

1990

Airline industry developments - 1990; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

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**AUDIT RISK
ALERTS**

Airline Industry Developments—1990

Update to AICPA Industry Audit Guide
Audits of Airlines

Includes *Audit Risk Alert—1990*

Issued by the
Auditing Standards Division

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This document, which contains *Airline Industry Developments—1990* and *Audit Risk Alert—1990*, is intended to provide auditors of financial statements of airlines with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Airline Industry Developments—1990

Industry and Economic Developments

The rising cost of fuel and the slowing economy are among the most significant factors contributing to the financial problems faced by the airline industry in 1990. The problems of individual airlines have affected the industry as a whole, depressing stock prices and creating difficulties in raising new capital. In addition, as union contracts expire, employees who previously agreed to wage cuts or freezes are demanding increases.

Fuel Costs

A dramatic increase in fuel costs resulting from the crisis in the Persian Gulf in the second half of the year followed a more modest rise in the price of fuel in 1989. After increasing, on average, by 30 percent, from approximately 50 cents per gallon in 1988 to just over 65 cents per gallon in 1989, and then falling slightly in the first half of 1990, fuel prices doubled between August and November, rising from approximately 60 cents per gallon to more than \$1.20 per gallon. It is estimated that for each 10-cent increase in the price of fuel, total fuel costs for U.S.-scheduled airlines rise by approximately \$1.5 billion.

Due to the significant increase in the price of fuel in the second half of 1990, several airlines reported operating losses in the third quarter. Although the airlines have attempted to increase fares, they so far have been unable to offset the increase in fuel costs, and many airline executives are pessimistic about fourth-quarter operating results.

Traffic Volume

The weakening economy compounded the effects of the expected seasonal decline in air traffic in the fall of 1990. Increasing fuel costs and the anticipated delivery of new aircraft, in conjunction with the deteriorating economy, may create excess capacity, and actions taken by some carriers in response may further weaken the carriers' financial position over time.

Many airlines have offered special discount fares to promote air travel, and some carriers may move to increase benefits for frequent flyers in an attempt to cultivate specific markets or customer segments. At the same time, several carriers have reduced the number of flights as

a means of adjusting to slackening demand. Moreover, while some carriers anticipate delivery of new aircraft, a number have grounded less fuel-efficient planes. These problems are further complicated by congestion at certain airports, which limits flexibility and growth.

Considered as a whole, these actions indicate increasing competition for a declining number of travelers, a situation that, in the past, has culminated in declining prices and, often, in fare wars. If continued for an extended period of time, these actions could threaten the financial health of the airlines, especially those lacking cash positions sufficient to sustain continued cash operating losses.

Audit and Accounting Developments

Audit Issues

Liquidity, Cash Flow, and Debt Covenants. In this environment, auditors should consider liquidity, cash flow, and compliance with debt covenants. Further, the decision by some airlines to cancel or delay the delivery of new equipment or to ground inefficient aircraft could have an impact on the price and financing options for new and used aircraft, as well as on the carriers' ability to raise additional cash through sale and leaseback transactions. Auditors of financial statements of "feeder" airlines may need to consider the financial condition of the related major airline in evaluating whether there is substantial doubt about the feeder's ability to continue as a going concern. Auditors should carefully evaluate the financial-statement classification of debt and related note disclosures as well as the discussion of cash flows and liquidity in the Management Discussion and Analysis (MD&A) section of reports of publicly held companies. AICPA Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, provides guidance concerning the auditor's responsibility to evaluate going-concern issues throughout an audit.

Accounting Issues

Aircraft Life and Residual Value. The determination of the estimated useful life of an aircraft and its estimated residual value generally has been based upon economic rather than physical factors. These factors have included market growth, technological developments, operating cost efficiency, and revenue-generating ability. In recent years, other factors such as the price and availability of fuel, new airworthiness directives, new maintenance procedures, and required aircraft modifications have also been considered. These factors will have an impact on the following accounting and auditing areas: economic obsolescence, aircraft modification, carrying value and depreciation of out-of-service aircraft, and residual value.

Economic obsolescence. The current level of fuel costs, if maintained, could hasten the obsolescence of certain types of aircraft. Judgment is needed in evaluating the appropriateness of the carrying value and balance-sheet classification of aircraft and related equipment. Factors that should be considered include, but are not limited to, the strength of the secondary market, alternative uses, and the contemplated and long-term utilization currently assumed by the airline. Additionally, guidance from third parties, such as leasing companies and valuation consultants, should be considered.

Aircraft modification. Recently, numerous voluntary and mandatory modifications have been made to older aircraft. The determination of whether a modification represents a capitalizable project should be made in a manner consistent with the airline's normal capital project guidelines and with AICPA Statement of Position (SOP) 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications*. In addition to the dollar value of a project, the impact of a modification on the usefulness of an aircraft, and its service life should be considered.

Any requirement to make additional aircraft modifications in order to maintain current levels of operation, as well as the source of funding such modifications, should generally be discussed in the MD&A section of the annual report of publicly held companies. Auditors also should consider the adequacy of disclosures regarding potential increases in maintenance or modification requirements resulting from increasing airport noise level complaints, structural failures due to age, and other relevant factors.

Carrying value and depreciation of out-of-service aircraft. High fuel prices and limited availability of fuel as well as updated airworthiness directives may cause airlines to decide that certain types of aircraft should be temporarily grounded. When this is the case, a determination of the appropriate balance-sheet classification and depreciation provision must be made. If an aircraft is temporarily grounded but continues to be part of an airline's strategic fleet, depreciation should continue; however, the life and residual values that are used should be carefully evaluated. When an airline has decided to remove an aircraft from service and offer it for sale, the aircraft should be classified as nonoperating property. In any event, grounded aircraft should not be carried at amounts in excess of net realizable value.

Residual value. Over the past five to ten years, the strength of the secondary market for various types of aircraft has led, in many instances, to the use of substantial residual values. The residual values assigned to aircraft may be significantly impacted by the industry and economic

conditions described previously. Airlines should carefully evaluate the need to adjust downward the estimated residual values that will be realized either currently or in the future.

Manufacturer's Credits

Over the last few years, airlines have ordered unprecedented numbers of new aircraft as they replace existing fleets and prepare for expected substantial growth. When ordering aircraft, airlines frequently negotiate purchase incentives with the aircraft manufacturer, engine manufacturer, or both. The purchase incentives may take many forms, including—

- Credits that may be used to purchase spare parts or services, or that may be applied against the purchase price of the aircraft.
- Guaranteed residual values and favorable financing support.

Many recent aircraft orders have provided for large numbers of option aircraft. Purchase incentives may increase or decrease depending upon whether an option is exercised and how many option aircraft are selected. When a manufacturer has agreed to provide lease financing to an airline, incentive credits that have been granted may be subject to partial or full repayment if the airline does not continue to lease the aircraft for a defined minimum term.

Regardless of the form, for accounting purposes the credits are applied as a reduction of the purchase price of the aircraft or deferred and amortized over the life or lease term of the aircraft. Credits that are conditional or may escalate should be evaluated for the realizability and the appropriateness of carrying values.

Frequent Travel Award Programs

Since frequent travel award programs were created in 1981, methods of accounting for the programs have been the subject of considerable discussion. Currently, industry practice is that the airlines accrue the incremental costs of a passenger's use of a free ticket when the lowest free-travel award level is reached. Some believe that the primary accounting issue is essentially one of revenue recognition and question the basis for recognizing all ticket revenue prior to performing all services associated with the ticket. Over the past few years, various alternative proposals have been considered; however, the incremental cost method continues to be widely used by the airline industry. The staff of the SEC has indicated that airlines should consider disclosing accounting policies and other relevant information about frequent travel award programs in their financial statements.

Complex Financing Structures

The airline industry is a capital-intensive business that requires significant outlays for new aircraft. Accordingly, the capital markets and the airlines have developed complex structures for financing the purchase of aircraft. This environment primarily results from the favorable tax treatment extended to some transactions by the Tax Reform Act of 1986, and from the airlines' desire to realize any appreciation in the value of an aircraft since the time it was initially ordered from the manufacturer. In order to determine the proper method of accounting for aircraft leasing structures, it is important to examine the entire transaction and not only the basic lease. For example, the global market has created a financing structure that is very popular in the airline industry, the cross-border tax-benefit lease. Various forms of this financing structure provide a foreign investor with an ownership right in, but not necessarily the title to, the aircraft. That ownership right enables the foreign investor to claim certain benefits of ownership of the aircraft for tax purposes in the foreign tax jurisdiction, while the U.S. enterprise (the lessee) claims ownership of the same aircraft for tax purposes in the U.S.

While this structure initially appears to be a sale/leaseback transaction, some versions include a full prefunding of a legal release from the lease obligation and, therefore, effectively involve nothing more than the sale of foreign tax benefits. The FASB's Emerging Issues Task Force (EITF), in Issue No. 89-20, reached a consensus that the determination of either immediate or deferred income recognition for the cash consideration received by the U.S. enterprise from the foreign investor for the tax benefits that the foreign investor will obtain in the foreign jurisdiction should be based upon individual facts and circumstances. However, immediate income recognition is not appropriate if there is more than a remote possibility of the loss of the received cash consideration due to indemnification or other contingencies. The EITF, in Issue No. 90-15, is also considering issues relating to accounting for leases involving nonsubstantive lessors, residual value guarantees, and certain other provisions. A complete understanding of these leasing structures, together with the application of the lease accounting pronouncements, including guidance issued by the EITF, is necessary to determine the proper accounting treatment for these complex transactions.

* * * *

Copies of AICPA authoritative guidance may be obtained by calling the AICPA Order Department at (800) 334-6961 (USA) or (800) 248-0445 (NY). Copies of FASB authoritative guidance may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

Audit Risk Alert—1990*

*General Update on Economic, Industry,
Regulatory, and Accounting and
Auditing Matters*

Introduction

This alert is intended to help auditors in finalizing their planning for 1990 year-end audits. Successful audits are a result of a number of factors, including acceptance of clients with integrity, adequate partner involvement in planning and performing audits, an appropriate level of professional skepticism, and the allocation of sufficient audit resources to high-risk areas. Addressing these factors in each audit engagement requires substantial professional judgment based, in part, on a knowledge of professional standards and current developments in business and government.

It is important to make sure that written audit programs are *adequately tailored* to reflect *each client's circumstances*, including areas of greater *audit risk*. This alert identifies areas that, based on current information and trends, may be relevant to many 1990 year-end audits. Although it does not provide a complete list of risk factors to be considered, and the items discussed do not affect risk in every audit, this alert can be used as a planning tool for considering matters that may be especially significant for 1990 audits.

Economic Developments

The Current Economic Downturn

Dramatic events in the Persian Gulf and around the world have raised many questions and concerns for American companies. Rising oil prices, lower consumer demand, and reduced availability of capital are just *some* of the factors affecting companies in all industries. Auditors should take these economic factors into consideration and be aware of the ways in which clients have been affected by them as well as of the potential, if any, of a going-concern problem.

*This Audit Risk Alert was published in the December 1990 issue of the AICPA's *CPA Letter*.

Business Failures on the Rise

The current illiquidity in the junk-bond market, coupled with the continuing tightening of credit by lenders throughout the country, have made it substantially more difficult for prospective borrowers to obtain financing, particularly for highly leveraged companies. A recent article in the *Wall Street Journal* called attention to increases in bankruptcy filings, particularly in the real estate, apparel, retailing, and construction industries, due in large part to the weakening cash flow of many businesses as well as the more cautious credit environment. Some industries are becoming very risky undertakings. For example, in 1990, the number of restaurant closings exceeded the number of openings; increased competition has made it nearly impossible to raise menu prices, while costs have continued to increase, especially those for energy, insurance, and wages.

The effects of the economic slowdown will vary across geographic regions and industries, and among companies even within the same industry. Therefore, auditors need to focus specifically on the environment of each client and address each client's particular issues accordingly. Nevertheless, many companies will be unable to pass on increased costs (particularly increased oil prices and medical expenses) due, in part, to increasing competition and softening demand for their products. This could make it difficult for companies to report favorable operating results for the year. With this in mind, auditors should be even more sensitive this year to ongoing issues that affect operating results, such as the collectibility of receivables and the potential obsolescence and realizability of inventories.

Highly leveraged companies are particularly vulnerable to a downturn in business activity and the other factors discussed above. Auditors should consider these circumstances when evaluating the ability of highly leveraged clients to continue as going concerns.

Economic Considerations Relating to Debt

Adverse developments in the economy in general, or in a particular financial institution, may cause an institution to refuse to renew loans, to exercise demand clauses (such as the due-on-demand clause), or to decline to waive covenant violations. In addition, these developments may make it more difficult for companies to obtain alternate sources of financing than in the past. In these cases, the auditor should consider the borrower's classification of the liability, potential going-concern issues, management's plans (such as those for alternate financing or asset disposition), and the adequacy of disclosures in the borrower's financial statements. Securities and Exchange Commission (SEC) rules

contain specific disclosure requirements in Management's Discussion and Analysis (MD & A) about liquidity and material uncertainties.

Regulatory and Legislative Developments

Environmental Liabilities

The Environmental Protection Agency is empowered by law (through the Superfund legislation) to seek recovery from anyone who ever owned or operated a particular contaminated site, or anyone who ever generated or transported hazardous materials to a site (these parties are commonly referred to as potentially responsible parties, or PRPs). Potentially, the liability can extend to subsequent owners or to the parent company of a PRP.

In connection with audit planning, the auditor should consider making inquiries of management about whether a client (or any of its subsidiaries) has been designated as a PRP or otherwise has a high risk of exposure to environmental liabilities. If a client has been designated as a PRP, the auditor should consider whether any amount should be accrued for cleanup costs and assess the need for disclosure and, possibly, for the inclusion of an explanatory fourth paragraph in the audit report citing the uncertainty, if management is unable to make reasonable estimates of the costs. In addition, for public entities, disclosure should be made in MD&A of estimates of cleanup costs or the reasons why the matter will not have a material effect.

Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*, and Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, provide guidance for the accounting and disclosure of loss contingencies, including those related to environmental issues. The FASB's Emerging Issues Task Force (EITF) reached a consensus in Issue 90-8, *Capitalization of Costs to Treat Environmental Contamination*, that, generally, the costs incurred to treat environmental contamination should be expensed and may be capitalized only if specific criteria are met.

Notification of Termination of Auditor-Client Relationship

The SEC staff has observed instances in which CPA firms have not notified the SEC's Chief Accountant when an auditor-client relationship ends. Under a rule effective May 1, 1989, member firms of the SEC Practice Section of the AICPA Division for Firms must notify the SEC directly by letter *within five business days* after the auditor resigns, declines to stand for reelection, or is dismissed.

New Auditing Pronouncements

Implementing SAS No. 55 on Internal Control

AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, is effective for audit periods beginning on or after January 1, 1990. Auditors who did not apply its provisions early are faced with implementation for December 31, 1990, year-end audits.

To help auditors with questions that may arise, the Auditing Standards Board (ASB) issued the Audit Guide *Consideration of the Internal Control Structure in a Financial Statement Audit*. The guide presents two preliminary audit strategies for assessing control risk and uses three hypothetical companies ranging from a small, owner-managed business to a large public company to illustrate how the strategies affect the nature, timing, and extent of procedures. Particularly helpful is a series of exhibits that includes sample workpapers documenting the hypothetical companies' compliance with SAS No. 55. A copy of the guide (product number 012450) may be obtained by calling the AICPA Order Department at (800) 334-6961 (USA) or at (800) 248-0445 (NY).

New Financial Institutions Confirmation Form

The AICPA will replace the existing 1966 Standard Bank Confirmation Inquiry. The new form will provide only confirmation of *deposit* and *loan* balances. To confirm other transactions and arrangements, auditors will have to send a separate letter, signed by the client, to a financial institution official responsible for the financial institution's relationship with the client or knowledgeable about the transactions or arrangements. Anyone ordering the new standard form from the AICPA Order Department will receive a copy of a notice to practitioners, which describes the revisions to the process of confirming information with financial institutions, and illustrative letters for confirming some of these types of transactions or arrangements. The new form should be used for confirmations mailed on or after March 31, 1991. Practitioners should neither use the new form before March 31, 1991, nor use the old form on or after that date.

New SAS on Internal Auditing

In January 1991, the ASB will issue a new SAS, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, that will provide practitioners with expanded guidance when considering the work of internal auditors. Many internal audit activities are relevant to an audit of financial statements because they provide evidence about

the design and effectiveness of internal control structure policies and procedures or provide direct evidence about misstatements of financial data contained in financial statements. The SAS is effective for audits of financial statements for periods beginning on or after January 1, 1991, and will include guidance to assist auditors in obtaining an understanding of the internal audit function, assessing the competence and objectivity of internal auditors, and determining the extent to which they may consider work performed by internal auditors. The SAS supersedes SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit*, and incorporates the terminology and concepts of more recent SASs, particularly SAS No. 55.

Forthcoming Guidance on Circular A-133

On March 8, 1990, the Office of Management and Budget (OMB) issued Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. The purpose of Circular A-133 is to establish audit requirements and to define federal responsibilities for implementing and monitoring audit requirements for institutions of higher education and other nonprofit institutions receiving federal awards. Institutions covered by Circular A-133 generally include colleges and universities (and their affiliated hospitals) and other not-for-profit organizations, such as voluntary health and welfare organizations and other civic organizations.

The circular applies to nonprofit institutions that receive \$100,000 or more in federal awards. (Circular A-133's definition of *financial awards* is broader than the term *financial assistance* used in SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*.) Nonprofit institutions that receive at least \$25,000 but less than \$100,000 in federal financial assistance have the option of applying either the requirements of Circular A-133 or separate program audit requirements. For institutions receiving less than \$25,000, records must be kept and made available for review, if requested, but the provisions of the circular do not apply.

In the first quarter of 1991, the AICPA's Auditing Standards Division plans to expose a statement of position, prepared by a subcommittee of the AICPA Not-for-Profit Organizations Committee, that will provide guidance about compliance-auditing requirements in Circular A-133. Circular A-133 is effective for audits of fiscal years beginning on or after January 1, 1990. Since the circular permits biennial audits, some institutions may not be required to follow its requirements until the audit of their financial statements for the fiscal year ending June 30, 1992.

Audit Reporting and Communication Issues

Reporting on Uncertainties

Some auditors have issued an unqualified report with an additional paragraph about the existence of an uncertainty in situations when a qualified or adverse opinion should have been issued.

SAS No. 58, *Reports on Audited Financial Statements*, requires an auditor to add an explanatory paragraph (after the opinion paragraph) to the standard report when a matter is expected to be resolved at some future date, at which time sufficient evidence about its outcome is likely to be available. Examples of such uncertainties include lawsuits against the entity and tax claims by tax authorities when precedents are not clear. Because its resolution is prospective, sometimes management cannot estimate the effect of the uncertainty on the entity's financial statements. However, those uncertainties have, in some cases, been confused with other situations in which management asserts that it is unable to estimate certain financial statement elements, accounts, or items.

Generally, matters whose outcomes depend on the actions of management and relate to typical business operations are susceptible to reasonable estimation and, therefore, are estimates inherent in the accounting process, not uncertainties. Management's inability to estimate in these situations should raise concerns about the possible use of inappropriate accounting principles or scope limitations. If the auditor believes that financial statements are materially misstated because of the use of inappropriate accounting principles, a qualified or adverse opinion is required due to the GAAP departure. A scope limitation should result in a qualified opinion or a disclaimer of opinion.

Going-Concern Matters

When an auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern, SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires the auditor to include an explanatory paragraph (following the opinion paragraph) in the report to reflect that conclusion. Auditors have issued reports in which it is unclear whether they are expressing a conclusion that there is substantial doubt about an entity's ability to continue as a going concern.

For situations in which the auditor expresses such a conclusion, the ASB recently amended SAS No. 59 to require the use of the phrase "substantial doubt about the entity's ability to continue as a going concern" (or similar wording that includes the terms *substantial doubt* and *going concern*) in the required explanatory paragraph.

Required Communications to Audit Committees and Others Having Oversight Responsibility

Instances have been noted in which auditors have overlooked the communication requirements of SAS No. 61, *Communication With Audit Committees*. This statement requires auditors to ensure that certain matters are communicated to audit committees or other groups with responsibility for oversight of the financial reporting process. SAS No. 61 applies to—

- Entities that have an audit committee or a formally designated group having oversight responsibility for financial reporting (for example, a finance or budget committee).
- All SEC engagements as defined in note 1 of the statement.

In considering the communications required by SAS No. 61, the auditor should also not overlook the communications required by the following:

- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*
- SAS No. 54, *Illegal Acts by Clients* (see discussion below)
- SAS No. 60, *Communications of Internal Control Structure Related Matters Noted in an Audit*

Illegal Acts

SAS No. 54 provides guidance for communications with clients of possible illegal acts. The auditor has a responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on financial statement line-item amounts. Auditors may also become aware of other illegal acts that have, or are likely to have, occurred and that may not have a direct and material effect on financial statement amounts.

Auditors should assure themselves that all illegal acts that have come to their attention, unless clearly inconsequential, have been communicated to the audit committee or its equivalent (the board of trustees or an owner-manager) in accordance with SAS No. 54.

Recurring Audit Problems

Questionable Accounting Practices

Managements of companies—public or private—might feel pressure to report favorable results—for example, to maintain a trend of growth in earnings, support or improve the price of the company's stock,

obtain or maintain essential financing, or comply with debt covenants. This pressure is most likely to affect public companies, but auditors should not underestimate the pressures on nonpublic companies to “stretch” earnings or report a favorable financial condition—particularly in light of the current credit crunch. In most cases, the actions taken are well-intentioned and believed to be appropriate by the company. However, in certain cases, the result is an inappropriate accounting practice.

The downturn in the economy may have an effect on the way a client conducts its business and carries out its revenue recognition policies. Auditors should be alert to facts and circumstances relating to revenue recognition policies that may not be appropriate, such as—

- Changes in standard sales contracts permitting, for example, continuation of cancellation privileges.
- Situations in which the seller has significant continuing involvement or the buyer has not made a sufficient financial commitment to demonstrate an intent or ability to pay.
- Certain sales with a “bill and hold” agreement.

Revenue should not be recorded until it is realized or clearly realizable, the earnings process is complete, and its collection is reasonably assured.

The following are some other accounting practices that distort operating results or financial position:

- Improperly deferring typical period costs and expenses (for example, personnel, training, and moving costs) or costs for which a specific quantifiable future benefit has not been determined
- Adjusting reserves without adequate support
- Nonaccrual of losses (for example, environmental liabilities) or inadequate disclosure in accordance with FASB Statement No. 5, *Accounting for Contingencies*
- Inadequate recognition of uninsured losses (for example, increased deductibles for workers’ compensation or medical care)
- Using improper LIFO accounting practices, including inappropriate pools and intercompany transactions

Competent and sufficient audit evidence continues to be the foundation for the auditor’s opinion. Insufficient professional skepticism, illustrated by “auditing by conversation,” or failing to obtain solid evidence to back up management’s representations, can lead to audit problems. In the final analysis, auditors need to step back and ask one of auditing’s most fundamental questions: Does it make sense?

Problems also can occur due to errors in recording relatively straight-

forward transactions, particularly in those situations where cost-reduction and restructuring programs have reduced the number and quality of accounting personnel. The importance of principal audit procedures (for example, sales and inventory cut-off tests, searches for unrecorded liabilities, and follow-up on errors noted during tests) cannot be overemphasized. These types of procedures are fundamental and critical to the audit process.

Although clients may impose fee pressures or tight deadlines on auditors, these pressures do not change the professional responsibility to understand and audit the facts and situations carefully and to make professional, knowledgeable decisions.

Communications Between Predecessor and Successor Auditors

SAS No. 7, *Communications Between Predecessor and Successor Auditors*, establishes requirements for communications between predecessor and successor auditors when a change of auditors has taken place or is in process. It has been observed that the guidance provided by SAS No. 7 is sometimes not followed. It is essential that both predecessor and successor auditors are aware of, and adhere to, the requirements of SAS No. 7. For example, the predecessor auditor should respond promptly and fully to the successor's reasonable inquiries unless he or she indicates that the response is limited.

Part of Audit Performed by Other Independent Auditors

In accordance with SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 543), in no circumstances should an auditor state or imply that an audit report making reference to another auditor is inferior in professional standing to a report without such a reference. When a principal auditor decides not to make reference to the work of another auditor, the extent of additional procedures to be performed by the principal auditor may be affected by the other auditor's quality-control policies and procedures (see auditing interpretation "Part of Audit Performed by Other Auditors: Auditing Interpretations of AU Section 543" [AICPA, *Professional Standards*, vol. 1, AU sec. 9543.18]).

Attorney's Responses

A letter of audit inquiry to the client's lawyer is the auditor's primary means of corroborating information furnished by management concerning litigation, claims, and assessments. Auditors should carefully read all letters from attorneys and ensure that all matters discussed are understood. Ambiguous and incomplete responses should be appropriately resolved with client management and attorneys, and

conclusions should be properly documented. An auditing interpretation of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, presented in the AICPA's *Professional Standards*, vol. 1, AU sec. 9337.18, discusses what constitutes an acceptable reply. Additional inquiries may be needed if replies are not dated sufficiently close to the date of the audit report.

Pitfalls for Auditors

Each year-end seems to abound with pitfalls for auditors. The following reminders are intended to alert auditors to some of these pitfalls.

- Watch out for large, unusual, one-time transactions, especially at or near year-end, that may be designed to ease short-term profit and cash flow pressures. Scrutinize each transaction to ensure validity of business purpose, timing of revenue or profit recognition, and adequacy of disclosure.
- In performing analytical procedures (for example, analyzing accounts, changes from period to period, and differences from expectations), maintain an attitude of objectivity and professional skepticism. Do not assume that the accounts or client explanations are right. Rather, question, challenge, and compare new information with what is already known about the client and of business in general.
- Make sure that receivables that are supported by real estate as collateral reflect the softening of the market. Increases in the allowance for uncollectibles may be needed. Recognize that assets acquired through foreclosure may be overvalued and difficult to sell.
- Pay special attention to the collectibility of significant receivables from debtors that have recently gone through a leveraged buyout (LBO). A company is not the same entity that it was before an LBO.

Accounting Developments

Financial Instruments Disclosure

In March 1990, the FASB issued Statement No. 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, effective for fiscal years ending after June 25, 1990. It applies to all entities, including small businesses (due to its requirement to disclose significant concentrations of credit risk arising from all financial instruments, including trade accounts receivable).

The statement applies to all financial instruments with off-balance-sheet risk of accounting loss and all financial instruments with concentrations of credit risk, with some exceptions that are detailed in paragraphs 14 and 15 of the statement. It requires all entities with financial instruments that have off-balance-sheet risk to disclose the face, contract, or underlying principal involved; the nature and terms of the financial instrument; the accounting loss that could occur; and the entity's policy regarding collateral or other security and a description of the collateral.

Postretirement Benefits Other Than Pensions

The FASB is expected to issue the final statement on postretirement benefits other than pensions in December 1990. The proposed statement would significantly change the prevalent current practice of accounting for postretirement benefits on the "pay as you go" (cash) basis by requiring accrual, during the years that employees render services, of the expected cost of providing those benefits to employees and their beneficiaries and covered dependents. This statement would be effective for calendar-year 1993 financial statements. An additional two-year delay would be provided for plans of non-U.S. companies and certain small employers.

In the SEC Staff Accounting Bulletin (SAB) No. 74, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period*, the SEC staff expressed its belief that disclosure of *impending* accounting changes is necessary to inform readers about expected effects on financial information to be reported in the future and should be made in accordance with existing MD&A requirements. The SEC staff provided supplemental guidance regarding SAB No. 74 in the November 1990 EITF minutes.

Reporting When in Bankruptcy

Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*, provides guidance for entities that have filed petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11.

The SOP recommends that all such entities report the same way while reorganizing under Chapter 11, with the objective of reflecting their financial evolution. To do that, their financial statements should distinguish transactions and events that are directly associated with the reorganization from the operations of the ongoing business as it evolves.

The SOP generally becomes effective for financial statements of enterprises that have filed petitions under the Bankruptcy Code after December 31, 1990.

Audit Risk Alerts

The Auditing Standards Division is issuing Audit Risk Alerts to advise auditors of current economic, industry, regulatory, and professional developments that they should be aware of as they perform year-end audits. The following industries are covered:

- Airlines (022071)
- Agricultural producers and agricultural cooperatives (022073)
- Banking (022063)
- Casinos (022070)
- Construction contractors (022066)
- Credit unions (022061)
- Employee benefit plans (022055)
- Federal government contractors (022068)
- Finance companies (022060)
- Investment companies (022059)
- Life and health insurance companies (022058)
- Nonprofit organizations, including colleges and universities and voluntary health and welfare organizations (expected to be available in March 1991) (022074)
- Oil and gas producers (022069)
- Property and liability insurance companies (022072)
- Providers of health care services (022067)
- Savings and loan institutions (022076)
- Securities (022062)
- State and local governmental units (022056)

Copies of these industry updates may be purchased from the AICPA Order Department. They will also be included in the new loose-leaf service for audit and accounting guides.

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