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Members in Business and Industry

February 2005

AICPA

Two New Publications on PCAOB Auditing Standard No. 2 Released

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In June 2004, the Securities and Exchange Commission approved the Public Company Accounting Oversight Board's auditing standard on internal control—PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*.

This new standard provides the definitive guidance for independent auditors on their required assessments of internal control in connection with the audit of public company financial statements. To help independent auditors and financial managers understand the requirements of the recently issued standard, the AICPA has published two new books (price each book: \$65 member/\$81.25 non-member; contact the AICPA Service Center). Following is a brief description of each of them.

PCAOB Auditing Standard No. 2: A Guide for Financial Managers (No. 006619CPA02) focuses on the way in which company management will conduct its own required assessment in internal control effectiveness. The standard requires auditors to assess the quality of the company's self-assessment of internal control; requires auditors to assess the adequacy of the company's documentation of internal control; allows the auditor to rely on the work performed by the company in its self-assessment process to support his or her conclusion on internal control effectiveness; and establishes the definition of a "material weakness" in internal control.

Pertinent guidance in the practice aid covers management's responsibilities relating to the company's self-assessment of internal control and the related audit; how the company may and may not work with its auditors to carry out its responsibilities; and the perfor-

mance requirements for each major phase of the assessment of internal control, including planning the scope of the work, documenting internal control, evaluating the design effectiveness of internal control, testing the operating effectiveness of internal control, and assessing internal control deficiencies.

The Auditor's Guide to Understanding PCAOB Auditing Standard No. 2 (No. 006620CPA02) covers the two audits of publicly traded companies that auditors are now required to conduct: the traditional audit of financial statements and a new audit of internal control. The two audits are intended to be tightly integrated, with the same firm performing both audits, using the results of each to plan, perform and report on the engagement.

PCAOB Auditing Standard No. 2 is long, complex and nuanced. Many of the concepts and required procedures described in the standard will be new to auditors and difficult to implement.

The Auditor's Guide to Understanding PCAOB Auditing Standard No. 2 will walk auditors through all the key requirements of the standard and provide them with insight and analysis on what these requirements mean. This book covers the responsibilities of both management and the auditor relating to the audit of internal control; how each party may and may not work together to carry out their respective responsibilities; and the performance requirements for each major phase of the engagement, including planning the scope of the work, evaluating the design effectiveness of internal control, testing the operating effectiveness of internal control, assessing internal control deficiencies and reporting on overall effectiveness, communications with management and documentation requirements.

now
available

Liquidity Analysis: Behind the Numbers

By Daniel L. Crumb, CPA

The common starting point for assessing a company's liquidity is looking at liquidity ratios such as the current ratio and acid test ratio. However, there is much more to analyzing a company's liquidity than analyzing ratios. You need to have a good understanding of the company's business model and the meaning behind the balance sheet account values.

Let's take a look at the balance sheet of XYZ Company, Inc. (XYZ) as an example. XYZ is in the business of selling and servicing industrial widgets.

Cash	\$50	Accounts Payable	\$100
Accounts Receivable	175	Unearned Revenues	20
Inventory	75	Taxes Payable	10
Total Current Assets	300	Notes Payable—Current	20
		Total Current Liabilities	150
Furniture & Fixtures	100		
Accumulated Depreciation	(50)	Notes Payable—Long Term	100
Total Fixed Assets	50	Total Long-Term Liabilities	100
Prepaid Insurance	15	Common Stock	100
Prepaid Taxes	15	Retained Earnings	30
Total Other Assets	30	Total Stockholder's Equity	130
Total Assets	\$380	Total Liabilities & Equity	\$380

At first glance, the key liquidity ratios are not cause for alarm. The current ratio is 2:1 and the acid test ratio is 1.5:1. However, in order to assess the true liquidity of the company, we need to drill down further and look at the real story behind the numbers.

Starting with cash, we need to confirm that there are no restrictions and that all the cash on the balance sheet is available to pay down current liabilities. The next account balance we need to examine is accounts receivable and calculate the average days receivable outstanding. If this number is greater than 90 days, we need to take note and factor that into our liquidity analysis. We should also go beyond the average days outstanding and check to see if there are a small number of accounts with large balances that are slow pays

and cannot be converted into cash quickly, thereby negatively affecting the company's liquidity.

For example, if XYZ had two customer accounts that were both 180 days outstanding and totaled \$125 there would be cause for concern. First, approximately 71% of receivables are concentrated in two customers with collectibility concerns and second, conventional liquidity ratio analysis would not have uncovered this problem.

Now that we have taken a look at the asset accounts that factor into the acid test ratio, we must examine inventory to calculate the current ratio and complete the liquidity ratio analysis. Inventory must be examined closely to determine how quickly it is turned over and if there are any obsolescence issues to deal with. For instance, in the durable goods industry, inventory turnover is not as critical whereas in the technology industry it is critical due to quicker rates of obsolescence.

Inventory cannot generally be relied upon to convert into cash quickly to pay down liabilities, therefore it is not included in the acid test ratio. However, inventory is the lifeblood of a manufacturer or distributor and needs to be examined closely for overall liquidity concerns. We can use the information obtained during our inventory analysis to forecast future trends relating to the overall health of the company.

As the asset side of the balance sheet generates the cash flow to pay off the liability side, we need to examine current liabilities as part of our liquidity analysis. Accounts payable is relatively straightforward, however, we need to make sure that all payables are correctly recorded and classified as current based upon a review of their terms.

Unearned revenue accounts need a close examination to see exactly what the nature of the liability is. For example, if XYZ's unearned revenue is related to service contracts that have not been fully amortized, this is not the type of liability that would require a cash outlay unless customers demanded a refund of their unamortized contract balance. A detailed examination of customer account history will show if any contracts in the past have been refunded and if there is a trend that warrants further examination. If there have been no refunds or customer satisfaction issues based on customer account examination, then theoretically, XYZ's liquidity could be increased by \$20.

Other current liabilities, such as taxes payable, should be examined along with prepaid taxes on the asset side to see what type of taxes make up the balances and if we can offset one against the other. For instance, if XYZ's prepaid tax balance of \$15 is composed of \$10 in prepaid payroll taxes and the taxes payable balance of \$10 is entirely payroll taxes, we can offset the two and have a more liquid balance sheet than the typical ratio analysis might not have shown.

As you can see, drilling down and examining various current

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asset and liability balances can reveal a much different picture of a company's liquidity than can conventional liquidity ratio analysis. Therefore, it is critical to gain a thorough understanding of the composition of these balance sheet accounts and the real story behind the numbers to derive a true picture of a company's liquidity.

Dan Crumb is the CFO of Hill City Oil Company located in Houma, La. He is the author of articles published in various state CPA society journals. This article was previously run in the Wisconsin CPA in Apr. 2004.

Information Security Top Tech Issue for 2005

For the third consecutive year, Information Security is the country's number one technology concern, according to the results of the AICPA's 2005 Top Technologies survey. The survey, conducted annually since 1990, seeks to determine the 10 most important technology issues for the coming year. There were more than 300 participants in the 2005 survey, a 30 percent increase over the previous year.

Interestingly, Spam Technology—an issue closely associated with Information Security—apparently has lost some currency. It made its debut on the 2004 list at number two. On the new list, it falls to number four. "Because our work and personal lives are now inextricably linked to information systems, security will always be top of mind," said Roman Kepczyk, CPA/CITP, chair of the AICPA's Information Technology Executive Committee. Commenting on Spam Technology's lower placement on the list, he said, "We've seen major improvements to filtering systems, which have allowed us to bring Spam under greater control. This most likely is the reason that Spam Technology doesn't command the importance it did in the previous survey."

A different issue closely allied with Information Security—Electronic Data Management, or the Paperless Office—moved up to second place. It was number three last year. There are two debuts on the Top Technologies list: Authentication Technologies and Storage Technologies. Another issue, Learning and Training Competency, reappears at number 10 after an absence of three years.

The following are the 2005 Top 10 Technologies (new issues are indicated):

1. *Information Security*: The hardware, software, processes and procedures in place to protect an organization's information systems from internal and external threats.

2. *Electronic Document Management (paperless or less-paper office)*: The process of capturing, indexing, storing,



retrieving, searching and managing documents electronically. Formats include PDF, digital and image store database technologies.

3. *Data Integration*: The ability to update one field and have it automatically synchronize between multiple databases, such as the automatic/seamless transfer of client information between all systems. In this instance, only the data flows across systems from platform to platform or application to application. Data integration also involves the application neutral exchange of information. For example, the increased use of XBRL (eXtensible Business Reporting Language) by companies worldwide provides for the seamless exchange and aggregation of financial data to meet the needs of different user groups using different applications to read, present and analyze data.

4. *Spam Technology*: The use of technology to reduce or eliminate unwanted e-mail commonly known as Spam.

5. *Disaster Recovery*: The development, monitoring and updating of the process by which organizations plan for continuity of their business in the event of a loss of business information resources through theft, virus/malware infestation, weather damage, accidents or other malicious destruction. Disaster recovery includes business continuation, contingency planning and disk recovery technologies and processes.

6. *Collaboration and Messaging Applications*: Applications that allow users to communicate electronically, including e-mail, voicemail, universal messaging, instant messaging, e-mailed voice messages and digital faxing. Examples include a computer conference using the keyboard (a keyboard chat) over the Internet between two or more people.

7. *Wireless Technologies*: The transfer of voice or data from one machine to another via the airwaves and without physical connectivity. Examples include cellular, satellite, infrared, Bluetooth, WiFi, 3G, two-way paging, CDMA, Wireless/WiMax and others.

8. *Authentication Technologies (new)*: The hardware, software, processes and procedures to protect a person's privacy and identity from internal and external threats, including digital identity, privacy and biometric authentication.

9. *Storage Technologies (new)*: Storage area networks (SAN) include mass storage, CD recordable, DVD, data compression, near field recording, electronic document storage and network attached storage (NAS), as well as small personal storage devices like USB drives.

10. *Learning and Training Competency (End Users)*: The methodology and curriculum by which personnel learn to understand and use technology. This includes measuring competency, learning plans to increase the knowledge of individuals, and hiring and retaining qualified personnel with career opportunities that retain the stars.

2005 Emerging Technologies

Each year, the AICPA Top Technologies Task Force prepares a "watch list" of five emerging technologies that may not have viable commercial acceptance currently, but show promise in the next 24–36 months as having a potential impact on businesses and individuals.

1. *RFID (Radio Frequency Identification)*: Silicon chips and an antenna that transmits data to a wireless receiver could one day be used to track everything from soda cans to cereal boxes. Unlike bar codes that need to be scanned manually and read individually (you have to actually see a bar code in order to read it), RFID tags do not require line-of-sight for reading. Within the field of a wireless reading device, it is possible to automatically read hundreds of tags a second.

2. *Search*: Companies like Google, Apple Computer and Microsoft are putting research and development resources into new ways of pinpointing digital files that do not require wading through directories of folders.

3. *Fuel Cells*: Methanol-powered fuel cells represent an exciting alternative to

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aging battery technology that will help users complete the “everything wireless” puzzle. These electromechanical devices represent both an environmentally friendly solution (they give off carbon dioxide and water as their by-product), as well as provide unlimited life for mobile devices (just fill the tank when they run low on fuel!).


4. *Digital Home*: The line between “digital home” and the office work-day

continues to blur. For example, “non-desk-top PC” technology is making a difference in how we work at the office and live at home: 802.11 cameras monitor the office after hours or home during the day (security system), while a 42” plasma screen resides in the office conference room, as well as the living room.

5. *Display Technology*: The continued evolution of various display technologies

allow for higher resolutions and smaller devices with lower power consumptions. Display technology is also merging, so that instead of having dedicated functions, such as a television receiver and a computer monitor, one display device is serving multiple functions.

For further information, visit:

 www.aicpa.org/infotech/technologies/toptechs.htm




Promoting Your Talent: A Second Edition


Author Nancy Baldiga has expanded the value of *Promoting Your Talent: A Guidebook for Women and Their*

Firms, with a new chapter, “Perspectives from Business and Industry.” The author interviewed successful female CPAs who practice in business and industry and learned that they face many of the same obstacles and challenges as their colleagues in public accounting. But, these professionals often find a less well-defined career path, fewer positive role models and more limited opportunities for advancement within their own organization. The good news is if you hone your technical and communication skills, maintain a broad business perspective and be willing to adjust these skills as necessary, you should be able to achieve success.

The handbook has been updated to reflect new statistics about women in the accounting profession while maintaining advice directly aimed at women about planning their careers and strategies for employers on how to advance their organization and their top talent.

To order *Promoting Your Talent*, request product number 872566CPA02 (\$25 member/\$31.25 non-member):

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The *CPA Letter Business and Industry* supplement encourages readers to share information and experiences through bylined articles on subjects of interest to your fellow practitioners. Moreover, if the topic fits our editorial calendar and your article is featured, you may claim continuing professional education credits for the time you spent preparing the article (in accordance with the Joint AICPA/NASBA Statement on Standards for Continuing Professional Education, revised as of Jan. 1, 2002). The first step is to submit article topics for approval to:

 pgreen@aicpa.org


Streamlined Reporting Survey for Public Companies

The Public Company Task Force to the AICPA Special Committee on Enhanced Business Reporting is about to embark on a project to identify opportunities for streamlining and reducing financial reporting requirements for public companies. This project will be looking primarily at

SEC reporting requirements within the context of emerging ideas for enhanced business reporting that have begun to emerge from the work of the Special Committee. These ideas are summarized in the report of the Public Company Task Force that can be found under “Sample Reports” at:


 www.ebrconsortium.org

The Public Company Task Force is in the process of forming a special task force to further explore possibilities for streamlining reporting and is seeking input that will be used for establishing priorities for this work. Your completion of a very brief survey would be greatly appreciated. You can access the survey at:

 websurveyor.net/wsb.dll/12391/StreamliningReporting.htm

Express Your Views on Peer Review Transparency

An online poll providing members with an opportunity to share their views on the topic of peer review transparency is now available at:

 websurveyor.net/wsb.dll/20058/AICPA_Peer_Review_Survey1.htm

Reasons why you should care about this issue as a member in *Business & Industry*:

1. As an AICPA member, you will be asked to vote (if such a vote happens) on any proposed changes making peer review results more transparent.

2. As a CPA, you care about issues of quality, the processes our

profession has in place to enhance quality, and how our profession presents itself to the public.

3. As someone who influences and often makes hiring decisions about outside CPA services, tell us what you want to know about your prospective CPA firm’s peer review results.

A new Web space has been created at www.aicpa.org/transparency/index.htm to provide a variety of resources for members to learn more about the issues and viewpoints surrounding peer review transparency.

We encourage you to invest the five to seven minutes required to complete the poll to give us your thoughts on this important subject for the profession.