2002

Securities industry developments - 2002/03

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Securities Industry Developments—2002/03

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.

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

The AICPA staff is grateful to Robert A. Flaum, Richard C. Flowers, Andrew Labadie, and the Commodity Futures Trading Commission regulatory staff for their assistance and contributions to this Audit Risk Alert.

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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

Securities Industry Developments—2002/03

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 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—2002/03* (product no. 022333kk).

Economic and Industry Developments

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

Weak Recovery and an Uncertain Future

The economic word of the day for 2001 was "uncertain" and it still holds true for 2002. The current mix of opposing trends—solid demand, but no strong pickup in jobs—stems partly from the nature of this business cycle. In other words, mild recoveries tend to follow mild recessions. The U.S. economy stands stuck between a double-dip recession and a robust economic expansion.

Growth in gross domestic product (GDP) soared in the first quarter of 2002 to an annual average of 5 percent but then fell back to an alarming growth rate of 1.3 percent. In the third quarter, GDP grew at a 3.1 percent annual rate, stimulated by increased car sales. Economists estimate that GDP will grow at a rate of less than 2 percent in the fourth quarter. The historical average for economic growth at this stage of the recovery is in excess of 5 percent.

In November 2002, the Federal Reserve Board lowered the federal funds rate to 1.25 percent, its lowest level in 41 years. Corporate earnings reports through the first three quarters of 2002 were weak in many sectors. Consumer confidence also showed signs of weakening. Unemployment has barely changed since last year and it stood at 5.7 percent in October of 2002, significantly up from 3.9 percent two years earlier. Economists believe that the economy needs to start growing at a faster rate before unemployment can decline.

Stock Market Woes

Through the first three quarters of 2002, the downward slide of the Dow Jones Industrial Average (DJIA), the National Association of Securities Dealers Automated Quotation (NASDAQ) Composite Index, and the Standard & Poor's 500 stock index (S&P 500) that began in 2000 continued. The volatility in the stock markets, concerns over possible military action in Iraq, corporate scandals, and fears that the recovery will not last have sapped investor confidence, prompting investors to reconsider their investment strategies. In July 2002, for the first time in 15 years, investors pulled more money out of stock mutual funds than they put in during the preceding year. This negative trend continued for the rest of the summer. Throughout the year analysts were evaluating economic conditions and drastic declines in stock market indexes—comparing them to prior periods and trying to decide if we had finally reached rock bottom. But the stock market kept surprising us all by further declining and sending various indexes to their record lows. On October 9, 2002, the DJIA finished at 7286.27, its lowest close in nearly five years; the NASDAQ ended at 1114.11, its lowest level in more than six years; while the S&P 500 fell to 776.76, its lowest finish in more than five years. All of these indicators are significantly below the panic levels following the events of September 11, which investors thought were the lowest they would ever see. The stock market began an upward climb during the fall, resulting in a 10.6 percent gain in the DJIA in the month of October, its strongest monthly gain since 1987.

The currency markets, too, have experienced nail-biting dips. Like stocks, the dollar was hit hard by the forecasts of weak growth. The dollar went into a nosedive against the euro, sinking 18 percent from mid-January to mid-July 2002. In the third quarter of 2002, however, the dollar rebounded and strengthened.

The year 2002 was another bad one for the securities industry. With a declining stock market and business dwindling in such profitable areas as stock and bond underwriting and mergers and acquisitions, investment bank earnings for the first three quarters of 2002 were significantly lower than last year. The economists do not foresee a turnaround until at least 2003. And even then nobody expects the activity levels to reach those of the late 1990s.

Aftermath of September 11

More than a year after the terrorist attacks of September 11, 2001, the financial industry is still dealing with the consequences. Out of 2,820 people dead or missing in New York City, more than 40 percent worked in the financial services sector. The industry that relies heavily on personal relationships lost a number of professionals who have been hard to replace. Some of the affected firms, in an attempt to restore some normalcy to their operations, rushed to fill vacancies. In a number of cases, people were elevated to high ranks without proper managerial experience. As an auditor of a securities firm that had to replace a significant portion of its staff, you need to consider the effect of new personnel on your client's internal control system. 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).

In the year since September 11 a number of securities firms left downtown Manhattan and moved their offices elsewhere. For some companies the move was necessary because their facilities were damaged or destroyed by the attacks. Others realized the need to disperse their operations to ensure business continuity in case of another disaster. One of the lessons learned after September 11 was the inappropriateness of concentrating people and operations in a small geographic area. The New York Stock Exchange (NYSE) soon will be divided into two separate locations—the existing one on Wall Street and another one somewhere within New York State. As you prepare to conduct audits of firms that relocated some or all of their operations, you must gain an understanding of this new environment in order to adequately plan and perform the audit.

Business Continuity Addressed by Regulators

The issue of business continuity was also addressed by various regulatory agencies this year. In August 2002, the Securities and Exchange Commission (SEC) together with the Federal Reserve and the Treasury Department (the agencies) issued for comment a *Draft Interagency White Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System*. After consideration of the comments received, the agencies intend to issue a final version of the white paper and to incorporate these sound practices into supervisory expectations or other forms of guidance. This white paper discusses business continuity objectives that have special importance after September 11 and their scope of application; the agencies' preliminary conclusions with respect to key factors affecting the resilience of critical markets and activities in the U.S. financial system; sound practices to strengthen financial system resilience; and an appropriate timetable for implementing these sound practices. Under the new plan, if adopted, securities firms might have to move their backup facilities as far as 200 or 300 miles away from their primary sites. The plan also states that the firms need to have sufficient trained staff located at or near the backup site to resume critical operations within a few hours of a disaster. The sound practices apply most directly to “core clearing and settlement organizations” and “financial institutions that play significant roles in critical markets.” Critical markets are defined as the markets for federal funds, foreign exchange, commercial paper, and government, corporate, and mortgage-backed securities. The critics of the plan say that the cost of setting up and staffing remote backup facilities would be too high for some firms to handle. Comments on the draft white paper were due by October 21, 2002.

Also in August, the NASD and the NYSE filed with the SEC proposed rule changes relating to business continuity plans. The proposed rule changes will require members to develop and maintain business continuity plans that establish procedures to be followed in the event of an emergency or significant business disruption. Members will be required to make such plans available to the NASD and/or NYSE (whichever organization is their designated examining authority with respect to financial and operational issues) upon request. Members will also be required to conduct an annual review of their business continuity and contingency plans to determine whether any modifications are necessary in light of changes to the member’s operations, structure, business, or location.

Recently the Securities Industry Association (SIA) published its *Best Practices Guidelines for Business Continuity*. According to the SIA, the best practices outline what securities firms should include in their own efforts to ensure that, in the event of an emergency, they can either continue operating or reestablish operations with minimal disruption to their business.

Compliance System

Recent high-profile broker fraud cases put a spotlight on Wall Street firms’ compliance practices. The general purpose of a compliance function within a securities firm is to review the activities of the sales departments and branch office operations. A recent case deserves some special attention. For 15 years a star broker, who recently pleaded guilty to a number of charges including misusing more than $50 million of investors' money, was making unauthorized transfers from customer accounts. To cover up his activities, he diverted clients' brokerage-account statements to post office boxes he controlled or third-party addresses and then sent his clients forged statements inflating the value of their holdings. What is special about this case is that the two securities firms where this broker was employed during this 15-year period did not discover his fraudulent activities until January 2002, when the perpetrator himself sent a letter to the Federal Bureau of Investigation describing in detail how he was able to execute his scam for so long. This case underscores a number of fundamental problems with the way some Wall Street firms monitor their brokers, especially top-producing ones.

One of the reasons why that broker's activities were never discovered by the compliance departments in both firms is that this broker, who was a branch manager, helped supervise the top compliance executive in his office. Experts say that despite the apparent conflict of interest, it is a common practice in the securities industry for compliance personnel to be subordinate to and report to branch managers whose activities they are supposed to be policing. Some firms responded to the this incident by prohibiting their branch managers from being active brokers and requiring them to focus more on supervising brokers in their offices.

Another issue raised by this case is the hesitancy on the part of some securities firms to supervise their top-producing brokers. Compliance officials are afraid that these high performers may find any scrutiny to be offensive and leave, taking their clients and the significant assets they control along with them. There were a number of red flags in the case described above which should have tipped off compliance personnel that something was going on. Industry experts say one of the circumstances that should have been questioned was the disproportionate amount of commissions the broker appeared to have earned from his clients' asset base. In 1999 the broker generated almost $6 million of commissions on client assets of just slightly over $100 million while the industry average for commissions that year was below $500,000.

Another issue that should have been addressed by compliance officials was the presence of the broker's personal computer on his desk despite the fact that it was against the firm's policy. Investigators allege that the broker used his personal computer to falsify client account statements. Mailing customer statements and confirmations to a post office box is a fundamental concern of any basic compliance program. Industry experts also question whether the broker's activities could have been discovered earlier had his employers called his customers to check on his performance. Instead of making phone calls, some companies prefer to send out letters to customers along with account statements to verify that the firm's information matches the clients' records. Securities firms routinely use such spot-checks as part of their compliance procedures. It is unclear if either of the securities firms ever called any of the broker's clients, but some of the clients claim they never received such calls.

After this case came to light, Wall Street's compliance became the center of attention of a congressional hearing. The SEC, NYSE, and the regulatory arm of the National Association of Securities Dealers (NASD) launched a joint "examination" of compliance practices in the securities industry. Recently, the NYSE proposed new rules to strengthen the internal controls at the branch offices of securities firms. The NASD is expected to come up with a similar proposal.

The aforementioned case highlighted a number of weaknesses in the compliance and internal control systems of some securities firms. As an auditor of a broker or dealer in securities (broker-dealer), you are required by the SEC to issue a report on your client's internal control describing any material inadequacies found to exist or to have existed since the date of the previous audit. Refer to SEC Rule 17a-5 and SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), for more guidance on reports on internal control. Also be aware that failure on the part of securities firms to supervise their employees opens them up to significant legal exposure. As an auditor of a securities firm, you need to consider the impact of litigation on your client's financial statements. See the "Litigation, Claims, and Assessments" section of this Alert for a further discussion of this topic. For a discussion of an auditor's responsibility with respect to fraud, see the "Fraudulent Financial Reporting" section of this Alert.

Research Analysts

Research analysts attracted a lot of attention in 2002. Analysts were questioned by Congress about their failure to foresee the collapse of Enron despite the presence of numerous red flags. According to the data released by the Senate Governmental Affairs Committee, 10 out of 15 analysts following Enron were still promoting the stock to their clients weeks after the SEC started probing Enron's financial condition.

Numerous Investigations Into Conflicts of Interest

The New York attorney general inquired into a major securities firm's research practices, generating more bad publicity for the securities industry. The attorney general alleged that the securities firm's research analysts issued bullish recommendations on certain Internet stocks while privately criticizing the same stocks. He argued that the firm's analysts were not independent and their ratings were influenced by the desire of their employer to win investment-banking business. To settle the case, the securities firm agreed to pay a $100 million penalty and agreed to a number of changes to separate research from investment banking and to enhance disclosures in its research reports of multiple relationships with stock issuers.

Having won a settlement in that case, the attorney general turned his attention to the research practices of other major securities firms. The latest focus of his investigation is on the work of a former star telecom analyst and his former firm. Among other things, the attorney general is investigating the telecom analyst's dual role of helping his former employer win investment-banking business from top telecom companies while also actively promoting stocks of those companies to individual investors in his research reports. Recently the attorney general expanded his probe to determine if the telecom analyst's superiors had any influence on his stock recommendations, indicating company-wide conflicts of interest.

Moreover, the NASD charged the telecom analyst and his former employer with improper action connected to his research on a communications company. The regulators allege that the analyst misled investors by maintaining a bullish recommendation on the company, an investment-banking client of his employer, up until a couple of days before the communications company filed for bankruptcy, despite numerous factors pointing to the company's deteriorating condition.

Having spent months dealing with allegations of conflicts of interest involving overly optimistic research analysts, industry regulators had to switch gears and investigate an analyst accused of going too far in trying to obtain information for his research report. In October 2002, the NASD imposed sanctions on a health-care analyst for trying to enroll into a clinical drug trial to find out about the drug's side effects and the progress of the trial. Based on the information the analyst was able to obtain, he published a research report telling his clients to sell the stock, thus causing a significant decline in the stock price. As it turned out, his report was inaccurate. The securities firm where the analyst had worked was also sanctioned for having inadequate training and written supervisory procedures for its research department.

Regulators Take Action on Conflicts of Interest

In April 2002, the SEC commenced a formal inquiry into market practices concerning research analysts and the potential conflicts that can arise from the relationship between research and investment banking. The inquiry will be conducted jointly with the NYSE, the NASD, the New York attorney general, the North American Securities Administrators Association (NASAA), and the state regulators. The inquiry will help determine the necessity of additional rulemaking and whether any laws have been violated.

In May, the SEC approved proposed changes to the rules of the NASD and the NYSE to address conflicts of interest that are raised when research analysts recommend securities in public communications. See the "Self-Regulatory Organization Regulations” section of this Alert for more information on the new rules. Also, the NYSE board of directors recently approved additional proposed rule changes requiring “further separation of analysts from investment banking activities.”

In August, the SEC proposed a rule entitled *Regulation Analyst Certification*. The proposed regulation would require that any research report disseminated by a broker or dealer include certifications by the research analyst that the views expressed in the research report accurately reflect the analyst’s personal views, and state whether the analyst received compensation or other payments in connection with his or her specific recommendations or views. A research analyst would also be required to provide certifications and disclosures in connection with public appearances.

In October 2002, the SEC, the New York State Attorney General’s Office, the NYSE, the NASD, and the NASAA announced a joint effort to bring to a speedy and coordinated conclusion the various investigations concerning analyst research and initial public offering (IPO) allocations. (See the “Initial Public Offering Practices” section below for more information on the issue of IPO allocations.) The participating regulatory entities will attempt to formulate a common plan to address conflict-of-interest and other issues pertaining to research analysts and IPO allocations. This plan will then be used as a template to structure appropriate settlements with the companies that are currently under investigation and to provide a sound basis for proposing industry-wide rules and regulations (including structural reforms) that will be used to govern in these areas.

Analyst conflicts of interest were also addressed in the landmark Sarbanes-Oxley Act of 2002. Section 501 of the new law requires the SEC, or industry regulators with the authorization and direction of the SEC, to adopt rules designed to address conflicts of interest in order to improve the objectivity of research and provide investors with more useful and reliable information and rules requiring disclosures of conflicts of interest.

Possible Litigation

In addition to being the focus of attention of various regulatory agencies concerning their research practices, brokerage firms face a number of class action suits and individual arbitration claims filed against them citing recommendations of their analysts. Legal experts believe that the activities of federal and state regulators regarding research analysts will benefit individual investors and make it easier for them to recover money lost on technology stocks from the securities firms. Legal proceedings are hurting investment banks' profitability by forcing them to pay significant amounts of money in legal fees and settlements. As an auditor of a securities firm, you need to consider the impact of litigation on your client's financial statements. See the "Litigation, Claims, and Assessments" section of this Alert for a further discussion of this topic.

Initial Public Offering Practices

Wall Street's IPO practices were another area that was heavily scrutinized by regulators in 2002. In January, following a 10-month investigation, the NASD and the SEC fined a major firm $100 million for extracting tens of millions of dollars from customers in inflated commissions that amounted to a "profit sharing" arrangement for allocations of "hot" IPOs, according to the NASD. During the tech boom, when IPOs almost always increased in value right after they started trading and, as a result, were hard to get, the firm allocated IPO stocks to customers who agreed to share their IPO profits with the firm in the form of excessive commissions on transactions unrelated to the IPO. The NASD found that such quid pro quo agreements violated a number of its rules, including the rules prohibiting brokers from sharing in the profits of client accounts and requiring brokerage firms to adhere to just and equitable principles of trade.

The New York attorney general, Congress, and the NASD are investigating another major firm's IPO practices. Based on the evidence available so far, it appears that during the telecom boom this firm allocated numerous shares of hot IPOs to personal brokerage accounts of telecom executives at below-market prices. If investigators determine this was done in the hopes of winning investment-banking business from the executives' companies, this practice, known as "spinning," can be found to be in violation of the NASD's Free-Riding Rule. According to the NASD, the purpose of the Free-Riding Rule is to protect the integrity of the public offering system by ensuring that shares are sold to the general public and that broker-dealers do not withhold the securities for their own benefit or use them to reward persons who are in a position to direct future business to the broker-dealer.

Securities firms were also accused of inducing investors who wanted IPO shares to purchase additional shares of the same stocks in the aftermarket in an attempt to drive up prices of those shares, a practice known as "laddering."

There were several lawsuits filed against brokerage firms charging that the firms profited illegally from IPOs by intentionally underpricing the shares in hopes of later on sharing profits generated by the stocks with clients who received the coveted IPO shares.

New Regulatory Actions

To address these alleged improprieties, in July the NASD proposed a set of new rules governing allocation of IPOs that would ban such practices as spinning, laddering, and quid pro quo agreements. These proposed rules have been released for public comment and will require SEC approval. In October, the NASD and the NYSE named the IPO Advisory Committee to review the IPO process. Based on the findings of the Committee, the two self-regulatory organizations intend to make rule proposals and other recommendations to the SEC. Also in October, the SEC along with other industry regulators announced a joint effort to bring to a fast conclusion the various investigations concerning analyst research and IPO allocations. (See the previous section "Research Analysts" for more information on this initiative.)

Regulatory actions and litigations discussed above may have significant adverse financial consequences for a broker-dealer as well as damage the firm's reputation and growth prospects. In the worst-case scenario, noncompliance with regulations may even lead to the suspension or revocation of a broker-dealer's registration. As an auditor of a securities firm, you need to consider the impact of litigation and new regulation on your client's financial statements. See the "Litigation, Claims, and Assessments" section of this Alert for a further discussion of this topic.

Enron

Enron Corp.'s collapse in 2001 turned out to be much more than the second largest bankruptcy in U.S. history. This scandal brought to light numerous conflicts of interest inherent in the business model of major Wall Street firms. Securities firms served in many conflicting capacities in their dealings with Enron. They acted as lenders, advisers, and underwriters for Enron while also managing assets for the energy company, its executives, and investors. Investigators in the Enron case recently switched their attention from accountants to financial institutions and the role they played in the rise and fall of the company. Congress, the SEC, and the Justice Department are questioning three of the largest U.S. financial firms about financing they provided to Enron. The investigators are examining whether the firms helped Enron artificially increase its earnings by structuring transactions in a way that allowed the energy concern to disguise loans as trades and hide debts in special-purpose entities.

In addition to the investigations, Wall Street firms that did business with Enron face lawsuits filed by the company's shareholders and employees accusing them of participating in a scheme with the energy company to defraud shareholders and creditors. There were also several lawsuits filed alleging that broker-dealers promoted Enron securities to the public even when as lenders they were or should have been aware of the true state of the company's finances and that it was about to collapse.

More Regulatory Action Coming

To boost investor confidence in the U.S. financial system following the collapse of Enron, the board of directors of the NASDAQ Stock Market, Inc. in July 2002 approved more than 25 new corporate governance reform proposals designed to increase accountability and transparency for the benefit of investors. Pending approval by the NASD board, they will be forwarded to the SEC for final approval. Shortly thereafter, on August 1, the NYSE board of directors ratified a sweeping set of proposals for its listed companies with respect to corporate governance. These proposals focus on giving boards greater independence and investors greater say in the governance of their companies. The American Stock Exchange (AMEX) board of governors formally approved enhanced rules that will increase disclosure requirements, strengthen board oversight and audit committee responsibility, and provide for increased shareholder rights for its listed companies. The measures will be presented to the SEC for review and approval.

Legislators are considering the need for more regulation. Section 705 of the Sarbanes-Oxley Act of 2002 requires the Comptroller General to conduct a study on whether investment banks and financial advisers assisted public companies in manipulating their earnings and obfuscating their true financial condition. Among other things, the study will address the role financial institutions played in the collapse of Enron. Upon the completion of the study, the Comptroller General will issue a report discussing regulatory or legislative steps that are recommended or that may be necessary to address concerns identified in the study.

Broker-dealers operate in a highly regulated industry that requires close attention to compliance matters. As an auditor of a broker-dealer, you need to stay alert to regulatory and legislative developments to ensure your client's compliance with the regulations.

Stock Options

As the rash of accounting scandals has put the spotlight on companies' financial statements, the accounting treatment of stock options has also come under scrutiny. Until now, just a few companies elected to account for stock options by using the fair value based method defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, which requires companies to recognize an expense for the fair value of the options granted in arriving at reported earnings. Most companies used the intrinsic value based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, which requires companies to recognize compensation cost based on the difference, if any, between the quoted market price of the stock and the amount an employee must pay to acquire the stock. Most fixed stock option plans have no intrinsic value at grant date, and under APB Opinion No. 25 no compensation cost is recognized for them. Throughout 2002, a number of major U.S. companies from various industries announced their intentions to change their accounting policies for stock options and to begin expensing them as early as 2003. In August 2002, the members of the Financial Services Forum, a group of top executives from 21 of the largest U.S. financial firms, decided to join these companies. At this point, most of the major securities firms have announced their decision to start expensing stock options.

The FASB decided to undertake a limited scope project to reconsider the transition and disclosure provisions of FASB Statement No. 123 to provide guidance to companies that are voluntarily adopting a fair value based method. In October 2002 the FASB issued an exposure draft of a proposed Statement, *Accounting for Stock-Based Compensation—Transition and Disclosure*, that would amend FASB Statement No. 123. The proposed Statement *would not* require companies to adopt the fair value recognition provisions of FASB Statement No. 123. It would provide optional transition methods for those companies that decide to voluntarily adopt the fair value recognition principles of Statement No. 123 and would modify the disclosure requirements of that Statement. The final Statement is expected to be issued by the end of 2002.

The international community is addressing the stock-based compensation issue as well. The International Accounting Standards Board (IASB) concluded its deliberations on the accounting for share-based payments, including employee stock options. It announced plans to issue a proposal for public comment in the fourth quarter of 2002. The proposal would require companies using IASB standards to recognize, beginning in 2004, the fair value of employee stock options granted as an expense in arriving at reported earnings. While there are some important differences between the methodologies in the IASB proposal and those contained in the proposed amendment to FASB Statement No. 123, the fundamental approach is the same—fair value measurement of employee stock options granted with expense recognition over the vesting period of the options.

The debate to expense or not to expense stock options continues. As an auditor of a securities firm which uses stock options as a method of compensation, you need to stay on top of these developments. See the "Expensing Stock Options" section of the AICPA general *Audit Risk Alert—2002/03* for more information.

Layoffs

To compensate for the drastic slowdown in merger-and-acquisition (M&A) activity and IPOs—traditionally the biggest sources of revenue for the securities industry—Wall Street firms had to find ways to cut costs to sustain their profitability. Big payrolls, which represent the largest expense for the securities industry, were a number one target. During 2001 securities firms made major cuts which affected mostly lower-level employees. In 2002 the firms were forced to let go some of their higher ranks. According to the SIA, securities firms have eliminated a total of 32,287 jobs, or 8.8 percent of their work force, since the end of 2000. An effort on the part of the regulators to separate research from investment banking is likely to lead to further reductions in staffing levels.

As an auditor of a securities firm that went through layoffs, you need to consider the effects of layoffs on your client's internal control as well as ensure that employee-related termination charges were properly accounted for. Depending upon the breadth and the handling of the layoffs, key people and key controls may be missing and a firm's employees may be significantly demoralized; as such the foundation of financial reporting may be compromised. Auditors will need to be alert and use common sense to discern the quality of the firm's operational practices and environment and the impact upon the reliability of the firm's financial records. See "Employee Layoffs" in the "Audit and Accounting Issues and

Developments" section of this Alert for a detailed discussion of this topic.

Increased Competition

The securities industry was hurt in 2002 by a dramatic slowdown in the IPO market and M&A activity. In the third quarter, there were only seven IPOs by U.S. companies, the lowest number since the first quarter of 1980. The volume of U.S. equity and equity-linked securities issuance declined by 43 percent in the same quarter. The value of U.S. merger deals also fell 42 percent from the third quarter of 2001 to the same period in 2002. With so few deals up for grabs the securities firms compete fiercely for business.

In addition to that, broker-dealers are facing increased competition from commercial banks. The biggest threat comes from megabanks which hope to lure customers away from traditional brokerages and investment banks by offering all kinds of financial services under one roof. To compete, investment banks are offering various types of financing to their clients, including credit lines, hoping the clients will not walk away and take the investment banking deals with them. In some cases, your broker-dealer clients may resort to unethical practices to retain and attract clients, such as providing loans in exchange for lucrative investment-banking business. In September 2002 the NASD advised its members that "the practice of tying commercial loans to investment-banking business violates federal statutes and NASD's rule requiring its members to adhere to just and equitable principles of trade."[1] It is important for broker-dealers to comply with regulatory requirements since noncompliance may result in fines or even the suspension or revocation of the broker-dealer's registration. See the "Pressure on Management to Perform " section of this Alert for a discussion of some additional issues auditors should be concerned with when auditing a client operating in a highly competitive environment.

1. National Association of Securities Dealers (NASD) News Release, *NASD Advises Securities Firms on Tying Arrangements*, September 19, 2002.

Going-Concern Issues

According to the SIA, it looks like the securities industry's profits for 2002 will hit the lowest level in seven or eight years. The continuous stock market decline and the mounting pressures from regulators are putting the securities industry to the test. Amid the multiple investigations into research and IPO practices of Wall Street firms and the poor economic outlook, ratings agencies warned they may lower the credit ratings of several major securities firms. If this happens, it will significantly raise the costs of conducting operations by making debt financing more expensive and less available as well as forcing the firms to pledge higher collateral to conduct their derivatives trading. Although larger firms may be able to absorb the higher cost, some smaller and medium-sized firms may not, thus raising possible going-concern issues.

A recent study conducted by Weiss Ratings Inc. indicated a weakness in auditors' ability to spot and disclose potential bankruptcies. Auditors issued unqualified opinions for nearly half the public companies that filed for bankruptcy during the 18-month period ending June 30, 2002. If an auditor fails to raise the issue of going-concern for a client that files for bankruptcy within a year from the date of the audit, the auditor is most likely to face litigation from his or her client's creditors and investors. Creditors in bankruptcy and bankruptcy trustees pursue all viable sources of recovery and often view a civil claim against an insured third-party professional service provider (auditors) as the only reliable source of recovery when there are no significant assets to be liquidated. With that in mind you should be especially careful when evaluating your client's ability to continue as a going concern for another year. See "Going-Concern Issues" in the "Audit and Accounting Issues and Developments" section of this Alert for guidance on evaluating whether there is substantial doubt about a client's ability to continue as a going concern.

Money Laundering

After the events of September 11, government officials have been increasingly concerned about the vulnerability of the securities industry to money laundering activities. On October 26, 2001, President Bush signed into law the "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot) Act of 2001." This law was intended to strengthen our nation's ability to combat terrorism and prevent and detect money laundering activities in all financial institutions. Broad authority to develop anti-money laundering regulations applicable to each of the various segments of the financial services industry was delegated to the Treasury Department (Treasury). "Money Laundering Activities" in the "Audit and Accounting Issues and Developments" section of this Alert provides an explanation of what money laundering is and how it can affect your client as well as your audit. It also discusses new anti-money laundering rules that were issued this year by the Treasury along with the SEC, CFTC, and other regulatory agencies.

The Commodities Industry

The Commodity Futures Trading Commission (CFTC or Commission) is an independent federal agency responsible for regulating commodity futures and options markets in the United States. The mission of the CFTC is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity futures and options and to foster open, competitive, and financially sound commodity futures and option markets. As part of this process, brokers and individuals who handle customer funds or give trading advice must apply for registration through the National Futures Association (NFA), a self-regulatory organization approved by the Commission as a registered futures association.

Commodity exchanges complement federal regulation with rules of their own—rules covering clearance of trades, trade orders and records, position limits, price limits, disciplinary actions, floor trading practices, and standards of business conduct. The CFTC also regularly reviews NFA's and each exchange's programs for ensuring member compliance with financial and other rules.

Futures and Options Business Doing Well

Judging by the first eight months of 2002, futures and options exchanges are on their way to another record year in terms of global trading volume. More than 3.8 billion listed derivatives contracts changed hands worldwide from January through August, an increase of 42.6 percent over the same period in 2001. Should this upward trend continue for the remainder of the year, it bodes well for futures commission merchants (FCMs), because the volume of futures and options contracts traded bears directly on their revenues.

In general, trading activity was driven by continued uncertainty about interest rates and exceptionally high volatility in equity markets, as well as a shift in the energy markets from over-the-counter (OTC) markets to exchanges. Equity index products showed very strong growth in all regions.

In August 2002, the SEC and the CFTC approved final rules for trading single-stock futures. Futures exchanges hope that this will lead to an increase in business. As a possible harbinger of that happening, single-stock futures trading on foreign exchanges soared 180 percent higher in the first eight months of 2002 over the comparable 2001 period.

Although most major commodities exchanges have in place the mechanisms needed to convert from membership-owned organizations to for-profit public companies, at the time of writing this Alert, none have offered shares to the public. It should be noted that the major stock exchanges have deferred their planned offerings as well.

Traditional open 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.

Regulatory Issues and Developments[2]

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 OTC 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).

2. 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" table at the end 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 2002.

- *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.* See the "Commodity Futures Trading Commission Regulations" section of this Alert for a detailed discussion of this regulation.

- *Confirmation Requirements for Transactions of Security Futures Products Effected in Futures Accounts*. In September 2002, in accordance with the Commodity Futures Modernization Act (CFMA), the SEC adopted rule amendments and a new rule under the Exchange Act which are designed to clarify the disclosures broker-dealers effecting transactions in security futures products in futures accounts must make in the confirmations sent to customers regarding those transactions. The amendments provide that broker-dealers effecting transactions in security futures products in futures accounts do not have to disclose all of the information required by the SEC's confirmation disclosure rule, but rather require that the transaction confirmations for these accounts disclose specific information and notify customers that certain additional information will be available upon written request. The new rule also exempts broker-dealers effecting transactions for customers in security futures products in a futures account from the disclosure requirements of Exchange Act Section 11(d)(2). Effective date: October 15, 2002. Compliance dates: October 15, 2002, and June 1, 2003.

- *Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports*. In September 2002, the SEC adopted amendments to its rules and forms to accelerate the filing of quarterly and annual reports under the Exchange Act by domestic reporting companies that have a public float of at least $75 million, that have been subject to the Exchange Act's reporting requirements for at least 12 calendar months, and that previously have filed at least one annual report. The changes for these accelerated filers will be phased in over three years. The annual report deadline will remain 90 days for year one and change from 90 days to 75 days for year two and from 75 days to 60 days for year three and thereafter. The quarterly report deadline will remain 45 days for year one and change from 45 days to 40 days for year two and from 40 days to 35 days for year three and thereafter. The phase-in period will begin for accelerated filers with fiscal years ending on or after December 15, 2002. The SEC also adopted amendments to require accelerated filers to disclose in their annual reports where investors can obtain access to their filings, including whether the company provides access to its Forms 10-K, 10-Q, and 8-K reports on its Internet Web site free of charge, as soon as reasonably practicable after those reports are electronically filed with or furnished to the SEC. Effective date: 60 days after publication in the *Federal Register*. See Release No. 33-8128 for compliance date information.

- *Certification of Disclosure in Companies' Quarterly and Annual Reports*. In August 2002, the SEC adopted rules, as directed by Section 302(a) of the Sarbanes-Oxley Act of 2002, to require an issuer's principal executive and financial officers each to certify the financial and other information contained in the issuer's quarterly and annual reports. The rules also require these officers to certify that they are responsible for establishing, maintaining, and regularly evaluating the effectiveness of the issuer's internal controls; they have made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and they have included information in the issuer's quarterly and annual reports about their evaluation and whether there have been significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation. In addition, the SEC adopted previously proposed rules to require issuers to maintain, and regularly evaluate the effectiveness of, disclosure controls and procedures designed to ensure that the information required in reports filed under the Exchange Act is recorded, processed, summarized, and reported on a timely basis. Effective date: August 29, 2002.

- *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*. In August 2002, the SEC adopted rule and form amendments to implement the accelerated filing deadline applicable to change of beneficial ownership reports required to be filed by officers, directors, and principal security holders under Section 16(a) of the Exchange Act, as amended by the Sarbanes-Oxley Act of 2002. The amendments are intended to facilitate the statutory changes, which became effective August 29, 2002, consistent with their purpose. Effective date: August 29, 2002.

- *Customer Margin Rules Relating to Security Futures*. See the "Commodity Futures Trading Commission Regulations" section of this Alert for a detailed discussion of this regulation.

- *Assessments on Security Futures Transactions and Fees on Sales of Securities Resulting from Physical Settlement of Security Futures Pursuant to Section 31 of the Exchange Act*. In July 2002, the SEC adopted an amendment to a rule under the Exchange Act to clarify how to calculate assessments that are required to be paid by national securities exchanges and national securities associations pursuant to Section 31(d) of the Exchange Act for security futures transactions. In addition, the amendment provides guidance on how to calculate fees that are required to be paid by national securities exchanges and national securities associations pursuant to Sections 31(b) and (c) of the Exchange Act, respectively, for sales of securities that result from the physical settlement of security futures. Effective date: August 12, 2002.

- *Technical Amendments to Rules and Forms Due to the National Securities Markets Improvement Act of 1996 and the Gramm-Leach-Bliley Act*. In June 2002, the SEC adopted technical amendments to rules and forms under the Investment Company Act of 1940 (Investment Company Act) and the Exchange Act. The amendments correct statutory references currently included in the rules and the forms. Effective date: July 8, 2002.

- *Cash Settlement and Regulatory Halt Requirements for Security Futures Products*. See the “Commodity Futures Trading Commission Regulations” section of this Alert for a discussion of this rule.

- *Mandated EDGAR Filing for Foreign Issuers*. In May 2002, the SEC adopted amendments to the rules that govern its electronic data gathering, analysis, and retrieval (EDGAR) system. These amendments require foreign private issuers and foreign governments to file electronically through the EDGAR system most of their securities documents, including registration statements under the Securities Act of 1933 (Securities Act) and registration statements, reports, and other documents under the Exchange Act. The SEC also adopted rule amendments to clarify when an electronic or paper filer may submit an English summary instead of an English translation of a foreign language document. The SEC further eliminated the current requirement that any first-time EDGAR filer, domestic or foreign, submit a paper copy of its electronic filing to the Commission. Finally, the SEC permitted a national securities exchange to file voluntarily on EDGAR a Form 25, which reports the delisting of a class of a company’s securities. Effective date: November 4, 2002, except for Sections 232.101(d), 232.101(b)(10), and 232.101(c)(9), which are effective May 24, 2002.

- *Amendment to Definition of "Equity Security."* The CFMA amended the definition of "security" in the Securities Act and the definitions of "security" and "equity security" in the Exchange Act to include a security future. In April 2002, the SEC amended the definitions of "equity security" in the rules under the Securities Act and the Exchange Act to conform them to the statutory definitions with respect to security futures. Effective date: June 7, 2002.

- *Exemption of Transactions in Certain Options and Futures on Security Indexes from Section 31 of the Exchange Act*. In January 2002, the SEC, by rule, exempted two classes of securities from the fee and assessment requirements of Section 31 of the Exchange Act: options on narrow-based security indexes and futures on narrow-based security indexes. In light of the very low amount of Section 31 fees currently collected on options on narrow-based security indexes, the SEC granted the exemption for options on such indexes to relieve certain national securities exchanges of the burden of having to calculate whether an index is narrow-based or broad-based. The SEC granted the exemption for futures on narrow-based security indexes to promote a level playing field between options and futures. Effective date: February 1, 2002.

- *Amendments to Rule 31-1, Securities Transactions Exempt From Transaction Fees*. In January 2002, the SEC amended the rule that provides an exemption from Section 31(c) of the Exchange Act for OTC transactions in OTC securities that are subject to unlisted trading privileges on a national securities exchange. One subparagraph of the rule has become obsolete and unnecessary due to the enactment of H.R. 1088, the Investor and Capital Markets Fee Relief Act. Effective date: January 16, 2002.

In addition, final rules that the SEC issued in 2001 since the writing of last year's Audit Risk Alert include the following:

- *Options Disclosure Document*. In December 2001, the SEC adopted a revision to a rule under the Securities Act to clarify that an options disclosure document prepared in accordance with the SEC rules under the Exchange Act is not a prospectus and is not subject to civil liability under Section 12(a)(2) of the Securities Act. This amendment codifies a long-standing interpretive position taken by the Division of Corporation Finance soon after the SEC adopted the current registration and disclosure system applicable to standardized options in 1982. The SEC codified this position to reduce the legal uncertainty regarding the liability issue. Effective date: February 1, 2002.

- *Disclosure of Equity Compensation Plan Information*. In December 2001, the SEC adopted amendments to the Exchange Act disclosure requirements applicable to annual reports filed on Forms 10-K and 10-KSB and to proxy and information statements. The amendments are intended to enhance disclosure of the number of outstanding options, warrants, and rights granted by registrants to participants in equity compensation plans, as well as the number of securities remaining available for future issuance under these plans. The amendments require registrants to provide this information separately for equity compensation plans that have not been approved by their security holders, and to file with the SEC copies of these plans unless immaterial in amount of significance. Effective date: 30 days after publication in the *Federal Register*. Compliance dates: Registrants must comply with the new disclosure requirements for their annual reports on Form 10-K or 10-KSB to be filed for fiscal years ending on or after March 15, 2002, and for proxy and information statements for meetings of, or action by, security holders occurring on or after June 15, 2002. Registrants voluntarily may comply with the new disclosure requirements before the compliance dates.

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 on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules thereunder to Trading in Security Futures Products*[3]

In June 2002, the SEC published its views regarding the application of certain provisions of the federal securities laws to trading in security futures products. On December 21, 2000, Congress enacted the Commodity Futures Modernization Act (CFMA), addressing the regulation of security futures products. Security futures products are securities for purposes of the federal securities laws, including the Securities Act and the Exchange Act, and are "futures" for purposes of the Commodity Exchange Act (CEA). Because these products are both securities and futures, the CFMA established a framework for the joint regulation of these products by the SEC and the CFTC. Security futures products must be traded on trading facilities and through intermediaries that are registered with both the SEC and the CFTC. Given this new regulatory framework, various industry participants have requested guidance regarding the application of certain provisions of the federal securities laws to trading in security futures products. The guidance is effective June 27, 2002.

Other SEC Information

SEC Section 31 Fees. SEC Section 31 fees are collected from customers and remitted to the SEC through NASD and national securities exchanges, such as the NYSE and the AMEX, or are directly charged to brokers as part of their Securities Industry Automation Corporation (SIAC) daily settlement. Due principally to rounding differences, clients may be charged a higher fee than is submitted to either the regulators or to the SIAC. This difference has grown over the last few years and the SEC is now re-

3. 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.

questing the brokers to pay this overage directly to the SEC as opposed to allocating it back to customers.

Variable Annuities. Suitability of variable annuities is a major focus of regulators who are concerned that investors do not fully understand the complexities of this product. The SEC is examining firms selling variable annuities to ensure that all features of this product are properly explained to customers. The fees associated with this product, the potential costs to investors due to paying for the life insurance benefit, and the tax consequences of the product need to be communicated to the investor. In addition, the surrender charges are not well known and investors should be alert to these consequences. NASD Regulation (NASDR) also focused on the issue of suitability of variable annuities. NASDR recently brought several enforcement actions against firms for the improper marketing and sale of variable annuities. Rule 2310(a) of the NASD Conduct Rules provides that "in recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, described by such customer as to his other security holdings and as to his financial situation and needs." Rule 2310(b) imposes upon a broker the duty to make reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives and other relevant information in making a recommendation to a customer. In various notices to members, the NASD has reminded members that they are subject to suitability requirements in connection with the sale of variable products and provided suitability guidelines for the sale of variable annuities and variable life products.

Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934. The SEC has commenced an investigation to ascertain facts, conditions, practices, and other matters relating to the financial statements and accounting practices of certain large publicly traded companies. As part of this investigation, in June the SEC issued an order requiring written statements, under oath, from senior officers of certain publicly traded companies (the companies) with revenues during their last fiscal year of greater than $1.2 billion that file reports with the SEC pursuant to the Exchange Act, regarding the accuracy of their companies' financial statements and their consultation with the companies' audit committees. Effective date: August 14, 2002.

Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations. In January 2002, the SEC issued a statement regarding Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A). The release sets forth certain views of the SEC regarding disclosure that should be considered by registrants. Disclosure matters addressed by the release are liquidity and capital resources including off-balance sheet arrangements; certain trading activities that include non-exchange traded contracts accounted for at fair value; and effects of transactions with related and certain other parties. In November 2002, the SEC proposed a new rule, *Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments*, which would require disclosure of off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of an issuer with unconsolidated entities or other persons that have, or may have, a material effect on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources. The new disclosure would be located in the MD&A section in a company's disclosure documents. The proposals would require a registrant to provide, in a separately captioned subsection of MD&A, a comprehensive explanation of its off-balance sheet arrangements. The proposals also would require a registrant (other than small business issuers) to provide an overview of its aggregate contractual obligations in a tabular format and contingent liabilities and commitments in either a textual or tabular format.

Cautionary Advice Regarding Disclosure About Critical Accounting Policies. In December 2001 the SEC issued a statement regarding the selection and disclosure by public companies of critical accounting policies and practices. The purpose of this statement is to alert companies to the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation. The SEC encourages public companies to include in their MD&A full explanations, in plain English, of their "critical accounting policies," the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. The objective of this disclosure is consistent with the objective of MD&A.

In May 2002, the SEC proposed a new rule, *Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies*, which would encompass disclosure in two areas: accounting estimates a company makes in applying its accounting policies and the initial adoption by a company of an accounting policy that has a material impact on its financial presentation. Under the first part of the proposals, a company would have to identify the accounting estimates reflected in its financial statements that required it to make assumptions about matters that were highly uncertain at the time of estimation. Disclosure about those estimates would then be required if different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the company's financial condition, changes in financial condition, or results of operations. A company's disclosure about these critical accounting estimates would include a discussion of the methodology and assumptions underlying them; the effect the accounting estimates have on the company's financial presentation; and the effect of changes in the estimates. Under the second part of the proposals, a company that has initially adopted an accounting policy with a material impact would have to disclose information that includes what gave rise to the initial adoption; the impact of the adoption; the accounting principle adopted and method of applying it; and the choices it had among accounting principles. Companies would place all of the new disclosure in the MD&A section of their annual reports, registration statements, and proxy and information statements. In addition, in the MD&A section of their quarterly reports, U.S. companies would have to update the information regarding their critical accounting estimates to disclose material changes.

Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases. The SEC issued a statement regarding the use by public companies of pro forma financial information in earnings releases. The purpose of this statement is to caution public companies on their use of pro forma financial information and to alert investors to the potential dangers of such information. The SEC staff is concerned that pro forma financial information, under certain circumstances, can mislead investors if it obscures generally accepted accounting principles (GAAP) results. Because this pro forma financial information by its very nature departs from traditional accounting conventions, its use can make it hard for investors to compare an issuer's financial information with other reporting periods and with other companies. In November 2002, the SEC proposed a new rule entitled *Conditions for Use of Non-GAAP Financial Measures* to address public companies' disclosure or release of certain financial information that is derived on the basis of methodologies other than in accordance with GAAP. The SEC is proposing a new disclosure regulation, Regulation G, which would require public companies that disclose or release these non-GAAP financial measures to include, in that disclosure or release, a presentation of the most comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most comparable GAAP financial measure. The SEC is also proposing to amend Item 10 of Regulation S-K and Item 10 of Regulation S-B to provide additional guidance to those registrants that include non-GAAP financial measures in Commission filings. Additionally, the SEC is proposing to amend Form 20-F to incorporate the proposed amendments to Item 10 of Regulation S-K. Finally, the SEC is proposing to require registrants to file on Form 8-K earnings releases or similar announcements, with those filings subject to the guidance in amended Item 10 of Regulation S-K and Item 10 of Regulation S-B.

Help Desk—The text of these and other SEC releases is available on the SEC Web site at www.sec.gov.

Commodity Futures Trading Commission Regulations

The following is a summary of some of the rulemakings and orders issued by the Commodity Futures Trading Commission (CFTC or the Commission) during 2002.

Implementing the Commodity Futures Modernization Act

The Commodity Futures Modernization Act (CFMA), which became law on December 21, 2000, establishes a framework for the joint regulation of the trading of futures contracts on single securities and on narrow-based security indexes (collectively "security futures") by the CFTC and the SEC. Previously, security futures were statutorily prohibited from trading in the United States. Several rulemakings and orders were issued during 2002 to address the trading of security futures. A summary of some of these rulemakings and orders is set forth below:

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 CFMA directs the CFTC and SEC to address certain duplicative or conflicting regulations to any firm that is fully registered both as a futures commission merchant (FCM) with the CFTC and a securities broker-dealer (BD) with the SEC. There are approximately 90 such firms. The principal area where this was an issue is the protection of customer funds. In the futures industry, segregation of customer funds from an FCM's proprietary funds is required; the securities regime requires account insurance that is administered by the Securities Investor Protection Corporation (SIPC).

The CFTC and SEC adopted final rules in this area on September 9, 2002. For the firms that are fully registered as both FCMs and BDs, in the first instance it is their choice as to whether security futures products (SFPs) will be held in futures or securities accounts. These firms may also permit some or all of their customers to make that election. Futures accounts will be protected by the segregation of funds framework, and securities accounts will be entitled to SIPC coverage. These firms must also establish written policies concerning how SFPs will be held.

All firms that are involved in SFP transactions, even those that are not dually registered with both the CFTC or SEC, must disclose to SFP customers the protections provided by segregation and by SIPC regulatory frameworks, the regulatory framework that is applicable to customer accounts, and the fact that the alternative regulatory framework is not applicable. For FCMs that do not register as full BDs with the SEC, only segregation is available; a BD that does not fully register as an FCM with the CFTC may only provide SIPC coverage.

This regulation became effective September 13, 2002, except for section 240.17a-4(l) and (m) which becomes effective May 2, 2003.

Customer Margin Rules Relating to Security Futures. As part of the statutory scheme for the regulation of security futures, the CFMA provided for the issuance of rules governing customer margin for transactions in security futures. Specifically, the CFMA directed the Federal Reserve Board to prescribe rules establishing initial and maintenance customer margin requirements. Pursuant to joint authority delegated by the Federal Reserve Board, in August 2002 the CFTC and SEC issued customer margin rules that became effective September 13, 2002.

The CFMA provides that the customer margin requirements for security futures must satisfy four requirements. First, they must preserve the financial integrity of markets trading security futures products. Second, they must prevent systemic risk. Third, they must be consistent with the margin requirements for comparable exchange-traded security options, and provide for initial and maintenance margin levels that are not lower than the lowest level of margin, exclusive of premium, required for comparable exchange-traded security options. Fourth, they must be and remain consistent with the margin requirements established by the Federal Reserve Board under Regulation T (which governs the initial margin requirements for all securities other than exempted securities and security futures products).

The customer margin rules for security futures, among other things:

1. Establish minimum initial and maintenance margin levels for outright positions in security futures at 20 percent of their "current market value," as defined in the rules.
2. Permit exchanges to set margin levels lower than 20 percent of current market value for customers with certain strategy-based offset positions involving security futures and one or more related securities or futures.
3. Establish stand-alone requirements that are consistent with Regulation T, but, unlike the proposed rules, do not apply Regulation T in its entirety to futures accounts.
4. Identify the types of collateral acceptable as margin deposits and establish standards for the valuation of such collateral and other components of equity.
5. Set forth procedures applicable to undermargined accounts.

Prior to commencing trading, exchanges must obtain the SEC's approval for exchange rules governing margin for security futures. They also must either certify to the CFTC that the rules do not violate the Commodity Exchange Act or CFTC rules, or obtain the CFTC's prior approval for the rules.

Cash Settlement and Regulatory Halt Requirements for Security Futures Products. In May 2002, the CFTC and the SEC (the Commissions) adopted a new rule generally to require that the final settlement price for each cash-settled security futures product fairly reflect the opening price of the underlying security or securities, and that trading in any security futures product halt when a regulatory halt is instituted with respect to a security or securities underlying the security futures product by the national securities exchange or national securities association listing the security. The rule would set forth more specifically how the exchange's or association's rules can satisfy provisions added to the Commodity Exchange Act (CEA) and the Exchange Act by the CFMA. The Commissions also issued an interpretation of the statutory requirement under the CEA and the Exchange Act that procedures be put in place for coordinated surveillance among the markets trading security futures products and any market trading any security underlying the security futures products or any related security. Effective date: June 24, 2002.

Additional Rulemakings and Orders Issued During 2002

Denomination of Customer Funds and the Location of Depositories. On August 7, 2002, the Commission published in the *Federal Register* a proposed new rule that would permit FCMs and derivative clearing organizations (DCOs), under certain conditions, to deposit customer funds in foreign depositories and in certain currencies other than U.S. dollars. Specifically, the proposal would provide that FCM obligations owed to customers may be held in: (1) U.S. dollars; (2) in a currency in which funds were deposited by the customer, or converted at the request of the customer, to the extent of such deposits and conversions; or (3) in a currency in which funds have accrued to the customer as a result of trading on a designated contract market. Additionally, the rule would permit an FCM or DCO to hold customer funds of any denomination in the U.S. or any money center country (defined in the proposal as the G7 countries) or in the country of origin of the currency.

The proposed rule also includes an amendment to Appendix B of the Commission's bankruptcy rules that would govern the distribution of property where the bankrupt FCM or DCO maintains customer property in depositories outside the U.S. or in a currency other than U.S. dollars. This new distributional framework is intended to assure that customers whose funds are held in a U.S. depository will not be adversely affected by a shortfall in the funds held in a depository outside the U.S. that is due to the sovereign action of a foreign government or court. The proposed rule would replace Financial and Segregation Interpretation No. 12.

Treatment of Funds Held in Connection With the Clearing of Over-the-Counter Products by the New York Mercantile Exchange. On May 30, 2002, the Commission issued an Order permitting the New York Mercantile Exchange (NYMEX) Clearing House and FCMs clearing through the NYMEX Clearing House, subject to specified terms and conditions, to commingle customer funds used to margin, secure, or guarantee transactions executed in the OTC markets with other customer funds held in segregated accounts maintained in accordance with the customer segregation provisions of Section 4d of the Commodity Exchange Act and Commission regulations.

Withdrawal of FCM or IB Registration. Commission Rule 3.33(c) was amended to no longer require an FCM or independent introducing broker (IB) to submit a financial statement Form 1-FR-FCM or 1-FR-IB to National Futures Association (NFA) as part of its request to withdraw its registration. This rule was effective June 6, 2002.

Review of 1-FR Financial Reports. The Commission continues to enhance it software for reviewing financial reports submitted by FCMs and IBs. RSR Express is a software program which Commission staff use to receive, process, review, and track financial reports received electronically from FCMs and IBs. The Commission receives and reviews approximately 175 FCM financial reports each month. The Commission is the only entity, regulatory or otherwise, that receives financial reports from all registered FCMs.

FCMs e-mail their financial reports to the Commission. An auto processor reads a prescribed mailbox every two minutes, processes newly received financial reports, and sends an automatic confirmation to the filing FCM. RSR Express also notifies Commission staff that a financial report has been received.

RSR software contains a comprehensive set of analytical tools and edit checks which greatly assist Commission staff in their review of reported financial data to ensure continued compliance with the Commission's net capital and customer protection rules. The analytical tools allow the reviewer to compare historical financial data to current data. The edit checks alert the staff to possible problems with the financial reports. RSR also contains important tools that allow staff to track the receipt of financial reports (whether due, received, or overdue) and the status of the reports in the review process, from original review to final signoff.

The Commission on a monthly basis queries RSR for key financial data, which is then posted on the Commission's Web page at www.cftc.gov/tm/tmfcm.htm.

> **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

On February 1, 2002, CFTC staff sent a letter to all commodity pool operators (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.

Addressed in the letter as major concerns are:

- New anti-money laundering requirements
- Applicability of GAAP to commodity pools' annual financial statements
- New investment companies guide
- Schedule of investments required for calendar year 2001 annual reports under GAAP
- Fund-of-funds considerations
- Master-feeder structures
- Extended due dates for fund-of-funds pools

In order to avoid some of the most common and easily remedied deficiencies 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, 2002, year end, the due date is Monday, March 31, 2003 (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. Omitting the oath was the most common deficiency noted in 2001 annual reports. (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 at www.cftc.gov/tm/tm94-03.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, January 12, 2001, and February 1, 2002, "Dear CPO" letters are available at the CFTC Web site, www.cftc.gov, under the heading "Law & Regulation, Compliance." Future "Dear CPO" letters also will be available on the CFTC's Web site.

Self-Regulatory Organization Regulations

Under the Exchange Act, all broker-dealers are required to be members of self-regulatory organizations (SROs) such as the 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:

- *Order With Respect to the Implementation of Nasdaq's SuperMontage Facility*. In January 2001, the SEC approved a rule change submitted by NASD, on behalf of the Nasdaq Stock Market, Inc. (Nasdaq), that would establish a new order display and collection facility for Nasdaq-listed securities (SuperMontage). To address the concerns expressed by several market participants that certain SEC rules would effectively make their participation in the SuperMontage mandatory, the SEC conditioned its approval of the SuperMontage on the implementation of an alternative display facility (ADF) by the NASD. On July 24, 2002, the Division of Market Regulation approved operation of the ADF as a pilot program for nine months (see below). Based on this and other developments, the SEC believes that participation in SuperMontage will be voluntary, because market participants will have alternative venues in which to display their quotes, including the ADF. In September, the SEC authorized the Nasdaq to begin operation of its SuperMontage facility on or after October 11, 2002 (see Release Nos. 34-46429 and 2002-134).

- *Operation of the Alternative Display Facility for Quoting and Trading in Securities of The Nasdaq Stock Market, Inc*. In July 2002, the SEC approved the NASD's ADF for Nasdaq stocks for a nine-month pilot period. The pilot period is to expire at the close of daily operation of the ADF Pilot on April 24, 2003.

- *Order Granting Temporary Exemption for Broker-Dealers from the Trade-Through Disclosure Rule*. In May 2002, the SEC temporarily exempted until January 1, 2003, broker-dealers from compliance with the Trade-Through Disclosure Rule for exchange-traded funds.

- *Research Analyst Conflicts of Interest*. In May 2002, the SEC approved proposed rule changes by the NASD and NYSE relating to research analyst conflicts of interest. The SROs proposed to amend their rules to address conflicts of interest that are raised when research analysts recommend securities in public communications. According to a joint memorandum issued by the NASD and the NYSE, generally, the SRO rules would restrict the relationship between research and investment banking departments; require disclosure of financial interest in covered companies by the analyst and the firm; require disclosure of existing and potential investment banking relationships with subject companies; impose quiet periods for the issuance of research reports; restrict personal trading by analysts; and require disclosure of information that helps inventors track the correlation between an analyst's rating and the stock's price movements. Effective date: the rules become effective over the period from July 9, 2002, to November 6, 2002.

- *Anti-Money Laundering Compliance Programs*. See "Money Laundering Activities" in the "Audit and Accounting Issues and Developments" section of this Alert for a discussion of this rule.

- *Order Granting Approval to Proposed Rule Change Relating to Revisions to Form U-4 and Form U-5.* In March 2002, the SEC approved NASD proposed rule change revising the Uniform Application for Securities Industry Registration or Transfer (Form U-4) and Uniform Termination Notice for Securities Industry Registration (Form U-5).

The following is a summary of some of the financial-related rules adopted by the NFA, an SRO for commodity futures, during the past year:

- *Changes to Capital Requirement*. Amended the risk-based capital computation requirement to eliminate calculating risk on naked long option positions, conforming to the

Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (CME) changes. In addition, the charge was eliminated for remote locations and associated persons for FCMs with adjusted net capital of $2 million or greater and introducing brokers with adjusted net capital of $1 million or greater. The changes were effective December 31, 2001.

- *Electronic Filing of Financial Reports*. Required that all financial reports be filed electronically using WinJammer 4.0 software.
- *Filing Financial Statements Monthly*. Required that FCMs, for which the NFA is the designated SRO, submit monthly financial statements within 17 business days of the date of the statement.
- *Filings with Other SROs*. Required that FCMs and independent IBs file copies with the NFA of any financial reports or statements filed with other SROs.

Audit and Accounting Issues and Developments

Fraudulent Financial Reporting

The dismal economic and business environment can generate increased pressure on the management of broker-dealers to commit fraud. The already strong pressures to achieve earnings goals and to battle fierce competition within the securities industry become even more intense during periods of economic decline. Auditors should also consider the implications of the stock market volatility on the risk of fraud by their broker-dealer clients. Auditors should note that, along with client bankruptcy, fraud is one of the more common reasons for litigation against auditors.

In 2002 the AICPA Auditing Standards Board (ASB) issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), which supersedes SAS No. 82, which carried the same title, and amends SAS No. 1, *Codification of Auditing Standards and Procedures*

(AICPA, *Professional Standards*, vol. 1, AU sec. 230, "Due Professional Care in the Performance of Work"). The new Standard does not change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1, AU section 110.02, "Responsibilities and Functions of the Independent Auditor." However, SAS No. 99 establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS). Discussed below are some of the more significant changes from SAS No. 82 and the effects on audits.

New Context for Considering Risks

To provide a richer understanding of the environment in which fraud is likely to occur, the new SAS expands the description of fraud and its characteristics. It describes three conditions generally present when fraud occurs—incentive/pressure, opportunity, and attitude/rationalization. Input from forensic experts, academics, and others consistently showed that evaluation of information about fraud was enhanced when auditors considered it in the context of these three conditions.

Team Discussion and Professional Skepticism

To increase awareness and sensitivity to fraud, and to enhance the fraud risk assessment process, SAS No. 99 requires audit team members to discuss during the planning stage the potential for material misstatements due to fraud. The more experienced team members should share their insights, and all the members should exchange ideas about how and where the entity's financial statements might be susceptible to material misstatements due to fraud.

The new SAS also emphasizes the importance of maintaining the proper mindset throughout the audit regarding the potential for material misstatement due to fraud, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Consequently, the audit team's discussion would acknowledge fraud can occur in any entity and be perpetrated by anyone.

Expanded Inquiries

SAS No. 99 requires auditors to query management on its views of the risks of fraud in the entity and knowledge of any known or suspected fraud. It also says auditors should query others—for example, individuals outside the entity's accounting or financial reporting areas or employees with varying levels of authority. This requirement is not intended to be onerous—the nature and extent of these inquiries would be based on the auditor's professional judgment and generally directed to employees with whom the auditor comes into contact during the course of the audit.

Expanded Scope for Assessing Fraud Risks

SAS No. 99 emphasizes obtaining a broader range of information to serve as the foundation for an assessment that goes beyond considering the fraud risk factors provided in SAS No. 82. The various sources of information—inquiries of management and others, consideration of fraud risk factors, the results of the analytical procedures performed in planning the audit, and certain other information—all feed into the auditor's evaluation of fraud risks.

The auditor uses the information to consider the *type* of risk that may exist (that is, whether it involves fraudulent financial reporting or misappropriation of assets), the *significance* or magnitude of that risk, the *likelihood* it will result in a material misstatement in the financial statements and the *pervasiveness* of the risk (that is, whether the potential risk is pervasive to the financial statements as a whole or specifically related to a particular assertion, account, or class of transactions).

Risks Related to Revenue Recognition

Revenue recognition issues have been at the center of numerous instances of fraudulent financial reporting and continue to be the number one reason for restating financial statements. To address this problem, SAS No. 99 says auditors should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. In planning the audit, auditors are now required to perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may be indicative of a material misstatement due to fraudulent financial reporting. The new SAS also provides examples of auditing procedures that auditors may want to consider related to the risk of improper revenue recognition.

Evaluating Programs and Controls

When the auditor identifies risks of material misstatement due to fraud, SAS No. 99 requires that he or she consider management's programs and controls to address those risks. They might include broader programs or specific controls designed to prevent, deter, or detect fraud. As in SAS No. 82, the auditor has to consider whether such programs and controls will mitigate or exacerbate those identified risks. However, in a change from SAS No. 82, the auditor should evaluate whether these programs and controls have been suitably designed and placed in operation. The auditor's ultimate assessment of the risks of material misstatement due to fraud should take this evaluation into account.

Auditor's Response

The new SAS requires the auditor to develop an appropriate response for each fraud risk identified and includes more extensive guidance and examples on how to do so. The auditor's responses, which are influenced by the nature and significance of the risks identified and the evaluation of the entity's programs and controls, might have an overall effect on how the audit is conducted (for example, additional persons with specialized skills or knowledge may be assigned) or might involve changing the nature, timing, or extent of auditing procedures for specific accounts or assertions. The response typically also will involve performing certain procedures to address the risk of management override of controls.

Management is in a unique position to perpetrate fraud because it can override established controls that would appear to be operating effectively. This risk exists in virtually all audits and can occur in a number of unpredictable ways. Currently, the auditor's planned procedures in response to inherent and control risks and the auditor's assessment of the risk of material fraud consider, at least implicitly, the risk of management override. SAS No. 99, however, requires auditors to perform certain procedures to further address this risk. These procedures include:

- *Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.* Many auditors already may review unusual or "nonstandard" journal entries. However, SAS No. 99 requires the auditor to design procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements (for example, entries posted directly to financial statement drafts).

- *Reviewing accounting estimates for biases that could result in material misstatement due to fraud.* Existing auditing standards already require the auditor to consider the potential for management bias when reviewing significant estimates. In addition, SAS No. 99 requires auditors to perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management.

- *Evaluating the business rationale for significant unusual transactions.* Although the auditor typically gains an understanding of significant transactions, SAS No. 99 places a greater focus on understanding the underlying business rationale for significant unusual transactions. In this context, unusual transactions are those that come to the auditor's attention that are outside the normal course of business for the company or that otherwise appear unusual.

The new standard also requires auditors to design tests that would be unpredictable and unexpected by the client. During the audit, the engagement team should test areas, locations and accounts that otherwise might not be tested.

SAS No. 99 includes an Exhibit, "Management Antifraud Programs and Controls: Guidance to Help Prevent, Deter, and Detect Fraud." It also includes an amendment to SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333.06 and .16), since SAS No. 99 requires the auditor to make inquiries of management about fraud and the risk of fraud. In support of and consistent with these inquiries, the amendment revises the guidance for management representations about fraud currently found in SAS No. 85.

SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 31, 2002. Early application of the provisions of SAS No. 99 is permissible.

The AICPA has developed a fraud Practice Aid titled *Fraud Detection in a GAAS Audit*, which will be published by the end of 2002. The Practice Aid includes topics such as how the new SAS changes audit practice, characteristics of fraud, understanding the new SAS, best practices, and practice aids such as specialized industry fraud risk factors (including for brokers and dealers in securities), common frauds, and extended audit procedures. Auditors should consider using the guidance in the Practice Aid to help them implement SAS No. 99.

Going-Concern Issues

Information that raises doubt about the going-concern assumption for broker-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 have certain responsibilities pursuant to SAS No. 59, *The Audi-*

tor's Consideration of an Entity's Ability to Continue as a Going Concern (AICPA, *Professional Standards*, vol. 1, AU sec. 341).

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, noncompliance with various rules and regulations, 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.[4] In particular, the auditor

4. Statement on Auditing Standards (SAS) No. 96, *Audit Documentation*, amended 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), by adding a requirement for the auditor to document (a) the conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern; (b) the work performed in connection with the auditor's evaluation of management's plans; (c) the auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated; and (d) the consideration and effect of that conclusion on the financial statements, disclosures, and the audit report.

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.

Pressure on Management to Perform

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

The AICPA fraud Practice Aid titled *Fraud Detection in a GAAS Audit* (scheduled to be published by the end of 2002) will list a number of risk factors that may indicate an increased risk of fraudulent financial reporting at a broker-dealer, including the following:

- High-degree of competition relating to bank-owned broker-dealers that have been granted expanded powers to engage in securities activities, registered investment companies/mutual funds, accompanied by declining margins
- The pressure on management to meet the expectations of analysts and rating agencies
- Unusually high level of internal competition for capital allocation among product types/trading desks
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend

Some of these factors and conditions may be present in entities where specific circumstances do not present a risk of material misstatement. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, the auditor should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

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.

Litigation, Claims, and Assessments

As discussed in the "Economic and Industry Developments" section of this Alert, the securities industry saw an increase in the number of arbitrations and lawsuits this year. 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 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 GAAS. 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. In addition, the auditor, with the client's permission, should inform the lawyer that the client has given the auditor 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.

Auditors also need to be aware that contingent liabilities could result in an increase in a broker-dealer's aggregate indebtedness and, accordingly, its net capital requirement. According to a comment from the SEC to NASD, a broker-dealer that is the subject of a lawsuit that could have a material impact on its net capital must obtain an opinion of counsel regarding the potential effect of such a suit on the firm's financial condition. Absent such opinion, the item must be considered, at a minimum, a contingent liability and included in the calculation of aggregate indebtedness.

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.

Money Laundering Activities

Criminals use financial institutions to launder the proceeds of crime. Omnibus providers of diversified financial services may be particularly vulnerable because they provide a broad range of financial services that money launderers want and need, often in higher risk jurisdictions.

Criminals use a wide variety of financial institutions and professional advisers to launder the proceeds of crime and, according to 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 Laundering and Financial Statements

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.

Financial Crimes Enforcement Network Advisories

The Financial Crimes Enforcement Network (FinCEN) is the policy-making and law enforcement agency within the U.S. Department of the Treasury that supports law enforcement investigative efforts and fosters interagency and global cooperation against domestic and international financial crimes. FinCEN constantly issues advisories about transactions. These advisories normally instruct financial institutions to give enhanced scrutiny to any transaction originating in or routed through higher risk jurisdictions. Periodically, the federal government reviews and reassesses foreign government and financial system risk, cooperation, and compliance and accordingly adds names to and removes names from the sanction lists. It should be emphasized that the issuance of these advisories does not mean that financial institutions should curtail legitimate business with these jurisdictions.

Compliance With the Bank Secrecy and Patriot Acts

The Bank Secrecy Act (BSA), as recently amended by the Patriot Act, authorizes the U.S. Department of the Treasury (Treasury) to issue regulations requiring financial institutions, as defined under the BSA, to keep records and file reports that are determined to have a high degree of usefulness in criminal, tax, and regulatory matters, or in the conduct of intelligence or counter-intelligence activities; to protect against international terrorism; and to implement counter-money laundering programs and compliance procedures. Section 321(b) of the Patriot Act specifically added any futures commodity merchant (FCM), commodity pool operator (CPO), or commodity trading advisor (CTA) that is or is required to be registered with the SEC to the "financial institution" definition in the BSA. Treasury also has interpreted the term "broker or dealer in securities or commodities," which is a term that is included within the BSA's financial institution definition, as including an introducing broker (IB).

The following is a brief summary of recent anti-money laundering regulatory developments:

Anti-Money Laundering Programs. Section 352 of the Patriot Act requires each financial institution, as defined in the BSA, to establish an anti-money laundering (AML) program, which, at a minimum, must contain the following components: (1) the development of internal policies, procedures, and controls; (2) the designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test programs. Section 352 became effective April 24, 2002. On April 22, 2002, the SEC approved NASD and NYSE proposed rule changes relating to AML compliance programs. Both the NASD and NYSE proposed rule changes require each member firm and member organization to establish and implement AML compliance programs designed to ensure ongoing compliance with the requirements of the BSA and the regulations promulgated thereunder. Each member firm is required to develop and implement a written AML program reasonably designed to achieve and monitor the member's compliance with the requirements of the BSA, and the implementing regulations promulgated thereunder by the Treasury. Each member organization's AML program must be approved, in writing, by a member of senior management. To help their members understand and implement the new rules related to AML programs, the NYSE issued Information Memo 02-21, *Approval of New Rule 445—Anti-Money Laundering Compliance Program*, and the NASD issued Special Notice to Members 02-21, *NASD Provides Guidance To Member Firms Concerning Anti-Money Laundering Compliance Programs Required By Federal Law*.

The NFA has issued a rule (NFA Compliance Rule 2-9(c)) and a related Interpretive Notice requiring each FCM and IB member of the NFA to establish and implement an AML program. The CFTC approved this rule on April 23, 2002. Treasury had deferred application of the AML program requirement for CPOs and CTAs until October 24, 2002. Recently, however, Treasury proposed a rule that will require certain unregistered investment companies, including commodity pools, to have AML programs. Because the proposed rule targets commodity pools, there may not be a need for a separate AML rule for CPOs. Treasury, however, may still issue a separate AML rule for CTAs.

Special Due Diligence Programs for Certain Foreign Accounts. In May 2002, Treasury issued a proposed regulation requiring U.S. financial institutions, including brokers-dealers, FCMs, and IBs, to establish due-diligence policies, procedures, and controls reasonably designed to detect and report money laundering through correspondent accounts and private banking accounts that U.S. financial institutions establish and maintain for non-U.S. persons. In July 2002, Treasury issued an interim final rule which requires broker-dealers, FCMs, and IBs to comply with provisions relating to private banking accounts and defers their compliance with the provisions related to correspondent accounts. The interim final rule became effective on July 23, 2002. NYSE's Information Memo No. 02-34, *Special Due Diligence for Correspondent Accounts and Private Banking Accounts*, summarizes relevant provisions of the new rule.

Suspicious Activity Reports (SARs). On July 1, 2002, Treasury issued a final rule requiring broker-dealers to report to Treasury suspicious transactions that involve $5,000 or more in funds or other assets. This rule is applicable to transactions after December 30, 2002. On August 5, 2002, Treasury published draft Form SAR-SF (Suspicious Activity Report by the Securities and Futures Industry). Once finalized, the form should be used by broker-dealers and may be used voluntarily by FCMs registered with the

CFTC to report suspicious activity to Treasury. The readers may wish to refer to the NASD Notice to Members No. 02-47, *Treasury Issues Final Suspicious Activity Reporting Rule for Broker/Dealers*, for a discussion of this new regulation and the proposed form.

Section 356(b) of the Patriot Act authorizes Treasury to issue rules requiring FCMs, CPOs, and CTAs to file SARs. Although Treasury has announced its intention to issue rules requiring FCMs and IBs to file SARs, rules have not yet been proposed.

Customer Identification and Verification Rules. On July 23, 2002, Treasury, along with the SEC, CFTC, and other federal financial regulators, issued proposed rules that would require certain financial institutions to establish minimum procedures for identifying and verifying the identity of customers seeking to open new financial accounts. These proposed rules implement Section 326 of the Patriot Act, which directs the issuance of regulations requiring financial institutions to implement reasonable procedures for (1) verifying the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintaining records of the information used to verify the person's identity; and (3) determining whether the person appears on any list of known or suspected terrorists or terrorist organizations. Section 326 specifies that final rules must take effect on or before October 25, 2002. However, on October 11, 2002, Treasury advised all financial institutions, including broker-dealers, FCMs, and IBs, that they will not be required to comply with Section 326 of the Patriot Act or the proposed rules issued by Treasury and the federal regulators on July 23 until final implementing regulations are issued and become effective.

Correspondent Accounts. On September 26, 2002, Treasury issued a final rule titled *Correspondent Accounts for Foreign Shell Banks; Recordkeeping and Termination of Correspondent Accounts for Foreign Banks*. The new rule prohibits certain financial institutions, including broker-dealers, from providing correspondent accounts to foreign shell banks; requires such financial institutions to take reasonable steps to ensure that correspondent accounts provided to foreign banks are not being used to indirectly provide banking services to foreign shell banks; requires certain financial institutions that provide correspondent accounts to foreign banks to maintain records of the ownership of such foreign banks and their agents in the United States designated for service of legal process for records regarding the corresponding account; and requires the termination of correspondent accounts of foreign banks that fail to comply with or fail to contest a lawful request of the Secretary of the Treasury or the Attorney General of the United States. The new rule is effective October 28, 2002.

Reports Concerning Transactions in Excess of $10,000 in Currency. The BSA requires FCMs, IBs, CTAs, and CPOs to file on a Form 8300 a report concerning any transaction (or series of related transactions) in excess of $10,000 or more in currency.

Reports Concerning Foreign Bank and Financial Accounts (FBAR). The BSA requires each United States person who has a financial interest in or signature or other authority over a bank, securities or other financial account in a foreign country to file an FBAR if the aggregate value of the financial account exceeds $10,000 at any time during the calendar year. The term "financial account" includes any commodity interest account. The term "United States person" includes any SEC or CFTC registrant (for example, a broker-dealer, FCM, IB, CPO, or CTA) that is a citizen or resident of the United States, domestic partnership, domestic corporation, or a domestic estate or trust.

Information Sharing. On September 26, 2002, Treasury issued a final rule to encourage information sharing among financial institutions and federal government law enforcement agencies to the purpose of identifying, preventing, and deterring money laundering and terrorist activity. Under the new rule, certain financial institutions will be able to share information among themselves for the purpose of identifying and reporting suspected terrorism and money laundering once the financial institutions have notified FinCEN that they intend to share such information and that they will take adequate steps to maintain confidentiality. Under the final rule, any financial institution that is required to establish and maintain an anti-money laundering program or is treated as having satisfied this requirement is eligible to share information. The rule became effective upon issuance.

Employee Layoffs

Many entities are resorting to layoffs during this economic downturn to counter-balance reduced earnings. Significant layoffs can have a serious effect on an entity's internal control, 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. SAS No. 55, as amended, provides guidance on the auditor's consideration of an entity's internal control in an audit of financial statements in accordance with 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 loss 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). Recently issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, 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. See the "Fraudulent Financial Reporting" section of this Alert for a detailed discussion of this new standard.

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*.

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

- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, establishes standards for accounting for curtailments and termination benefits, among other issues. Practitioners should refer to paragraphs 6 to 14 for guidance on curtailment and paragraphs 15 to 17 for guidance on termination benefits. FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, requires the effect of the curtailment (for example, the termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a segment of a business) to be recorded as a loss. Practitioners should refer to paragraphs 96 to 99 for guidance on how to account for plan curtailment. The Statement also provides guidance on how to measure the effects of termination benefits in paragraphs 101 and 102.
- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, requires that entities providing postemployment benefits to their employees accrue the cost of such benefits. Inactive employees include those who have been laid off, regardless of whether or not they are expected to return to work. Postemployment benefits that can be attributed to layoffs can include salary continuation, supplemental unemployment benefits, severance benefits, job training and counseling, and the continuation of benefits such as health care benefits and life insurance coverage.

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

- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, addresses disclosures only and requires the disclosure of the amount of gain or loss recognized resulting from a settlement or curtailment. Additionally, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event is required to be disclosed.

AICPA 2002 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, 2002 (the Guide), has been updated to reflect the issuance of recently issued authoritative pronouncements. The Guide is available through the AICPA's reSOURCE Online and reSOURCE CD-ROM products, as well as through a loose-leaf subscription service. Paperback editions of Audit and Accounting Guides can be purchased as well.

Help Desk—Subscriptions to AICPA reSOURCE, subscriptions to the loose-leaf service, and paperback 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, or by going online to www.cpa2biz.com.

New Auditing and Attestation Pronouncements, Quality Control, 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*, the *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. 97	*Amendment to Statement on Auditing Standards No. 50,* Reports on the Application of Accounting Principles
SAS No. 98	*Omnibus Statement on Auditing Standards—2002*
SAS No. 99	*Consideration of Fraud in a Financial Statement Audit*
SAS No. 100	Interim Financial Information
Statement of Position (SOP) 02-1	*Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*
SSAE No. 12	*Amendment to Statement on Standards for Attestation Engagements No. 10,* Attestation Standards: Revision and Recodification
SQCS No. 6	*Amendment to Statement on Quality Control Standards No. 2,* System of Quality Control for a CPA Firm's Accounting and Auditing Practice
Audit Guide	*Service Organizations: Applying SAS No. 70, As Amended*
Auditing Interpretation No. 4 of SAS No. 70	"Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls"
Auditing Interpretation No. 5 of SAS No. 70	"Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods"
Auditing Interpretation No. 14 of SAS No. 58	"Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing"
Auditing Interpretation No. 12 of SAS No. 1	"The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Changes in the Year of Adoption"
Auditing Interpretation No. 15 of SAS No. 58	"Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations"
Related-Party Toolkit	*Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors*
Practice Alert No. 02-1	*Communications With the Securities and Exchange Commission*
Practice Alert No. 02-2	*Use of Specialists*
Practice Alert No. 02-3	*Reauditing Financial Statements*

Practice Aid	*Fraud Detection in a GAAS Audit*
Practice Aid	*New Standards, New Services: Implementing the Attestation Standards*
Practice Aid	*Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel*
Booklet	*Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users (3rd edition)*

The following summaries are for informational purposes only and should not be relied on 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.

Related-Party Toolkit

The AICPA staff has developed an electronic document, *Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors*, to provide accountants and auditors of private-sector business enterprises with an overview of selected authoritative accounting and auditing literature, SEC requirements, and nonauthoritative best practice guidance concerning related parties and related-party transactions. The related-party toolkit is available on the AICPA Web site at www.aicpa.org/public/download/news/relpty_toolkit.doc.

Practice Alert 02-1, *Communications With the Securities and Exchange Commission*

The AICPA Securities and Exchange Commission Practice Section (SECPS) Executive Committee established a Professional Issues Task Force (PITF) which formulates guidance based on issues arising in peer reviews, firm inspections, and litigation to facilitate the resolution of emerging audit practice issues. This guidance takes the form of Practice Alerts. The information contained in these Practice Alerts is nonauthoritative. It represents the views of the members of the PITF and does not represent official positions of the AICPA.

Practice Alert No. 02-1 provides registrants and their auditors with the most up-to-date information about when, why, and how they may wish to discuss SEC accounting, financial reporting, and disclosure issues and questions with the staff at the SEC. In addition, this Alert is intended to provide professionals with references to other resources that may be useful when working with SEC registrants.

Practice Aid *Fraud Detection in a GAAS Audit*

In connection with the issuance of SAS No. 99, the AICPA is issuing a Practice Aid to help practitioners implement the new fraud guidance. The practice aid is entitled *Fraud Detection in a GAAS Audit* (product no. 006613kk) and will be available in December 2002. The Practice Aid includes topics such as:

- How the new SAS changes audit practice
- Characteristics of fraud
- Understanding the new fraud SAS
- Best practices
- Practice aids, such as:
  —Specialized industry fraud risk factors
  —Common frauds and extended audit procedures

The Practice Aid represents valuable guidance in helping practitioners understand and implement SAS No. 99.

New Accounting Pronouncements and Other Guidance[5]

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

5. 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 Financial Accounting Standards Board (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.

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

FASB Statement No. 145	*Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*
FASB Statement No. 146	*Accounting for Costs Associated with Exit or Disposal Activities*
FASB Statement No. 147	*Acquisitions of Certain Financial Institutions, an amendment of FASB Statements No. 71 and 144 and FASB Interpretation No. 9*
SOP 01-5	*Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*
SOP 01-6	*Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*
Technical Practice Aids	*Software Revenue Recognition*
Questions & Answers	*FASB Statement No. 87, Employers' Accounting for Pensions*

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. Many more accounting and auditing projects exist beyond those discussed below. Readers should refer to information provided by the various standard-setting bodies for further information.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB)	www.aicpa.org/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 publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to 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.

Auditing Pipeline

Exposure Draft on Auditing Fair Value Measurements and Disclosures

The ASB has issued an exposure draft of a proposed SAS entitled *Auditing Fair Value Measurements and Disclosures*. The proposed SAS addresses auditing considerations relating to measurement, presentation, and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. A vote to ballot a document for final issuance is expected to occur in the autumn of 2002.

New Framework for the Audit Process

The ASB has voted to expose a suite of seven proposed SASs relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance the auditor's application of the audit risk model in practice by requiring:

- A more in-depth understanding of the entity and its environment, including its internal control, that would better enable the auditor to identify the risks of material misstatement in the financial statements and any steps the entity is taking to mitigate them.
- A more rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- A better linkage between the assessed risks of material misstatement and the nature, timing, and extent of audit procedures performed in response to those risks.

The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)
- *Audit Evidence,* which would supersede SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)
- *Audit Risk and Materiality in Conducting an Audit,* which would supersede SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)
- *Planning and Supervision*, which would supersede "Appointment of the Independent Auditor" (AICPA, *Professional Standards*, vol. 1, AU sec. 310), and SAS No. 22,

Planning and Supervision (AICPA, *Professional Standards*, vol. 1, AU sec. 311)

- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Assessing Risks)
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, which would supersede SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and, together with the proposed SAS *Assessing Risks*, would supersede SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319)
- *Amendment to SAS No. 39,* Audit Sampling (AICPA, *Professional Standards*, vol. 1, AU sec. 350)

You should keep abreast of the status of these projects and 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.

Accounting Pipeline

Exposure Draft on Loans and Certain Debt Securities Acquired in a Transfer (formerly known as Purchased Loans and Securities)

AcSEC has issued an exposure draft of a proposed SOP titled *Accounting for Loans and Certain Debt Securities Acquired in a Transfer*. This proposed SOP considers whether Practice Bulletin (PB) No. 6, *Amortization of Discounts on Certain Acquired Loans*, continues to be relevant given a number of FASB pronouncements issued subsequent to PB No. 6. The proposed SOP excludes originated loans from its scope. A final SOP is expected to be issued during the fourth quarter of 2002.

Consolidation of Certain Special-Purpose Entities

The FASB has issued an exposure draft of a proposed Interpretation of Accounting Research Bulletin (ARB) No. 51 entitled

Consolidation of Certain Special-Purpose Entities. This proposed Interpretation would address consolidation by business enterprises of special-purpose entities (SPEs) to which the usual condition of consolidation described in ARB No. 51, *Consolidated Financial Statements*, does not apply because the SPEs have no voting interest or otherwise are not subject to control through ownership of voting interests. A final Interpretation is expected to be issued during the fourth quarter of 2002.

Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others

The FASB has issued an exposure draft of a proposed Interpretation of FASB Statements No. 5, 57, and No. 107, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. This proposed Interpretation would elaborate on the disclosures to be made by a guarantor in its financial statements about its obligations under certain guarantees that it has issued. It also would require a guarantor to recognize, at the inception of a guarantee, a liability for the fair value of the obligations it has undertaken in issuing the guarantee. This proposed Interpretation does not address the subsequent measurement of the guarantor's recognized liability over the term of the related guarantee. This proposed Interpretation also would incorporate, without change, the guidance in FASB Interpretation No. 34, *Disclosure of Indirect Guarantees of Indebtedness of Others*, which would be superseded.

This proposed Interpretation would not apply to guarantee contracts issued by insurance and reinsurance companies and accounted for under specialized insurance accounting principles, a lessee's residual value guarantee embedded in a capital lease, contingent rents, and vendor rebates. The provisions related to recognizing a liability at inception for the fair value of the guarantor's obligations would not apply to product warranties, guarantees that are accounted for as derivatives, contingent consideration in a business combination, guarantees for which the guarantor's obligations would be reported as an equity item (rather than a liability), and an original lessee's guarantee of lease payments for which it remained secondarily liable in conjunction with being relieved of its primary obligation under a lease restructuring. However, those guarantees would be subject to the disclosure requirements of the proposed Interpretation. A final Statement is expected to be issued during the fourth quarter of 2002.

Amendment of FASB Statement No. 133 on Derivative Instruments and Hedging Activities

The FASB has issued an exposure draft of a proposed Statement entitled *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. This proposed Statement would amend the definition of a derivative in paragraph 6(b) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This proposed Statement also would amend Statement No. 133 for various decisions made as part of the Derivatives Implementation Group process. A final Statement is expected to be issued during the fourth quarter of 2002.

Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment

Proposed AICPA SOP *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment* and proposed FASB Statement *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment—an amendment of APB Opinions No. 20 and 28 and FASB Statements No. 51 and 67 and a rescission of FASB Statement No. 73* were issued simultaneously for public comment. Principally, the proposed FASB Statement would amend FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to exclude from its scope the accounting for acquisition, development, and construction costs of real estate developed and used by an entity for subsequent rental activities. The accounting for those costs would be subject to the guidance in the proposed SOP. It also would amend APB Opinion No. 28, *Interim Financial Reporting*, to require that those costs that the proposed SOP would require be expensed as incurred on an annual basis also be expensed as incurred in interim periods.

The proposed SOP addresses accounting and disclosure issues related to determining which costs related to property, plant, and equipment should be capitalized as improvements and which should be charged to expense. The proposed SOP also addresses capitalization of indirect and overhead costs and component accounting for property, plant, and equipment. Final Statements are expected to be issued during the first half of 2003.

Exposure Draft on Liabilities and Equity

The FASB has issued an exposure draft of a proposed Statement *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*. This proposed Statement would establish standards for issuers' classification in the statement of financial position of financial instruments with characteristics of liabilities, equity, or both. It would require that an issuer classify liability components and equity components of a financial instrument separately. This proposed Statement would prohibit the presentation of items between the liabilities section and the equity section of the statement of financial position.

The FASB also issued an exposure draft of a proposed amendment to Concepts Statement No. 6 titled *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*. This proposed amendment would revise the definition of liabilities to also include as liabilities certain obligations that require or permit settlement by issuance of the issuer's equity shares and that do not establish an ownership relationship. The objective of the project is to improve the transparency of the accounting for financial instruments that contain characteristics of liabilities, equity, or both.

Final Statements are expected to be issued during the fourth quarter of 2002.

Resource Central

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

On the Bookshelf

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

- Audit and Accounting Guide *Brokers and Dealers in Securities* (product no. 012702kk)
- 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)
- Audit Guide *Service Organizations: Applying SAS No. 70, As Amended* (product no. 012772kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques—2002*
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Practice Aid *Fraud Detection in a GAAS Audit* (available December 2002)
- Audit Risk Alert *E-Business Industry Developments—2002/03* (product no. 022323kk)

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

This Practice Aid (product no. 006600kk) provides practitioners with nonauthoritative practical guidance on auditing financial statements of FCMs, IBs, and commodity pools. Organized to complement the Audit and Accounting Guide *Brokers and Dealers in Securities*, this Practice Aid includes an overview of the commodity industry; discussions of regulatory considerations, auditing considerations, and accounting standards; and illustrative financial statements of FCMs, IBs, and commodity pools.

Audit and Accounting Manual

The *Audit and Accounting Manual* (product no. 005132kk) 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, and engagement letters, management representation letters, and confirmation letters.

AICPA reSOURCE Online: Accounting and Auditing Literature

Get access—anytime, anywhere—to the AICPA's latest *Professional Standards, Technical Practice Aids*, Audit and Accounting Guides (all 23), Audit Risk Alerts (all 19), and *Accounting Trends & Techniques*. To subscribe to this essential online service, go to cpa2biz.com.

Educational Courses

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

- *AICPA's Annual Accounting and Auditing Workshop* (product no. 737082kk (VHS tape/manual) and 187082kk (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.

- *Fair Value Accounting for Hedge Transactions* (product no. 735182kk). This course helps you understand GAAP for derivatives and hedging activities. Also, you will learn how to identify effective and ineffective hedges.
- *Fraud and the Financial Statement Audit: Auditor Responsibilities Under New SAS* (product no. 731810kk (text) and 181810kk (video); available December 31, 2002). The new fraud standard may not change your responsibilities for detecting fraud in a financial statement audit, but it will change how you meet that responsibility. Practitioners will benefit from a risk assessment approach to detecting fraud in a financial statement audit. You will learn the conceptual framework necessary to understand the characteristics of fraud.
- *Auditing for Internal Fraud* (product no. 730237kk). This course provides an auditor with the tools to identify fraud schemes. It trains CPAs to focus their analytical and substantive tests on the fraud triangle when evaluating internal controls. It also illustrates the latest in fraud prevention and detection programs implemented by industry leaders.
- *Identifying Fraudulent Financial Transactions* (product no. 730243kk). Learn to identify the red flags of fraud in financial information and to analyze a variety of fraud schemes. You will develop a framework for detecting financial statement fraud and learn about fraud schemes in revenue, inventory, liabilities, and assets.
- *Independence* (product no. 739058kk). This interactive CD-ROM course reviews the AICPA authoritative literature covering independence standards (including the SECPS independence requirements), SEC regulations on independence, and Independence Standards Board (ISB) standards.
- *SEC Reporting* (product no. 736747kk). This course helps the practicing CPA and corporate financial officer learn to

apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.

- *E-Commerce: Controls and Audit* (product no. 731551kk). 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) provides 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. 738450kk) 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 and CPA2Biz

AICPA Online, at www.aicpa.org, 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, www.cpa2biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the professional standards, and CPE courses.

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.

This Audit Risk Alert replaces *Securities Industry Developments—2001/02*. 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 them 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 11 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 360 Madison Avenue New York, NY 10017-7111 Telephone: (646) 637-9200
Commodity Futures Trading Commission	www.cftc.gov Three Lafayette Center 1155 21st Street, NW Washington, DC 20581 Telephone: (202) 418-5000
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 Telephone: (800) 621-3570

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