist attacks.

Responding to inquiries from accounting firms and registrants, the Securities and Exchange Commission (SEC) issued Interpretive Release No. IC-25157, *Bookkeeping Services Provided by Auditors to Audit Clients in Emergency or Other Unusual Situations* (effective date: September 14, 2001), which states that accounting firms may assist clients that had offices in and around the World Trade Center by participating in the recovery process to facilitate a timely, effective, and efficient revitalization of their audit client's records and systems that were destroyed in the events of September 11, 2001, without impairing the auditor's independence from those clients.

Also, for the first time the SEC used its emergency powers under the Securities Exchange Act of 1934 to ease certain regulatory restrictions temporarily. (See Release No. IC-25156, *Order Under Sections 6(c), 17(d), and 38(a) of the Investment Company Act of 1940 Granting Exemptions from Certain Provisions Under the Act and Certain Rules Thereunder*, and Release No. IC-25165, *Order Extending Prior Order Under Sections 6(c), 17(b) and 38(a) of the Investment Company Act of 1940 Granting Exemptions from Certain Provisions Under the Act and Certain Rules Thereunder*).

Copies of the SEC orders and interpretive releases are available on the SEC Web site at www.sec.gov, along with information on additional SEC actions taken on September 21, 2001.

A thorough discussion of the ability of auditors to assist their clients in recovering accounting records, obtaining audit evidence, considering the risk of fraud, and other audit-related matters is offered at www.cpa2biz.com. In addition, www.cpa2biz.com offers extensive guidance on accounting, independence, tax, technology, and regulatory considerations.

See the AICPA general *Audit Risk Alert—2001/02* for a detailed discussion of how the September 11 attacks may affect the business environment, your clients, and the planning of your audits. The general Alert also discusses specific accounting matters related to the September 11 attacks.

Increased Competition

Commercial banks are providing increased competition to the securities industry. The biggest threat comes from megabanks which hope to lure customers away from traditional brokerages and investment banks by offering them all kinds of financial services under one roof. To compete, investment banks offer various types of financing to their clients, including credit lines, to ensure that the clients are not going to walk away and take the investment banking deals with them. However, unlike banks, they do not have access to cheap deposits and are required to value their loans each day at market prices, which forces them to recognize unrealized losses on their positions. In today's environment, where the investment banking business is all about scale, balance sheet size, and liquidity, one might expect to see a number of mergers and acquisitions in the securities industry. Weak players are likely to be acquired while strong players might team up with each other or commercial banks to create balance sheets that would rival those of megabanks. The "Business Combinations" section of this Alert discusses points you will need to consider as an auditor of a company that is involved in these complex transactions.

Possible Restructurings and Audit Issues

In light of the adverse conditions experienced by the securities industry this year, some securities firms may decide to restructure their business by retreating from one or several business lines while trying to strengthen the remaining operations. Entities undergoing restructurings and incurring related charges may be more inclined to record excessive liabilities and charges during periods of plunging earnings and business decline. While things are going poorly for everyone, and while the markets expect an entity to perform poorly, an entity could decide to take a big bath, clear the decks, clean the balance sheet, and throw as much as possible into its restructuring charges. This practice can help entities reduce expenses and enhance earnings in the future. As an auditor, you may need to determine whether accruals related to restructuring are reasonable and not excessive. In addition, you may need to be especially careful when auditing balances and transactions based on estimates developed by management. Refer to the general *Audit Risk Alert 2001/02* (product no. 022280kk) for a thorough discussion of the accounting and auditing issues involved in restructurings.

Layoffs

The securities industry had to deal this year with both the economic decline and the impact of September 11. As a result, most securities firms had to start cutting their costs to improve their profitability.

Big payrolls, which represent the largest expense for the securities industry, were a number one target. Since 1992, the number of jobs in the securities industry increased by 72 percent to approximately 770,000 jobs. In the past two years alone more than 150,000 jobs have been added. Analysts estimate that 15 percent of those jobs could be lost by the end of 2001.

Significant layoffs can have a serious effect on an entity's internal control and financial reporting and accounting systems. For instance, employees who remain at the company may feel overwhelmed by their workloads, feel pressure to complete their tasks with little or no time to consider their decisions, and may be performing too many tasks and functions. The auditor may need to consider whether these situations exist and what their effect is on internal control. Statement on Auditing Standards (SAS) No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, provides guidance on the auditor's consideration of an entity's internal control in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).

Additionally, the auditor may need to consider the possible effects that key unfilled positions can have on internal control. Entities that have had strong financial reporting and accounting controls could see those controls deteriorate due to the lack of employees. Layoffs can also create additional exposure to possible internal fraudulent activities (for example, when an employee performs a job function that otherwise would be segregated). SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by fraud.

You may want to consider these issues in planning and performing the audit and in assessing control risk. Remember that gaps in key positions may represent reportable conditions that should be communicated to management and the audit committee in accordance with SAS No. 60, *Communication of Internal Control*

Related Matters Noted in an Audit (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

Decimalization

As of April 9, 2001, all U.S. stocks are priced and traded in decimals (dollars and cents) rather than fractions (8ths and 16ths of a dollar). That changed the tradition that went back to the establishment of the U.S. markets in the 1700s. The transition went smoothly and did not result in any significant systems or capacity problems. The goal of the decimalization project was to help individual investors compete with professionals in the marketplace by simplifying the pricing system and reducing trading costs. Decimalization is also expected to make U.S. markets more competitive internationally since most of the world trades its stocks in decimals as well.

The decimalization project met significant resistance from the securities companies due to its negative impact on their profits. Trading firms used to rely heavily on the spreads—that is, the difference between buying and selling prices—as a source of their revenues. They made money by trading stocks on a net basis and keeping a portion of the spread as a fee for executing transactions. Decimalization resulted in a significant decline in spreads. Before the conversion to decimals, most of the trades involved a minimum spread of 6.25 cents, or 1/16 of a dollar, approximately half of which was kept by the traders as a fee. But with the introduction of decimals, spreads decreased to 3 cents or less, thus reducing trader's fees in half, or in some cases, eliminating them completely. And although the difference seems to be insignificant, it may result in billions of dollars of lost revenues for trading firms. To compensate for this loss of income, trading companies have been exploring the possibility of switching from the traditional payment system to a commission system, in which the traders and their customers agree to a set fee. The SEC encourages this move since clearly disclosed commissions will provide investors with a better idea of true trading costs.

Narrowed spreads had an indirect effect on retail brokerage firms by significantly reducing the practice of payment for order flow—

the system by which trading firms pay fees to retail brokers in exchange for receiving orders to be executed. Trading firms simply cannot afford to pay brokerage firms from the spreads as low as 3 cents or less if they want to remain profitable. This change may initially benefit trading firms by reducing their costs but it may also hurt them if retail firms lose their incentive to provide the order flow. The latter scenario might have a significant negative effect on trading firms, especially when the stock market is declining. Once the markets rally again, trading volumes should increase, leading to an increase in order flow and in commissions. However, discount brokerages that rely heavily on those payments for revenues might have to find new ways to make money to succeed in this highly competitive environment.

In light of the changes brought about by decimalization, auditors of the securities companies should be especially vigilant this year with respect to fraud. SAS No. 82 suggests, among other matters, a number of fraud risk factors relating to misstatements arising from fraudulent financial reporting. Some of these factors may be particularly relevant to securities firms. These fraud risk factors may include new regulatory requirements that could impair the financial profitability of the entity (such as decimalization), high degree of competition accompanied by declining markets, and rapid changes in the industry.

Many of the problems experienced by the securities industry due to decimalization are likely to be compounded by the practice of trading in subpenny increments. Even in a fraction environment, it was a common practice to trade securities in increments smaller than the public quote. This practice has continued into the decimal environment, with approximately 4 percent to 6 percent of trades in NASDAQ securities priced in subpenny increments even though the quotations for these securities are at a penny increment. In July 2001 the SEC issued Concept Release *Request for Comment on the Effect of Decimal Trading in Subpennies*, seeking comment on the impact on markets and investor protection of trading and potentially quoting securities in an increment of less than a penny. Even though the conversion to decimals was finally completed this year, it is important to realize that problems surrounding this issue are far from being resolved. As an auditor of a security firm you should keep abreast of the regulatory developments in this area since they can have a serious impact on the operations of your client.

Increase in Arbitrations and Litigation

This year the securities industry experienced a significant increase in the number of arbitrations and litigations. The number of complaints filed with the National Association of Securities Dealers (NASD), which oversees 90 percent of arbitrations, increased by 24 percent. The main reasons for complaints are analysts failing to disclose a conflict of interest and brokers exposing clients to unsuitable risks, such as margin trading, excessive trading, or unauthorized trading. There is also no shortage of lawsuits. Six major brokerage firms are facing one of the biggest class action suits charging them with allegedly requiring analysts to issue positive recommendations on Internet stocks in an effort to increase investment banking business while not disclosing this fact to the public. In addition to that, there are more than a hundred class action suits filed against investment banks alleging unfair allocation of initial public offering shares and subsequent manipulation of stock prices. The SEC, the U.S. Attorney's Office in New York, and the NASD are also investigating this last allegation. Legal proceedings are hurting investment banks' profitability by forcing them to pay significant amounts of money in legal fees and settlements.

Conflict of interest by research analysts is the area that has attracted the most attention. Investors raised concerns about analysts' independence and objectivity under the arrangement that ties their compensation to the performance of the investment banking division. In June, the Securities Industry Association issued a new code of conduct, which states, among other things, that analysts should not report to investment banking, that their compensation should not be directly linked to the performance of the investment banking unit, and that they should disclose whether they hold direct ownership positions in the securities they cover. In July, the SEC issued an investor alert educating investors about potential conflicts of interest analysts may face and urging them not to rely solely on analyst recommendations when making their investment decisions.

Congress has also held hearings on the connection between analysts' recommendations and their compensation. Some securities firms took voluntary steps to address the issue of conflict of interest by prohibiting equity analysts from owning shares in the companies they cover.

As an auditor of a securities firm, you need to consider the impact of litigation on your client's financial statements. See the "Litigations, Claims, and Assessments" section of this Alert for a further discussion of this topic.

Technology and E-Business

This was a difficult year for online brokers. The declining stock market discouraged small investors, which represent the majority of Web brokers' clientele, from trading. Average assets per account as well as the number of trades per account continued to fall. According to analysts, Internet trading declined by more than 50 percent in the first half of 2001, delivering the biggest blow ever to the online brokers. Their revenues were hammered since most of them are not diversified and rely heavily on trading commissions and interest from margin loans as the main sources of their income. The grim situation was further worsened by increased competition from full-service brokerage firms that have incorporated online trading into their operations. This year we saw a number of mergers in the online brokerage sector. This trend is likely to continue as strong players are trying to expand their customer base at the expense of the weak ones. Some analysts expect that the number of online brokers in the U.S. will decline from approximately 140 to less than a dozen. Auditors whose clients are involved in mergers and acquisitions should ensure that their clients properly account for those complex transactions. See the "Business Combinations" section of this Alert for further discussion of this topic.

In today's market, online brokers experiencing recurring losses might not be able to raise capital to fund their operations. Auditors should consider whether clients that require additional funding in the next 12 months to maintain operations have the ability to continue as a going concern. See the "Going-Concern Issues" section of this Alert for further discussion of the going-concern issue.

Wireless Trading

Wireless trading was another source of disappointment for the securities industry this year. A number of companies spent millions of dollars to acquire and set up technology necessary to support wireless trading. However, declining stock markets did little to encourage customers to execute more of their trades using wireless devices. In the bearish markets, investors simply do not feel the need to be connected all the time. Also, a number of people do not feel comfortable conducting their trades over cell phones because they fear getting disconnected before completing the transaction. According to analysts, the percentage of online trades executed using wireless technology increased from 0.1 percent last year to less than 0.5 percent this year. However, securities firms are not about to give up on wireless trading. On the contrary, they keep investing in the technology necessary to support it in hopes that once the market rebounds, wireless trading will reach new heights. According to some estimates, by 2006 as much as 18 percent of online trading revenue will be generated with the help of wireless technology.

Settlement Cycle

Several years ago the securities industry initiated efforts to address compressing the settlement cycle on certain securities from trade date plus three days (T+3) to trade date plus one day (T+1). Initially, the deadline for the completion of the industry's conversion from T+3 cycle to T+1 cycle was set for June 2004. However, in October 2001 the Securities Industry Association (SIA) moved the deadline to June 2005. According to the SIA, the new target date means that securities firms must be ready by mid-2004 so that they can participate in a full year of utilizing the new processing infrastructure and industry testing as envisioned in the original plan.

For comprehensive discussions of the considerations unique to the e-business environment the auditors should refer to Audit Risk Alert *E-Business Industry Developments—2001/02*.

Money Laundering

After the events of September 11, government officials are increasingly concerned about the vulnerability of the securities industry to money laundering activities. According to a survey conducted earlier this year by the General Accounting Office, only 17 percent of 3,015 brokerage firms and dealers had in place anti-money-laundering measures that went beyond the minimum requirements. Law enforcement agencies are investigating short sales made before the attacks, especially the ones involving stocks of the industries affected the most—airlines and insurance companies. One of the goals of the recently enacted antiterrorism law is to prevent terrorists from using the U.S. financial system to legitimize and multiply their resources. Under the new law, the securities firms will be required to establish new anti-money-laundering programs. Among other things, the new law will prohibit securities firms from setting up accounts for foreign shell banks with no physical location and will require them to verify the identities of their clients. Also, starting in June of 2002, the securities firms will have to file "Suspicious Activity Reports" for any unusual transaction. The "Money Laundering Activities" section of this Alert provides an explanation of what money laundering is and how it can affect your client as well as your audit.

Gramm-Leach-Bliley Financial Services Modernization Act of 1999

Broker-dealers, among other entities in the financial services industry, will likely be assessing the implications of the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (the Act) on their organizations. The Act, which became effective July 1, 2001, among other matters, eliminated many of the existing barriers (notably the Glass-Steagal Act) that prohibited affiliations among organizations in the financial services industry, such as securities firms, banks, and insurance companies. The Act provided for a financial holding company structure (with the Fed serving as an umbrella regulator). The Act also eliminated the blanket exemption for banks from the definitions of *broker* and *dealer* in the Securities Act of 1933 and replaced it with a series of targeted exceptions for certain bank securities activities. If banks meet the conditions for relying on the various exceptions, they can engage in the activities without registering as brokers and dealers.

The Act may provide opportunities as well as challenges for broker-dealers. For example, to the extent that this legislation allows financial institutions to enter into new lines of business and affiliate with banks or insurance companies, there may also be additional challenges from an increase in competition from other financial services organizations that are similarly expanding their product lines. Auditors should be alert for any changes in the broker-dealer's business, including its products and services, related parties, and changes to applicable regulations that may follow in the wake of the Act.

The Act also requires that financial institutions must provide their customers with a notice of their privacy policies and practices. The Act restricts the disclosure of nonpublic customer information by financial institutions. All financial institutions must provide customers the opportunity to "opt out" of the sharing of the customers' nonpublic information with unaffiliated third parties. See the "Reminder About Privacy Regulations and Safeguarding Information" section of this Alert for a further discussion of this topic.

The Commodities Industry

The volume of futures and options contracts traded bears directly on revenues of commodity brokers. Despite the events of September 11, 2001, the number of contracts traded on U.S. markets was 16 percent greater for the first nine months of 2001 as compared to the same period in 2000. Non-U.S. market volume was up 54 percent in 2001 over the corresponding period in 2000.

During the past year most major commodities exchanges put in place the mechanisms needed to convert from membership-owned organizations to for-profit public companies, although, as of this writing, none have sold shares to the public. Given the current state of the economy and the uncertainty engendered by the attacks of September 11, 2001, the timeline for conversion to public ownership likely has been lengthened.

Traditional outcry trading on commodity exchange floors continues to be challenged by electronic trading platforms. It remains to be seen how these developments will affect the value of exchange memberships and customers served by those exchanges. For a discussion of the audit implications related to the value of exchange memberships, see the “Value of Commodity Exchange Memberships” section of this Alert.

The most significant regulatory development was the adoption, in December 2000, of a new regulatory framework by the Commodity Futures Trading Commission (CFTC). The new framework replaces “one size fits all” regulations with broad flexible core principles. For a discussion of new rules implementing that framework see the “Commodity Futures Trading Commission Regulations” section of this Alert. Further details on the new regulatory framework are available at the CFTC Web site, www.cftc.gov.

The economic viability of financial institutions offering limited products continues to be eroded by accelerating competitive pressures. Additionally, the increasing complexity of financial products and operations that cross regulatory lines, such as security futures contracts, further blur the lines of demarcation between securities and commodities entities. The trend toward cross-industry operations has been encouraged by regulatory actions, such as repeal of the Glass-Steagal Act and cancellation of the 1983 Shad-Johnson Accord between the SEC and the CFTC, now permitting single-stock futures trading.

The CFTC recognized a joint venture futures exchange, OneChicago LLC (formed by the Chicago Board Options Exchange, the Chicago Board of Trade, and the Chicago Mercantile Exchange), for trading futures contracts on single-stocks and narrow-based securities indexes.

More and more, broker-dealers function in areas that are subject to regulation by the CFTC. They may deal in commodity futures and options on futures contracts, or advise and operate entities (such as commodity pools) that do so. To conduct such activities, they must register with the CFTC as futures commission merchants (FCMs), introducing brokers (IBs), commodity pool operators (CPOs), or commodity trading advisers (CTAs), depending on the nature of their activities and operations involving futures and options on futures. The new regulatory framework for the CFTC provides an expedited procedure for such registration. For further information see “Implementing the Commodity Futures Modernization Act… Expedited registration of broker-dealers as FCMs or IBs” in the

"Commodity Futures Trading Commission Regulations" section of this Alert.

Regulatory Issues and Developments[1]

What are some of the recent regulatory developments affecting broker-dealers?

Chapter 5, "Auditing Considerations," of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* discusses auditing considerations for an audit of the financial statements of a broker-dealer. The Guide notes that the regulatory environment of a broker-dealer has a major effect on the audit of a broker-dealer because of the requirements that auditors report on the adequacy of the broker-dealer's internal control and on its compliance with the specific rules addressing financial responsibility and recordkeeping. Accordingly, certain tests of controls are performed even if the auditor might not otherwise do so.

The audit and reporting requirements for securities broker-dealers are regulated by Rule 17a-5 under the Securities Exchange Act of 1934 (Exchange Act). An alternative regulatory framework has been created for over-the-counter derivatives dealers that establishes a special class of broker-dealers who may choose to register with the SEC under a limited regulatory structure. Registered broker-dealers in U.S. government securities are regulated by Section 405.02 of the regulations pursuant to Section 15C of the Exchange Act.

Qualifications and reports of independent accountants of commodity entities are specified by Regulation 1.16 of the Commodity Exchange Act (CEA).

1. Readers should be alert for updates, amendments, or other changes to the rules discussed in this section of the Audit Risk Alert and other recent developments related to regulatory activities. The brief summaries provided in this section of the Alert are for informational purposes only. Readers should refer to the full text of the regulations. The complete text of Securities and Exchange Commission (SEC) final rules, including rules adopted subsequent to the writing of this Alert, can be obtained from the SEC Web site at www.sec.gov. The complete text of Commodity Futures Trading Commission (CFTC) final rules, including rules adopted subsequent to the writing of this Alert, can be obtained from the CFTC Web site at www.cftc.gov. See the "Information Sources" section of this Alert for a list of Internet resources, including some Web sites that can provide additional information on regulatory issues and developments.

Before undertaking the audit of a regulated entity, auditors should read the applicable rules and understand the prescribed scope of the audit and the related reporting requirements.

SEC Regulations

What are some of the final rules issued during the past year by the SEC that may affect broker-dealers?

The following is a summary of some of the rules that the SEC issued during 2001.

- *Integration of abandoned offerings*. In January 2001, the SEC adopted new Rule 155 under the Securities Act of 1933 (Securities Act) to provide safe harbors for a registered offering following an abandoned private offering, or a private offering following an abandoned registered offering, without integrating the registered and private offerings in either case. To facilitate reliance on the public-to-private safe harbor, the SEC amended Securities Act Rule 477 to provide automatic effectiveness for any application to withdraw an entire registration statement before it becomes effective unless the SEC objects within 15 days after the issuer files that application. The SEC amended Rules 429 and 457 to move provisions addressing the offset of filing fees to Rule 457. Rule 457 was also amended to permit filing fees to be offset from withdrawn registration statements and to provide other technical changes to the calculation of filing fees. Effective date: March 31, 2001.

- *Adjustments to civil monetary penalty amounts*. In January 2001, the SEC adopted a final rule that implements the Federal Civil Penalties Inflation Adjustment Act of 1990, as amended by the Debt Collection Improvement Act of 1996, which requires that the SEC adopt a regulation adjusting for inflation the maximum amount of civil monetary penalties under the Securities Act, the Exchange Act, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. Effective date: February 2, 2001.

- *Recordkeeping requirements for transfer agents*. In April 2001, the SEC amended its transfer agent record retention rule, Rule 17Ad-7, under the Exchange Act. The amendments will allow registered transfer agents to use electronic, microfilm, and microfiche records maintenance systems to preserve records that they are required to retain under Rule 17Ad-6. The new requirements apply only to those registered transfer agents that elect to store their records using these methods. Effective date: May 31, 2001.

- *Definition of terms in and specific exemptions for banks, savings associations, and savings banks under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*. In May 2001, the SEC adopted, as interim final rules, new Rules 3a4-2, 3a4-3, 3a4-4, 3a4-5, 3a4-6, 3a5-1, 3b-17, 3b-18, 15a-7, 15a-8, and 15a-9 under the Exchange Act, and amended Rule 30-3 of the SEC's Rules of Organization and Program Management. These new rules clarify the terms of the functional exceptions for banks from the definitions of "broker" and "dealer" and provide additional exemptions, which will aid banks in complying with the provisions of the Gramm-Leach-Bliley Act. Effective date: May 11, 2001.

- *International disclosure standards; correction*. In June 2001, the SEC adopted technical amendments to final rules adopted in Release No. 33-7745. The rules relate to the international disclosure standards on Form 20-F under the Exchange Act and registration statements on Form F-2 and F-3 under the Securities Act. Effective date: Date of publication in the *Federal Register*.

- *Electronic submission of securities transaction information by exchange members, brokers, and dealers*. In June 2001, the SEC adopted Rule 17a-25 under Section 17 of the Exchange Act, to require brokers and dealers to submit electronically to the SEC, upon request, information on customer and firm securities trading. Effective date: 30 days after publication in the *Federal Register*, except Section 240.17a-25(b) which is effective 180 days after publication.

- *Registration of national securities exchanges pursuant to Section 6(g) of the Securities Exchange Act of 1934 and proposed rule changes of certain national securities exchanges and limited purpose national securities associations*. In August 2001, the SEC adopted Rule 6a-4 under the Exchange Act and registration Form 1-N prescribing the requirements for designated contract markets and derivative transaction execution facilities to register as national securities exchanges pursuant to Section 6(g)(1) of the Exchange Act to trade security futures products. The SEC also adopted conforming amendments to Rules 6a-2 and 6a-3 under the Exchange Act and Rule 202.3 of the SEC's procedural rules. In addition, the SEC adopted Rule 19b-7, Form 19b-7, and amendments to Rule 19b-4 and Form 19b-4 to accommodate proposed rule changes submitted by national securities exchanges registered pursuant to Section 6(g) of the Exchange Act and limited purpose national securities associations registered pursuant to Section 15A(k) of the Exchange Act. Effective date: August 20, 2001.
- *Method for determining market capitalization and dollar value of average daily trading volume; application of the definition of narrow-based security index*. In August 2001, the CFTC and the SEC adopted joint final rules to implement new statutory provisions enacted by the Commodity Futures Modernization Act of 2000. See Release No. 34-44724. Effective date: August 21, 2001.
- *Registration of broker-dealers pursuant to Section 15(b)(11) of the Securities Exchange Act of 1934*. In August 2001, the SEC adopted rules to implement certain provisions of the Commodity Futures Modernization Act of 2000 (CFMA). First the SEC amended its broker-dealer registration requirements and adopted a new form to implement Section 203 of the CFMA. Second, the SEC adopted an exemption from registration under Section 15(a) of the Exchange Act. Third, the SEC adopted amendments to Regulation S-P, which was implemented under the Gramm-Leach-Bliley Act. Effective date: date of publication in the *Federal Register*.

- *Books and records requirements for brokers and dealers under the Securities Exchange Act of 1934*. In October 2001, the SEC adopted amendments to its broker-dealer books and records rules. The amendments clarify and expand record-keeping requirements with respect to purchase and sale documents, customer records, associated person records, customer complaints, and certain other matters. In addition, the amendments expand the types of records that broker-dealers must maintain and require broker-dealers to maintain or promptly produce certain records at each office to which those records relate. Effective date: May 2, 2003.

- *Adoption of updated EDGAR Filer Manual*. The SEC adopted revisions to the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) Filer Manual. See Release Nos. 33-7933, 33-7999, and 34-44834.

- *Delegation of authority to the director of the Division of Market Regulation*. The SEC issued several final rules in 2001, amending its rules delegating authority to the Director of the Division of Market Regulation. See Release Nos. 34-44691, 34-44626, 34-44397, 34-44079, and 34-43985.

In addition, final rules that the SEC issued in 2000 since the writing of last year's Audit Risk Alert include the following:

- *Amendments to Rule 9b-1 under the Securities Exchange Act of 1934 relating to the options disclosure document*. In October 2000, the SEC adopted amendments to Rule 9b-1 which governs the filing and dissemination of, and the information to be included in, an options disclosure document. The amendments are adopted to make technical and clarifying changes to the rule to better reflect the disclosure requirements regarding standardized options. Effective date: 30 days after publication in the *Federal Register*.

- *Delivery of proxy statements and information statements to households*. In October 2000, the SEC adopted amendments to Rule 154 under the Securities Act, and Rules 14a-2, 14a-3, 14a-7, 14b-1, 14b-2, 14c-3, and schedules 14A and 14C under the Exchange Act. The amendments permit companies and intermediaries to satisfy the delivery requirements for proxy statements and information statements with respect to two or more security holders sharing the same address by delivering a single proxy statement or information statement to those security holders; modify the rules for householding annual reports; and permit householding of proxy statements combined with prospectuses. Effective date: December 4, 2000, the date on which companies can rely on these rules to begin householding. Companies were permitted to solicit consents to householding prior to the effective date of these rules.

- *Disclosure of order execution and routing practices*. In November 2000, the SEC adopted two rules to improve public disclosure of order execution and routing practices. Under Rule 11Ac1-5, market centers that trade national market system securities are required to make available to the public monthly electronic reports that include uniform statistical measures of execution quality. Under Rule 11Ac1-6, broker-dealers that route customer orders in equity and option securities are required to make publicly available quarterly reports that, among other things, identify the venues to which customer orders are routed for execution. In addition, broker-dealers are required to disclose to customers, on request, the venues to which their individual orders were routed. Effective date: January 30, 2001. Section V in Release No. 34-43590 contains compliance date information. In March 2001, the SEC extended the compliance date for the first phase-in of securities subject to Rule 11Ac1-5 from April 2, 2001, to May 1, 2001.

- *Firm quote and trade-through disclosure rules for options*. In November 2000, the SEC adopted an amendment to Rule 11Ac1-1 under the Exchange Act to require options exchanges and options market makers to publish firm quotes. The SEC also adopted new Rule 11Ac1-7 under the Exchange Act to require a broker-dealer to disclose to its customer when its customer's order for listed options is executed at a price inferior to a better published quote and what that better quote was, unless the transaction was effected on a market that is a participant in an intermarket options linkage plan approved by the SEC. Effective date: February 1, 2001. In March 2001, the SEC extended the compliance date for Rule 11Ac1-7 from April 1, 2001, to October 1, 2001. In September 2001, the SEC further extended the compliance date from October 1, 2001, to April 1, 2002.

- *Adoption of amendments to national market system plan*. In November 2000, the SEC adopted amendments to the Options Price Reporting Authority (OPRA) Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information. The amendments establish a formula, as a short-term solution to OPRA capacity shortages, to allocate the message capacity of the OPRA system among the participant exchanges during peak usage periods. Effective date: January 2, 2001.
- *Regulation of alternative trading systems; extension of temporary stay of effectiveness*. In December 2000, the SEC extended the stay of effectiveness of Rules 301(b)(5)(D) and (E) and 301(b)(6)(i)(D) and (E) until December 1, 2001. These provisions relate to alternative trading systems that trade certain categories of debt securities.

Other Recent SEC Developments

The following is a brief discussion of some other SEC developments that might be of interest to the auditors of securities firms.

SEC Interpretive Release, *Commission Guidance to Broker-Dealers on the Use of Electronic Storage Media under the Electronic Signatures in Global and National Commerce Act of 2000 with Respect to Rule 17a-4(f)*[2]

In June 2001, the SEC issued the Interpretive Release *Commission Guidance to Broker-Dealers on the Use of Electronic Storage Media*

2. The SEC from time to time will provide guidance relating to topics of general interest to the business and investment communities by issuing an "interpretive release," in which it publishes its views on the subject matter and interprets the federal securities laws and its own regulations. The SEC Interpretive Release *Commission Guidance to Broker-Dealers on the Use of Electronic Storage Media under the Electronic Signatures in Global and National Commerce Act of 2000 with Respect to Rule 17a-4(f)* is available on the SEC Web site at www.sec.gov.

under the Electronic Signatures in Global and National Commerce Act of 2000 with Respect to Rule 17a-4(f), providing guidance on the operation of its rule permitting electronic storage of broker-dealer records in light of the recently enacted Electronic Signatures in Global and National Commerce Act of 2000. In particular, this interpretation explains how the electronic storage requirements of Rule 17a-4(f) under the Exchange Act meet, and are consistent with, the requirements of the Electronic Signatures in Global and National Commerce Act. The effective date is date of publication in the *Federal Register*.

SEC Special Studies

Payment for Order Flow and Internalization in the Options Markets. In December 2000, the SEC staff released a special study, *Payment for Order Flow and Internalization in the Options Markets*. The SEC Office of Compliance Inspections and Examinations examined the various payment for order flow and internalization arrangements and analyzed the market quality reviews and order routing practices of 24 order routing firms over the 14-month period from August 1999 to October 2000. The report describes current payment for order flow and internalization practices and outlines how the practices of payment for order flow and internalization have affected order routing decisions and the execution quality of customer options orders. The SEC expects that this report will be helpful in determining whether regulatory action is needed to strengthen price competition and order interaction in the options markets.

Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations. In January 2001, the SEC staff released a special study, *Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations*. The Office of Compliance Inspections and Examinations undertook a review of broker-dealers offering online trading in light of the phenomenal increase in online trading in recent years. The report describes the general findings and observations from the examinations in areas such as disclosure and investor education, advertising, best execution, operational capability, security measures, and employee supervision. The examinations revealed examples of sound practices as well as areas where some broker-dealers can enhance their practices.

The text of these and other SEC staff special studies are available on the SEC Web site at www.sec.gov.

Commodity Futures Trading Commission Regulations

What are some of the rules, proposed rules, and final rules issued by the CFTC during 2001?

The following is a summary of some of the rules proposed and issued by the CFTC during 2001.

Implementing the Commodity Futures Modernization Act. In December 2000, Congress adopted the Commodity Futures Modernization Act (the Act). The Act created a flexible structure for regulation of futures trading, codified an agreement between the CFTC and the SEC repealing the ban on trading single-stock futures, and provided legal certainty for over-the-counter derivatives markets. Significant rule-making efforts were undertaken during 2001, and will continue, to implement the provisions of the Act. Some rules will affect broker-dealers because the Act authorized joint regulation by the CFTC and the SEC of security futures products on individual equity issues and on narrow-based indexes of securities. As of this writing, some final rules have been issued and others are still being considered, significant among which are:

- Trading of security futures products in the U.S. The CFTC and the SEC jointly adopted the first rules to permit trading of security futures products in the U.S., lifting the 19-year ban on trading single-stock and narrow-based stock index futures. The rules were effective August 21, 2001.
- American depository receipts (ADRs). The CFTC and the SEC issued a joint order to permit, under certain circumstances, an ADR to underlie a security future and be a component security of a narrow-based security index underlying a security future. The order was effective August 20, 2001.
- Expedited registration of broker-dealers as FCMs or IBs. The CFTC adopted an order permitting the National Futures As-

sociation to process registration filings for securities broker-dealers that, among other things, limits a broker-dealer's operations as an intermediary for commodity futures and options on futures trades to security futures products. The order was effective September 17, 2001.

- Margin requirements and treatment of customer funds for security futures products. The CFTC and the SEC proposed rules that would govern the collection of customer margin for security futures. The proposed rules address the applicability of CFTC and SEC customer protection, recordkeeping, reporting and bankruptcy rules, and the Securities Investor Protection Act of 1970 to accounts holding security futures products. The comment period for those proposed rules ended on December 5, 2001.

Investment of customer funds by FCMs. The CFTC amended Rule 1.25 to expand the range of instruments in which FCMs and clearing organizations may invest customer funds. The amendments allow such funds to be invested in certain highly liquid and readily marketable instruments (referred to as permitted investments), including certain sovereign debt, agency debt, money market mutual funds, and corporate notes. Except for SEC-regulated money market mutual funds and U.S. Treasury securities, all investments must be highly rated by a nationally recognized (that is SEC-recognized) statistical rating agency. The new rule also provides concentration limitations based on type of issuer and counterparty, for both direct investment and for collateral accepted in connection with repurchase transactions. Previously, investment of customer funds was limited to U.S. government securities, municipal securities, and instruments fully guaranteed by the U.S. government. The amendment was effective December 28, 2000.

Opting out of segregation. The CFTC adopted rules to permit certain customers to opt out of having their funds segregated by an FCM for trades on or through a registered derivatives transaction execution facility. Customers to which the rule applies are generally institutional customers. The rule was effective April 25, 2001.

Help Desk—The complete text of the preceding rules, along with other CFTC final rules, including those rules adopted, or changes made, subsequent to the writing of this Audit Risk Alert, can be downloaded from the CFTC's Web site at www.cftc.gov.

Commodity Futures Trading Commission Annual "Dear CPO" Letter

What are the significant issues raised in the most recent "Dear CPO" letter?

On January 12, 2001, CFTC staff sent a letter to all CPOs, which outlined key reporting issues and common reporting deficiencies found in annual reports for commodity pools. The letter pointed out the CFTC staff's concerns and, accordingly, may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of commodity pools. CFTC staff suggested that CPOs share the letter with their independent auditors.

A major concern is the level of disclosure in the financial statements of pools that invest in other investment companies (funds-of-funds). That topic continued to account for a significant proportion of noncompliance letters issued for 2000 annual reports. A best practices illustration was included with the "Dear CPO" letter. CFTC staff plans to continue its scrutiny of annual reports of funds-of-funds to assure adequate disclosure to investors in such entities.

In order to avoid some of the most common and easily remedied deficiencies (they are discussed in detail in the January 19, 2000, and the February 10, 1999, "Dear CPO" letters), the letter suggested that CPOs do the following:

- File one copy of the report with the National Futures Association (NFA) and two copies with the CFTC at the regional office in whose jurisdiction the CPO's principal place of business is located (the addresses are attached to the letter).
- File the report as soon as possible, but no later than the due date. For pools with a December 31, 2001, year-end, the due date is Monday, April 1, 2002 (unless an extension of time has been granted). CPOs operating a fund-of-funds

pool should review the streamlined procedures described in Regulation 4.22(f)(2) for requesting an extended due date.

- Include a signed oath or affirmation, as required by Regulation 4.22(h), with each and every copy of the report, including those copies filed with NFA and the CFTC. (Binding the oath as part of the report package or attaching it to the cover page is a helpful practice followed by a number of CPOs.)
- If the pool is operating under a Rule 4.7 or 4.12 exemption, the rule requires that a notation of that fact be made on the cover page of the report.
- Report special allocations of partnership equity as required by CFTC Interpretive Letter 94-3, *Special Allocations of Investment Partnership Equity*. (The letter is available at the CFTC Web site: www.cftc.gov/tm/94-03.htm.)
- Include information concerning net asset values or schedules of participants' interests, as required by Regulation 4.22(c)(2).
- Include appropriate footnote disclosures with unaudited financial statements.

Copies of the February 10, 1999, January 19, 2000, and January 12, 2001, "Dear CPO" letters are available at the CFTC Web site, www.cftc.gov/tm/tmcompliance.htm. CFTC staff expects to issue another "Dear CPO" letter in January 2002, which also will be posted on the CFTC Web site.

Self-Regulatory Organization Regulations

What are some of the rules issued during the past year by SROs?

Under the Exchange Act, all broker-dealers are required to be members of self-regulatory organizations (SROs) such as the New York Stock Exchange (NYSE) or NASD, or other organization which performs routine surveillance and monitoring of its members. During the past year, a number of significant regulations were issued by SROs. Among these were the following:

- *SuperMontage*. In January 2001, the SEC approved rule changes requested by NASD, through its wholly-owned subsidiary, the Nasdaq Stock Market, Inc. (Nasdaq), to establish the Nasdaq Order Display Facility and the Order Collector Facility and to modify its primary trading platform, the Nasdaq National Market System. The SuperMontage proposal is designed to modify Nasdaq's systems in three principal areas: quote-order collection, quote-order display, and execution services.

- NYSE Information Memo No. 01-50, SEC *Transaction Fees*. Section 31 of the Exchange Act requires the remittance of a fee to the SEC of 1/300 of 1 percent of the aggregate dollar amount of the sales of securities. The Investor and Capital Markets Relief Act amends Section 31 of the Exchange Act to reduce the fee to $15 per $1 million of the aggregate dollar amount of the sale of securities. Effective date: December 28, 2001.

- NYSE Information Memo No. 01-17, *Reporting Statement of Financial Accounting Standards No. 140—Disclosure on Focus Reports*. This memo discusses how FOCUS Report has been changed to accommodate the reclassification entries required by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Effective date: June 2001.

- NYSE Information Memo No. 01-9, *Amendments to Rule 431 ("Margin Requirements") Regarding "Day Trading."* In February 2001, the SEC approved amendments to Exchange Rule 431 establishing new requirements to address the intraday risks associated with day trading in customer accounts. The amendments require that equity and maintenance margin be deposited and maintained in customer accounts that engage in a pattern of day trading in amounts sufficient to support the risks associated with such trading activities. The minimum equity requirement for pattern day traders is raised to $25,000. Margin requirements will be based on a day trader's activities during the day, rather than on open securities positions at the end of the day. Additionally, the amendments prohibit the use of cross guarantees and early withdrawal of account equity as these practices do not require customers to demonstrate actual financial ability to engage in day trading. Effective date: August 27, 2001.

- NYSE Information Memos Nos. 01-26, 01-35, and 01-39, *Terrorism Executive Order and Updated Listing of the Department of Treasury "Specially Designated Nationals and Blocked Persons."* On September 24, 2001, President Bush issued an Executive Order targeting financial assets of terrorists. The Order added new names to the Department of the Treasury's Office of Foreign Assets Control's (OFAC) list of "Specially Designated Nationals and Blocked Persons". Members and member organizations are reminded that they should routinely monitor the OFAC Web site (http://www.treas.gov/ofac) for updates and additional information.

Audit Issues and Developments

Related-Party Transactions and Fraud

A common thread in many frauds is the use of related parties unknown to the auditor to facilitate management intentionally misstating the financial statements. SAS No. 82 lists the following example risk factors that may involve transactions with related parties:

- Significant related-party transactions not in the ordinary course of business (including transactions with related entities that are unaudited or audited by another firm)
- Unusual or highly complex transactions (particularly those close to year end) that are difficult to assess for substance over form
- Overly complex organizational structure involving numerous or unusual legal entities, lines of authority, or contractual arrangements that do not appear to have a clear business purpose
- Difficulty in determining the individual(s) or organization that controls the company

- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification

Some Audit Procedures

When the auditor becomes aware that a transaction involves a guaranty or similar action by another party to protect the principal from risk of loss, the auditor should seek information about the identity of the guarantor and the nature and extent of the guaranty. Also, any time a principal party to a transaction (such as a seller, buyer, lender, or guarantor) is in a tax-haven jurisdiction, the auditor should consider the risk of undisclosed related-party transactions.

Other procedures that can be performed to identify undisclosed related parties or to investigate potential related-party transactions if the auditor decides to modify his or her procedures based on the consideration of fraud risk factors include the following:

- Review material cash disbursements, advances, and investments to consider whether the client provided funds to a related entity.
- Discuss with tax and consulting personnel who have provided services to the client their knowledge of the client's relationships and knowledge of related parties.
- Discuss with intermediaries (such as lawyers, predecessor auditors, and others providing professional services to the client) their knowledge of the identity of principal parties to material transactions.
- Use sources of information about principal parties to material transactions (such as newspapers, the Internet, and so on) to search for information about key members of management and the company. (For example, the Internet can be used to search for corporation and limited partnership records in which a particular person's name appears.)

Business Combinations

There has been significant merger activity in the securities industry recently, as entities attempt to increase client base, gain access to resources needed to provide their clients financing and investment banking services under one roof, or acquire the knowledge or the infrastructure to keep competitive. As a result, auditors of securities firms face a greater likelihood of dealing with clients that were involved in a business combination in the last year and with clients facing an upcoming business combination. The following is a discussion of some of the issues relating to business combinations that the auditor may be facing.

A business combination, according to FASB Statement No. 141, *Business Combinations*, occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over that entity or entities. The auditing and accounting issues that arise out of corporate business combinations are numerous and varied. Auditors should carefully consider the individual circumstances of the client to identify those issues and to then develop an appropriate audit strategy. Some of the issues that should be considered by auditors include the following.

- Careful consideration should be given to management's accounting for the business combination to ensure that all relevant generally accepted accounting principles have been considered, and all relevant SEC rules and regulations have been considered. All business combinations initiated after June 30, 2001, should be accounted for in accordance with FASB Statement No. 141, using the purchase method. However, for transactions initiated before June 30, 2001, the client may choose to account using the pooling-of-interest method. If the pooling-of-interest method has been used, the auditor needs to ensure that the specific criteria of Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*, have been met. If the purchase method has been used, the auditor should verify that the purchase price has been allocated to the assets (including recognizable intangibles) and liabilities acquired and goodwill properly calculated.[3]

- If specialists have been used in asset or liability valuation, auditors relying on such information should understand their responsibilities when using the work of a specialist, as set forth under SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).

- With a combination comes dramatic change in the structure of an entity. In an effort to create greater cost efficiencies in the consolidated entity, departments may be combined and duplicative functions eliminated. Auditors should consider the impact of such changes on their client's internal control when making the assessment of control risk. SAS No. 55, as amended by SAS No. 78 and SAS No. 94, provides guidance on the auditor's consideration of an entity's internal control in an audit of financial statements in accordance with GAAS.

- Merger may result in the reduction of services provided by a particular entity within the combined organization and significantly reduce its ability to generate future cash flows. In this instance, the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*,[4] may need to be applied.

3. In June 2001, Financial Accounting Standards Board (FASB) issued FASB Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, which changes the accounting for goodwill from an amortization method to an impairment-only approach. Thus, amortization of goodwill, including goodwill recorded in past business combinations, will cease upon adoption of this Statement. The provisions of this Statement are required to be applied starting with fiscal years beginning after December 15, 2001. Early application is permitted for entities with fiscal years beginning after March 15, 2001, provided that the first interim financial statements have not previously been issued.

4. FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, supersedes FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early application encouraged. The provisions of FASB Statement No. 144 generally are to be applied prospectively.

- Business combinations often result in the gain of a client for one auditor and a loss of a client for another. Thus, in the current environment, auditors may be more likely to find themselves in the role of either a predecessor or successor auditor. SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place.

- Mergers and acquisitions may be effected in part through the use of debt financing. Auditors should carefully evaluate the terms of the debt agreement to identify, among other things, whether there are any loan covenants, and if so, the terms. Auditors should evaluate compliance with restrictive covenants and the implications of any loan covenant violations.

- The acquisition of an entity by one party may mean that another party has disposed of a business segment. Accordingly, auditors of the selling party should consider whether management has followed the accounting and disclosure requirements of APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.*[5] Audit risk may be significant for discontinued operations involving an extended phase-out period. Auditors should give careful consideration to management's estimates when the disposal date of the segment occurs after year end. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU

5. FASB Statement No. 144 supersedes the accounting and reporting provisions of Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, for the disposal of a segment of a business. FASB Statement No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early application encouraged. The provisions of Statement No. 144 generally are to be applied prospectively. If FASB Statement No. 144 is effective, its provisions should be followed for the disposal of long-lived assets and discontinued operations.

sec. 342), provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates.

- Subsequent to the business combination, auditors should consider whether management has prepared the financial statements of the combined entity in accordance with appropriate accounting standards, including FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*.

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

Going-Concern Issues

Although larger firms may be able to absorb losses incurred by steep declines in the values of their stock portfolios, smaller and medium-sized firms may not, thus raising possible going-concern issues. Information that raises doubt about the going-concern assumption for brokers-dealers includes (1) failure to meet statutory net capital requirements, (2) noncompliance with various other rules and regulations, and (3) substantial disposition of assets outside the ordinary course of business. Auditors should also consider that changes in key financial ratios caused by the stock market's decline may trigger repayment clauses contained in debt covenants or bank-imposed limits on credit due to the decline in the value of a firm's portfolio. In these circumstances, auditors should consider the guidance set forth under SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341).

Auditor's Responsibilities Related to a Going-Concern Issue

You should be aware of your responsibilities pursuant to SAS No. 59. SAS No. 59 provides guidance to auditors in conducting an audit of financial statements in accordance with GAAS for evaluating whether there is substantial doubt about a client's ability to continue as a going concern for a period not to exceed one year from the date of the financial statements being audited.

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

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

Increased Competition

The increasing competition from megabanks as well as from within the securities industry itself generates more intense pressure on management to perform and meet earnings and revenue expectations. Some specific matters auditors should be concerned with when auditing a client subject to intense pressures include the risk of material misstatement due to fraud, aggressive accounting methods, and internal control weaknesses.

Risk of Material Misstatement Due to Fraud

SAS No. 82 points out the following factors that may indicate an increased risk of fraudulent financial reporting at an entity:

- High degree of competition or market saturation, accompanied by declining margins
- An excessive interest by management in maintaining or increasing the entity's earnings trend through the use of unusually aggressive accounting practices
- Management setting unduly aggressive financial targets and expectations for operating personnel
- Significant pressure to obtain additional capital necessary to stay competitive, considering the financial position of the entity
- Unrealistically aggressive sales or profitability incentive programs

When one or more of these risk factors is identified, professional judgment should be exercised when assessing their significance and relevance. Auditors assessing the risk of material misstatement due to fraud should keep in mind that the presence of a risk factor should not be considered in isolation, but rather in combination with other risk factors and conditions or mitigating circumstances. SAS No. 82 provides guidance to the auditor when considering risk factors in assessing the risk of material misstatement of the financial statements due to fraud.

Aggressive Accounting

To achieve expected results or report improved financial results, management may adopt aggressive accounting positions. Auditors should be alert to aggressive accounting positions taken by management and determine whether the accounting is appropriate under the circumstances.

Overriding Internal Control

Management engaged in a severely competitive environment may aggressively engage in transactions that bypass normal internal control. If auditors determine that there is a risk of this occurring, they will need to take this into account in their consideration of internal control and in their consideration of the nature, timing, and extent of their auditing procedures.

Accounting Estimates

As discussed in Chapter 5, "Auditing Considerations," in the Audit and Accounting Guide *Brokers and Dealers in Securities*, as part of the scope of audit procedures performed, the auditor should be aware that certain areas of an audit of a broker-dealer's financial statements concern management accounting estimates that may be material in the preparation and presentation of the broker-dealer's financial statements. For example, financial statements may reflect reserves for undermargined, undersecured, or partially secured customer receivables, or receivables from other broker-dealers; reserves for exposure for litigation contingencies associated with investment banking underwriting deals; or exchange membership valuation.

An accounting estimate is an approximation of a financial statement element, item, or account. It is the responsibility of the broker-dealer's management to prepare estimates for the financial statements. The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on obtaining and evaluating sufficient, competent evidential matter in support of accounting estimates included in the financial statements.

As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them. Even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors. Accordingly, when planning and performing procedures to evaluate accounting estimates, auditors should consider, with an attitude of professional skepticism, both the subjective and objective factors.

In evaluating the reasonableness of an estimate, auditors normally concentrate on key factors and assumptions that are:

- Significant to the accounting estimate
- Sensitive to variations
- Deviations from historical patterns
- Subjective and susceptible to misstatement and bias

In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. In many situations, the auditor assesses the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate.

In applying SAS No. 57, auditors may wish to consider these additional factors:

- *Stock market volatility*. Auditors may wish to consider the impact of sudden and significant stock market fluctuations on the relevance of key factors and assumptions used by management in estimating the value of a broker-dealer's security portfolio. In the event that the broker-dealer employs matrix pricing (a mathematical technique used to value normal institutionalized debt securities without relying exclusively on quoted securities prices), the auditor should evaluate the relevance of the model's existing underlying assumptions to determine whether they are consistent with recent economic and industry developments.
- *Adoption of new trading strategies*. The declining business environment, competitive forces, and changing global factors

may cause some broker-dealers to adopt new trading strategies that include the use of more speculative, complex, or innovative investments. The adoption of new trading strategies often brings about new valuation procedures that cause factors different from those previously considered by the auditors to become significant to the estimate. Because of the inherent difficulties in valuing such investments, auditors may wish to consider obtaining written representation from management (AU sec. 342.09) and using the work of specialist (SAS No. 73). As stated in SAS No. 73, complex or subjective matters that are potentially material to the financial statements may require special skill or knowledge that, in the auditor's judgment, requires using the work of a specialist to obtain competent evidential matter.

Litigation, Claims, and Assessments

As was mentioned before, this year the securities industry saw an increase in the number of arbitrations and lawsuits. According to the SEC, most of the complaints allege misrepresentations, unauthorized trading, and unsuitable recommendations. As an auditor of a securities firm involved in legal proceedings, you need to evaluate management's consideration of the financial accounting and the reporting implications of those proceedings pursuant to FASB Statement No. 5, *Accounting for Contingencies*. FASB Statement No. 5 addresses the accounting and reporting for loss contingencies, including those arising from litigation, claims, and assessments.

Auditors need to be aware of their responsibilities under SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337). SAS No. 12 provides guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for the financial accounting and reporting for such matters when performing an audit in accordance with generally accepted auditing standards. The SAS provides, in part, that auditors should obtain evidential matter relevant to the following factors:

- The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments
- The period in which the underlying cause for legal action occurred
- The degree of probability of an unfavorable outcome
- The amount or range of potential loss

Because the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge and, often, control of management of an entity, management is the primary source of information about such matters. Accordingly, the independent auditor's procedures with respect to litigation, claims, and assessments should include the following:

- Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel; and obtain assurances from management, ordinarily in writing, that they have disclosed all such matters required to be disclosed by FASB Statement No. 5.
- Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.
- Obtain assurance from management, ordinarily in writing, that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with FASB Statement No. 5. Also the auditor,

with the client's permission, should inform the lawyer that the client has given the auditors this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter.

An auditor ordinarily does not possess legal skills, and therefore cannot make legal judgments concerning information coming to his or her attention. Accordingly, the auditor should request that the client's management send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

The audit normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments. Such procedures might include reading minutes of meetings of stockholders, directors, and appropriate committees; reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents; obtaining information concerning guarantees from bank confirmation forms; and inspecting other documents for possible guarantees by the client.

Value of Commodity Exchange Memberships

During the past year, the value of U.S. commodity exchange memberships continued to fluctuate. Although declines in the value of exchange memberships generally do not affect regulatory net capital (exchange memberships, in most instances, are noncurrent or nonallowable assets excluded from the net capital calculation), such declines continue to raise concerns about the value of such assets reported in financial statements prepared in accordance with generally accepted accounting principles (GAAP).

When addressing valuations of exchange memberships, auditors should evaluate management's consideration of FASB Statement No. 121.[6] FASB Statement No. 121 states, in part, that a significant

6. FASB Statement No. 144 supersedes Statement No. 121 effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early application encouraged. The provisions of Statement No. 144 generally are to be applied prospectively.

decrease in the market value of an asset indicates that the recoverability of the carrying value of that asset should be assessed. It further states that quoted market prices in active markets are the best evidence of fair value and should be used as the basis of measurement, if available. Exchange memberships are bought and sold continuously. Paragraph 7.34 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* states that exchange memberships owned by a broker-dealer and held for operating purposes should be valued at cost or at a lesser amount if there is an other-than-temporary impairment in value. The AICPA Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* describes the same accounting treatment. In light of the volatility in the prices of exchange memberships, the auditor may wish to consider whether management has valued them correctly. Recent membership sales prices are available from each exchange.

Auditors should consider the need to obtain evidence supporting management's assumptions underlying fair value determinations and also consider the need to determine whether appropriate disclosures regarding fair value determinations have been made in the financial statements.

Money Laundering Activities[7]

Money laundering is the funneling of cash or other funds generated from illegal activities, often through legitimate financial institutions or businesses, to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national, or international boundaries. Current estimates of the size of the global annual "gross money laundering product" range from $500 billion to $1.5 trillion.[8]

Criminals use a wide variety of financial institutions and professional advisers to launder the proceeds of crime, and according to the U.S.

7. This section of the Alert was drafted after consultation with the U.S. Department of Treasury.

8. By definition, money launderers are in the business of cloaking their activities and revenue, making this approximation difficult.

Department of the Treasury, brokers and dealers in securities may also be vulnerable. The evolving dynamics of the industry—mergers and acquisitions, broader product lines, new technologies, and new distribution channels—generate important business opportunities, but they also generate risks for securities firms, including increased vulnerability to money laundering. As these industry trends continue, as money launderers increasingly look for a wide range of financial services and conservative, legitimate-appearing asset holdings, and as greater regulatory requirements for banks and other nonbank financial institutions make it more difficult for them to evade detection, the securities industry may become more attractive to money launderers.

Money launderers tend to use the business entity more as a conduit than as a means of directly expropriating assets. For this reason, money laundering is far less likely to affect financial statements than are such types of fraud as misappropriations and consequently is unlikely to be detected in a financial statement audit. In addition, other forms of fraudulent activity usually result in the loss or disappearance of assets or revenue, whereas money laundering involves the manipulation of large quantities of illicit proceeds to distance them from their source quickly and in as undetectable a manner as possible. However, money laundering activities may have indirect effects on an entity's financial statements.

Money laundering is considered to be an illegal act and independent auditors have a responsibility under SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), to be aware of the possibility that illegal acts may have occurred, indirectly affecting amounts recorded in an entity's financial statements. In addition, if specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect (for example, the entity's contingent liability resulting from illegal acts committed as part of the money laundering process) on the entity's financial statements, the auditor should apply auditing procedures specifically designed to ascertain whether an illegal act has occurred.

Auditors should also note that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication of cases.

Possible indications of money laundering include the following:

- Transactions that appear inconsistent with a customer's known legitimate business or personal activities or means; unusual deviations from normal account and transaction patterns.
- Situations in which it is difficult to confirm a person's identity.
- Unauthorized or improperly recorded transactions; inadequate audit trails.
- Unconventionally large currency transactions, particularly in exchange for negotiable instruments or for the direct purchase of funds transfer services.
- Apparent structuring of currency and negotiable instrument transactions to avoid identification requirements, regulatory recordkeeping, and reporting thresholds (such as transactions in amounts less than $10,000).
- Businesses seeking investment management services when the source of funds is difficult to pinpoint or appears inconsistent with the customer's means or expected behavior.
- Uncharacteristically premature redemption of investment vehicles, particularly with requests to remit proceeds to apparently unrelated third parties.
- The purchase of large cash value investments, soon followed by heavy borrowing against them.
- Large lump-sum payments from abroad.
- Purchases of goods and currency at prices significantly below or above market.
- Use of many different firms of auditors and advisers for associated entities and businesses.
- Forming companies or trusts that appear to have no reasonable business purpose.

In June 2000, the Organization for Economic Cooperation and Development (OECD)'s Paris-based Financial Action Task Force (FATF), the world's anti-money-laundering watchdog intergovernmental organization, issued a *Review to Identify Non-Cooperative Countries or Territories*, expressly identifying 15 governments as noncooperative with other countries and jurisdictions in combating money laundering. Subsequently, in July, the U.S. Treasury Department followed suit with a series of Financial Crimes Enforcement Network (FinCEN) country advisories, which asked U.S. businesses to pay closer attention to transactions linked to these countries. During 2001, several of these jurisdictions were removed from the noncooperative lists and new ones added.

Reminder About Privacy Regulations and Safeguarding Information

Financial institutions had to comply with the provisions of the Gramm-Leach-Bliley Act that protect the privacy of consumers' nonpublic personal information on July 1, 2001. The new regulation on the privacy of consumers' financial information:

- Requires a financial institution to provide notice to customers about its privacy policies and practices
- Describes under what conditions a financial institution may disclose nonpublic personal information about consumers to nonaffiliated third parties
- Provides an "opt out" method for consumers to prevent the financial institution from disclosing that information to nonaffiliated third parties

Protected Information

Under the regulation, restrictions on sharing information with nonaffiliated third parties apply to "nonpublic personal information" about a consumer. Nonpublic personal information is "personally identifiable financial information" that is provided by a consumer to a financial institution, that results from any transaction with or service performed for the consumer, or that is otherwise obtained by the financial institution.

The regulation excludes “publicly available information” from the definition of nonpublic personal information. Publicly available information is any information that an institution has a reasonable basis to believe is lawfully made available to the general public from government records, widely distributed media, or disclosures to the public required to be made by federal, state, or local law.

Privacy Policy Notice

Under the regulation, financial institutions must provide a clear and conspicuous notice that accurately reflects their privacy policies and practices. The notice must be given to any individual who becomes a customer of the financial institution by the time the customer relationship is established, and annually thereafter as long as the relationship continues. Also, the notice must be given to any consumer who does not become a customer before nonpublic personal information about the consumer may be shared with nonaffiliated third parties.

Opt-Out Requirement

Before an institution can share nonpublic personal information with nonaffiliated third parties, consumers must be given a reasonable opportunity to opt out from having that information shared. The opt-out notice must be given to:

- Customers as a part of the initial notice of the financial institution’s privacy policies and practices, or before sharing nonpublic personal information about them with nonaffiliated third parties.
- Individual consumers who do not become customers of the financial institution, and former customers, before nonpublic personal information about them may be shared with nonaffiliated third parties.

The regulation does provide certain exceptions that permit a financial institution to share nonpublic information with third parties without providing privacy or opt-out notices. These exceptions include disclosures of nonpublic personal information made:

- In connection with certain processing and servicing transactions
- With the consent of or at the direction of the consumer
- To protect against potential fraud or unauthorized transactions
- To respond to judicial process

Disclosures to independent auditors in connection with the audit process are also exempted. This includes any peer review of CPA firms. It is less clear whether the exemptions also cover work done by consultants not in conjunction with the audit.

Audit Implications

The auditor should obtain appropriate representations from management that the institution has taken steps to ensure compliance with legal or regulatory requirements. Noncompliance could result in significant financial and reputational risk to the institution.

AICPA 2001 Audit and Accounting Guide *Brokers and Dealers in Securities*

AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, with conforming changes as of May 1, 2001 (the Guide), has been updated to reflect the issuance of recently issued authoritative pronouncements. The Guide is available through the AICPA's looseleaf subscription service. Paperback editions of Audit and Accounting Guides as they appear in the service are printed annually.

> **Help Desk**—Copies of the Guide may be obtained by calling the AICPA Order Department (Member Satisfaction) at (888) 777-7077 or faxing a request to (800) 362-5066.

New Auditing and Attestation Pronouncements and Other Guidance

Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 94	*The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*
SAS No. 95	*Generally Accepted Auditing Standards*
SAS No. 96	*Audit Documentation*
SOP 01-3	*Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*
SOP 01-4	*Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards*
SSAE No. 10	*Attestation Standards: Revision and Recodification*
SSAE No. 11	*Attest Documentation*
Audit Guide	*Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*
Audit Guide	*Auditing Revenue in Certain Industries*
Audit Guide	*Audit Sampling*
Audit Guide	*Analytical Procedures*
Audit Interpretation No. 1 of SAS No. 73	"The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board No. 140"
Practice Alert No. 01-1	*Common Peer Review Recommendations*
Practice Alert No. 01-2	*Audit Considerations in Times of Economic Uncertainty*

The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 95, *Generally Accepted Auditing Standards*

This new SAS (AICPA, *Professional Standards*, vol. 1, AU sec. 150) creates a hierarchy of generally accepted auditing standards. The SAS:

- Identifies the body of auditing literature
- Clarifies the authority of auditing publications issued by the AICPA and others
- Specifies which auditing publications the auditor must comply with and which ones the auditor must consider when conducting an audit in accordance with GAAS
- Identifies specific AICPA auditing publications and provides information on how to obtain them

SAS No. 96, *Audit Documentation*

This new SAS replaces SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), and amends several other SASs. It presents revised guidance regarding the objective, nature, and extent of documentation required for compliance with SASs.

Statement on Standards for Attestation Engagements No. 11, *Attest Documentation*

This new SSAE is being issued concurrently with the new SAS on audit documentation and presents revised guidance regarding the objective, nature, and extent of documentation required for compliance with SSAEs.

New Accounting Pronouncements and Other Guidance[9]

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For infor-

9. Readers should refer to the full text of the accounting pronouncements that are discussed in this section of the Audit Risk Alert. Readers should also be alert for updates to the topics discussed in this section of the Alert, and for other recent FASB and SEC developments. Further information related to FASB projects can be obtained from the FASB Web site at www.fasb.org. Further information related to SEC rules and releases can be obtained from the SEC Web site at www.sec.gov

mation on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 141	*Business Combinations*
FASB Statement No. 142	*Goodwill and Other Intangible Assets*
FASB Statement No. 143	*Accounting for Asset Retirement Obligations*
FASB Statement No. 144	*Accounting for the Impairment or Disposal of Long-Lived Assets*
FASB Technical Bulletin No. 01-1	*Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*
SOP 00-3	*Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*
SOP 01-1	*Amendment to Scope of Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools*
SOP 01-2	*Accounting and Reporting by Health and Welfare Benefit Plans*
AICPA Audit and Accounting Guide	*Audits of Investment Companies*
Questions and Answers	*FASB Statement No. 140*
AICPA Practice Aid	*Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries* (expected to be issued in December 2001)

The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. 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.

FASB Technical Bulletin No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*

FASB Technical Bulletin No. 01-1 defers until 2002 application of the isolation standards of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, as clarified in FASB staff guidance published in April 2001 (see below), to banks and certain other financial institutions. Those institutions also will be allowed up to five years of additional transition time for transfers of assets to certain securitization master trusts. That additional transition time applies only if all beneficial interests issued to investors after July 23, 2001, permit the changes in structure necessary to comply with those isolation standards.

Questions and Answers About FASB Statement No. 140

The FASB published a special report on February 15, 2001, which addresses the most frequently asked questions about FASB Statement No. 140. On April 19, 2001, the FASB staff published a set of questions and answers about isolation of financial assets transferred by banks and other entities, focusing on rights of redemption. Finally, on August 7, 2001, the FASB staff published a set of questions and answers about the limitations on the activities of a qualifying special-purpose entity set forth in paragraphs 35 through 44 of FASB Statement No. 140.

Statement of Position 01-1, *Amendment to Scope of Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools*

Issued by AICPA's Accounting Standards Executive Committee (AcSEC), this Statement of Position (SOP) is effective for financial statements issued for periods ending after December 15, 2001, with earlier application encouraged. The SOP repealed the exemption from complying with SOP 95-2 applicable to investment partnerships that are commodity pools subject to regulation under the Commodity Exchange Act of 1974. Such entities are now required, among other things, to include a schedule of investments in their financial statements formatted in accordance with the SOP.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that may be relevant to your engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing 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 a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline.

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

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

New Framework for the Audit Process

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

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

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to assessment of the risk of material misstatement of the financial statements. Among other things, this will improve the auditor's assessment of inherent risk and eliminate the "default" to assess inherent risk at the maximum.
- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit.
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls.
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures.

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

In connection with this major initiative, the ASB and the International Auditing Practices Committee (IAPC) have agreed to form a joint task force to develop a joint standard addressing the risk assessment process. This standard will represent a significant step towards converging U.S. and international auditing standards. The standard produced by this joint task force will form the basis for the ASB's overall project.

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

New Fraud Standard to Be Proposed

The ASB is revising SAS No. 82 to address recommendations and findings of:

- The Public Oversight Board's (POB's) Panel on Audit Effectiveness regarding earnings management and fraud
- The ASB's Fraud Standard Steering Task Force
- Academic research on the effectiveness of SAS No. 82
- Other financial reporting stakeholders

The following areas have been identified for possible proposals for standard-setting changes and enhancements. Remember that these areas are only early considerations in the process. The guidance on fraud that the ASB eventually issues may not address these areas or may address other areas.

- *Fraud risk factors*. A consideration of whether additional risk factors should be added (or any deleted) from SAS No. 82, whether the risk factors should be re-categorized, and whether the risk factors should be weighted in some manner.
- *Additional substantive procedures*. A consideration of the POB Panel recommendation to require the performance of "forensic" procedures.
- *Other POB Panel recommendations*. A consideration of recommendations dealing with supervisory discussions, nonstandard journal entries, retrospective procedures, and interim procedures.
- *Corporate governance*. An exploration of requirements that would help assure an auditor understanding of the extent of focus by management and the audit committee on the risk of fraud, including added auditor communication with management and the audit committee.

- *Incorporating a technology focus.* Responding to recommendations of the ASB's Computer Audit Subcommittee related to SAS No. 82 and otherwise incorporating into the standard more focus on the current technological environment.

An exposure draft of a new fraud SAS is expected to be issued in the Spring of 2002.

Resource Central

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

On the Bookshelf

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

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk)
- Audit Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012551kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques—2001* (product no. 009893kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Practice Aid *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (product no. 008883kk)
- Audit Risk Alert *E-Business Industry Developments—2001/02* (product no. 022277kk)

AICPA Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools*

The AICPA Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* (product no. 006600kk) provides practitioners with nonauthoritative practical guidance on auditing financial statements of FCMs, IBs, and commodity pools. Organized to complement the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, this Practice Aid includes discussions of a commodity industry overview, regulatory considerations, auditing considerations, and accounting standards, in addition to illustrative financial statements of FCMs and IBs.

Audit and Accounting Manual

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

CD-ROM

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

Educational Courses

The AICPA has developed a number of continuing professional education courses that are valuable to CPAs working in public practice and industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Workshop* (product no. 737061kk (text) and 187078kk (video)). Whether you are in industry or public practice, this course keeps you current, informed, and shows you how to apply the most recent standards.

- *SFAS 133: Derivative and Hedge Accounting* (product no. 735180kk). This course helps you understand GAAP for derivatives and hedging activities. Also, you will learn how to identify effective and ineffective hedges.
- *Independence* (product no. 739035kk). This interactive CD-ROM course will review the AICPA authoritative literature covering independence standards (including the newly issued SECPS independence requirements), SEC regulations on independence, and Independence Standards Board (ISB) standards.
- *SEC Reporting* (product no. 736745kk). This course will help the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.
- *Internal Control Implications in a Computer Environment* (product no. 730617kk). This practical course analyzes the effects of electronic technology on internal controls and provides a comprehensive examination of selected computer environments, from traditional mainframes to popular personal computer set-ups.
- *E-Commerce: Controls and Audit* (product no. 731550kk). This course is a comprehensive overview of the world of e-commerce. Topics covered include internal control evaluation and audit procedures necessary for evaluating business-to-consumer and business-to-business transactions.

Online CPE

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

CPE CD-ROM

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

National Securities Industry Conference

Each year the AICPA cosponsors with the Financial Management Division of the Securities Industry Association a National Conference on the Securities Industry that is specifically designed to update auditors and securities industry financial executives on significant accounting, legal, financial, and tax developments affecting the securities industry. Information on the conference may be obtained by calling the AICPA CPE Conference Hotline at (888) 777-7077 or visiting the AICPA Web site at www.aicpa.org.

Member Satisfaction Center

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

Hotlines

Accounting and Auditing Technical Hotline

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

Ethics Hotline

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

Web Sites

AICPA Online

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

CPA2Biz.com

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

Some features cpa2biz provides or will provide include:

- Online access to AICPA products including Audit and Accounting Guides and Audit Risk Alerts
- News feeds each user can customize
- CPA "communities"
- Online CPE
- Web site development and hosting
- Electronic procurement tools to buy goods and services online
- Electronic recruitment tools to attract potential employees online
- Links to a wider variety of professional literature
- Advanced professional research tools

Other Helpful Web Sites

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

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This Audit Risk Alert replaces *Securities Industry Developments—2000/01*. The *Securities Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share those with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to ymishkevich@aicpa.org, or write to:

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INFORMATION SOURCES

Organization	*Web Site, Address, Telephone*
American Institute of Certified Public Accountants	www.aicpa.org Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 Telephone: (888) 777-7077
Financial Accounting Standards Board	www.fasb.org Order Department: 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Telephone: (203) 847-0700
Financial Crimes Enforcement Network (FinCEN)	www.treas.gov/fincen
U.S. Securities and Exchange Commission	www.sec.gov Publications Unit: 450 Fifth Street, NW Washington, DC 20549-0001 Telephone: (202) 942-4040 Public Reference Room: Telephone: (202) 942-8090 (202) 942-8092 (tty)
Securities Industry Association	www.sia.com 120 Broadway, 35th floor New York, NY 10271-0080 Telephone: (212) 608-1500
New York Stock Exchange, Inc.	www.nyse.com Eleven Wall Street New York, NY 10005 Telephone: (212) 656-3000

Organization	*Web Site, Address, Telephone*
National Association of Securities Dealers, Inc.	www.nasd.com 1735 K Street, NW Washington, DC 20006-1500 Telephone: (202) 728-8000
The Bond Market Association	www.bondmarkets.com 40 Broad Street New York, NY 10004 Telephone: (212) 440-9400
Commodity Futures Trading Commission	www.cftc.gov Three Lafayette Center 1155 21st Street, NW Washington, DC 20581 Division of Trading and Markets: Telephone: (202) 418-5430
Futures Industry Association	www.futuresindustry.org 2001 Pennsylvania Avenue, NW Suite 600 Washington, DC 20006 Telephone: (202) 466-5460
National Futures Association	www.nfa.futures.org 200 West Madison Street Chicago, IL 60606 Information Center: Telephone: (800) 621-3570

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