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Members in Medium Public Accounting Firms, April 2005

American Institute of Certified Public Accountants (AICPA)

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AICPA

American Institute of Certified Public Accountants

Highlights

An Update on Ethics Interpretation 101-3

news update

To answer practitioners' questions about Ethics Interpretation 101-3, *Performance of Nonattest Services,* here is a selection of Qs&As that cover some of the most frequently asked questions about the interpretations. Extensive information and guidance on this interpretation can be found at:

www.aicpa.org/members/div/ethics/intr_101-3.htm

Q. As part of performing bookkeeping services, a member records adjusting journal and reclassification entries and prepares the client's preliminary financial statements. The member does not review each and every journal entry with the client but, rather, the member describes the nature of the journal entries and their impact on the preliminary financial statements. The client approves the preliminary financial statements and issues them to its bank. Would the requirements of Interpretation 101-3 be met?

A. Yes, provided all of the other requirements of Interpretation 101-3 are met.

Q. General requirement no. 1 under Interpretation 101-3 states that the member should not perform management functions or make management decisions for the attest client. What are some examples of management functions for purposes of Interpretation 101-3?

A. A management function would generally include doing or having the authority to:

- Make decisions on behalf of the client.
- Authorize, execute or consummate client transactions.
- Supervise, hire or terminate client employees.
- Oversee or manage any aspect of the client's business.
- Set policy for the client.
- Have access to or custody of client assets.
- Sign or co-sign client checks.
- Establish or maintain internal controls for the client.

Note: The preceding list is not intended to be all inclusive.

Providing advice, research materials and recommendations to assist the client's management in performing its functions and making decisions would not constitute the performance of a management function.

Enhanced Web Site for Employee Benefit Plan Audit Quality Center

The AICPA has created an enhanced Web site for members who audit or are interested in auditing employee benefit plans. The Employee Benefit Plan Audit Quality Center, a firm-based, voluntary membership center, is designed to promote the importance of quality audits of employee benefit plans.

Employee benefit plan audits include audits of pension, health and welfare, and 401(k) plans covered by the Employee Retirement Income Security Act (ERISA) under the regulatory authority of the U.S. Department of Labor.

"Our goal is to provide CPA firms that audit employee benefit plans with a comprehensive online resource that offers tools and professional guidance about how to perform an audit of an employee benefit plan," said Anita F. Baker, CPA, chair of the AICPA Employee Benefit Plan Audit Quality Center Executive Committee.

"The center is intended to make a direct statement to members of our profession about the importance of their audit performance," said Susan Coffey, CPA, SVP–Member Quality & State

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Regulation. "CPA firms that join the center demonstrate their commitment to audit quality by agreeing to, and meeting, specific center membership requirements. They also show their dedication to sharing best practices, learning about emerging issues and demonstrating their commitment to enhancing quality in their practices."

The homepage for the enhanced Web site serves as a single access point to the latest developments in employee benefit plan audits. The center's mission is to:

- Create a community of firms that demonstrate a commitment to employee benefit plan audit quality.
- Serve as a comprehensive resource provider for member firms.
- Provide information about the center's activities to other employee benefit plan stakeholders.
- Raise awareness about the importance of employee benefit plan audits.

The center was launched in Mar. 2004 and has nearly 900 members. It is one of three AICPA audit quality centers. The others are the Center for Public Company Audits Firms and the Governmental Audit Quality Center. The center can be found at:

www.aicpa.org/EBPAQC

Two Investor Guides on SOX 404

The AICPA Center for Public Company Audit Firms is making available two investor resource guides developed collectively by member firms. The guides assist investors, brokers, analysts, rating agencies and other market intermediaries, both small and large, in understanding the new internal control reporting. The first guide, *Internal Control over Financial Reporting: An Investor Resource,* is a broad overview of Sarbanes-Oxley Act Section 404, providing the background and rationale for the internal control reports; a description of these new types of reports; and a discussion of control deficiencies, the management's report and the independent auditor's opinion. It can be found at:

www.aicpa.org/cpcaf/download/An_Investor_Resource_Guide-Appendix2B.pdf

The second guide, *Perspectives on Internal Control Reporting: A Resource for Financial Market Participants,* provides a detailed Q&A on specific topics related to SOX 404, including material weaknesses and potential implications of the new reporting. It can be found at:

www.aicpa.org/cpcaf/download/Perspectives_on_Reporting-Appendix2C.pdf

New EDs on Auditing Standards, Standards for Attestation Engagements

The Auditing Standards Board has approved for exposure a proposed auditing standard, *Defining Professional Requirements in Statements on Auditing Standards,* and a proposed attestation standard, *Defining Professional Requirements in Statements on Standards for Attestation Engagements.* The EDs define the terminology the ASB will use to describe the degrees of responsibility that the requirements impose on the auditor or the practitioner.

The proposed statements define two categories of professional requirements:

- *Requirements.* The auditor or practitioner is required to comply with a requirement in all cases in which the circumstances exist to which the requirement applies. A requirement is indicated by the words *must* or *is required.*
- *Presumptive requirements.* The auditor or practitioner is also required to comply with a presumptive requirement in all cases in which the circumstances exist to which the presumptive requirement applies. In rare circumstances, the auditor or practitioner may depart from a presumptive requirement provided he or she documents his or her justification for departure and how alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptive requirement. The word *should* indicates a presumptive requirement.

The provisions of these statements will apply to existing statements on auditing standards and statements on standards for attestation engagements. The comment period ends May 15, 2005, for each document. Copies of the EDs are available for download at:

www.aicpa.org/members/div/auditstd/drafts.htm

TPA on Medicaid/Medicare Cost Reports

The AICPA's Audit and Attest Standards Team, with the assistance of the AICPA's Healthcare Expert Panel, issued TIS 9110.15, a technical practice aid (TPA) that provides guidance to auditors who have been engaged to report on Medicaid/Medicare cost reports. The TPA can be found at:

www.aicpa.org/download/members/div/auditstd/reporting_on_medicaid.pdf

In response to several questions recently raised by auditors, the expert panel would like to remind members of the guidance contained in the TPA. It explains how an auditor may report when the Medicaid/Medicare cost report is included as supplemental (or accompanying) information to a health care organization's audited financial statements. Auditors may only provide an "in relation to" opinion on that portion of supplemental information that has been subjected to the auditing procedures applied in the audit of the basic financial statements. The auditor should disclaim on any supplemental information in the cost report that has not been subjected to the auditing procedures applied in the audit of the basic financial statements.

In addition, the expert panel and staff have met with the New York State Society of CPAs' Healthcare Committee to assist them in dealing with specific issues raised by the New York State Department of Health. The Institute will continue to advise members on this issue.

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Stock-Based Payments Webcast: Top Questions

A recent AICPA CFO Quarterly Roundtable Series Webcast focused on "Stock-Based Compensation Strategies Under FASB Statement No. 123[R]," a subject of interest to companies of all sizes. This article covers several important questions related to trends in executive compensation in light of this guidance. It is based on an interview with Don Delves, CPA, of the Delves Group compensation consulting firm, who was one of the panelists at the Webcast.

Q. What significant changes are occurring in executive compensation as a result of the issuance of FASB Statement No. 123R, *Share-Based Payments?*

A. There has been a shift from the granting of options towards the granting of other awards, such as restricted stock and long-term performance-based plans. More important, however, a shift seems to be emerging from a singular focus on long-term stock price performance to long-term *financial* performance.

Q. How is the accounting change affecting corporate governance, and especially the actions of the compensation committee of the board of directors?

A. Compensation committees are asking much tougher questions about:

- The cost and value of options.
- The alternatives to options.
- The best use of shareholder resources.
- How to really measure and reward long-term performance.

Q. In your opinion, what are the main reasons that such a wholesale change is happening so quickly?

A. These changes are occurring, in part, because the expense to record the granting of stock options is:

- Large.
- Up front.
- Not adjusted for the subsequent actual results.

Q. What is the difference in accounting treatment between stock-based incentives (options or restricted stock) that vest based on company performance and those that vest based on market performance?

A. For stock-based incentives that vest based on company performance, the expense may be reversed if the shares do not vest. If the vesting is based on market performance (stock price or total return to shareholders), then the expense cannot be reversed if the shares do not vest.

Archived versions of this Webcast and others are available on CD-ROM. This one (No. 737172HSCPA04), which qualifies for CPE credit, can be found at:

https://www.cpa2biz.com/CS2000/Products/CPA2BIZ/Webcast/CFO+Quarterly+Roundtable+-+1st+Quarter+05+-+CD-ROM.htm?cs_catalog=CPA2Biz

Cost: $79

CPE Credit:

Recommended CPE Credit (based on a 100-minute hour): 2
Recommended CPE Credit (based on a 50-minute hour): 4

QAS Credit: TBD

Recommended CPE credit for this course is "preliminary."
Level: Intermediate
More information on AICPA Webcasts can be found at:

www.cpa2biz.com/webcasts 888/777–7077

Using Benchmarking to Assess Audit Risk

By Bradley J. Allen, CPA

Quality-driven companies constantly benchmark, or compare their performance and practices in given areas against that of other organizations, either inside or outside the company. This powerful performance management technique can highlight areas to address and has been found to help uncover best practices that lead to superior performance.

How might the auditor use benchmarking to better assess risk through an improved understanding of a client's business and industry and preliminary analytics?

Understanding the Company's Business and Industry

The auditor is obligated to update an understanding of the client's business and industry at the inception of an audit. Obtaining knowledge about the financial performance of industry peers and industry trends is critical to assess audit risk and focus audit scope in key areas.

Comparing client performance to peers could help the auditor understand market dynamics.

The exhibit on page B4 shows a benchmark comparison of several financial performance measures of a company presented as the baseline data and two peer companies given as the comparison data.

The company's ratio of fixed assets to tangible equity is much higher than its peers, and fixed asset turnover is much lower. This result is also reflected in ratios for net investment, property, plant and equipment and goodwill, all as a percentage of sales. A good auditor should ask: "Why does my client require so much more investment than its peers to generate a comparable amount of sales?"

The auditor might also note that the company's accounts receivable collection period (also referred to as days sales outstanding or DSOs) is high, but in line with its peers. However, by also looking at accounts receivable as a percentage of sales, the auditor would notice that the company's investment is 50% higher than its peers. The auditor might reasonably expect a plausible relationship between DSOs and accounts receivable as a percentage of sales, so this unusual result merits further investigation.

The auditor discovers through further review that what is driving this result is that the company has an investment in other receivables as a percentage of sales of 13%, whereas the peer companies had little or none. The auditor will surely want to know why the client has such a high investment in other receivables, especially since transactions in this account most likely did not arise from standard systems transactions.

Ultimately, for the company analyzed above it was discovered that most of the so-called assets highlighted in this example were really *expenses classified as assets* and as such were subsequently written off. Using benchmarking to understand industry performance metrics could have high-

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continued from page B3—**Benchmarking**

lighted some of these problem areas for the auditors.

Performing Preliminary Analytics

Professional standards require the following four-step process in performing analytical procedures:

- Develop an independent expectation.
- Define a significant difference or threshold.
- Compute differences.
- Investigate significant differences and draw conclusions.

Developing an independent expectation can be a struggle, but benchmarking could help. For example, benchmarking a company's sales growth rate against the industry can place the historical performance in a given quartile relative to the industry. Let's say that historically a company's growth rate has tracked the median sales growth rate for the industry. The auditor supplements the benchmark information with a review of analyst reports that indicate the industry is expected to grow at 5% this year.

Barring any other changes to the business, it might be reasonable to set an expectation that the company's sales will grow by 5% this year. However, because the auditor updated an understanding of the company's business, the auditor knows that management added 10 new salespeople which, based on past performance, should add an additional 2% sales growth.

The auditor sets the expectation at 7%, defines a threshold of +/– 1% and computes the difference from current year actual results. If the actual sales growth rate is 15%, the difference of 8% is well outside of the threshold and the auditor would need to consider audit scope modifications to focus more attention on revenue recognition and sales cut-off.

Sources of Benchmark Data

Data for publicly held companies is available and easy to obtain using EDGAR, or can be purchased from a number of data vendors, such as Multex. Privately held company data, presented in aggregate form, can be obtained through subscription services such as:

- BenchmarkReport.
- IntegraInfo.
- PricewaterhouseCoopers' AMMBIT®.
- ProfitCents.
- RMA.

In selecting comparables, it is important to consider the source of the data, the depth of the industries it covers, the quality control over the data, whether it reports in averages or quartiles and whether it includes the KPIs needed for the analysis.

Benchmarking can be a powerful audit tool, with no batteries required.

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Measures	Baseline Data	Comparison Data					
Select Measures Filter by Group: All		Data	Amount Change	% Change	Data	Amount Change	% Change
Fixed Assets to Tangible Equity	2.49	-6.35	-8.83	-355.35%	.059	-1.90	-76.43%
Accounts Receivable Collection Period	74.49	77.32	2.83	3.79%	71.63	-2.87	-3.85%
Fixed Asset Turnover	0.59	0.93	0.33	56.32%	1.24	0.65	109.11%
Net Investment as % of Sales	182.90%	89.30%	-93.60%	-51.18%	56.60%	-126.30%	-69.05%
Other Receivables – NS	13.10%	0.00%	-13.10%	-100.00%	3.40%	-9.70%	-74.05%
Receivables, Total – Net – NS	30.60%	21.40%	-9.20%	-30.07%	20.30%	-10.30%	-33.66%
Property, Plant and Equipment – Net – NS	172.30%	111.60%	-60.70%	-35.23%	63.50%	-108.80%	-63.15%
Goodwill – NS	190.00%	0.00%	190.00%	-100.00%	13.90%	-176.10%	-92.68%

(Currency values represented in 1,000s)