University of Mississippi
eGrove

Industry Developments and Alerts | American Institute of Certified Public Accountants (AICPA) Historical Collection

1990

Construction contractors industry developments - 1990; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_indev

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation

American Institute of Certified Public Accountants. Auditing Standards Division, "Construction contractors industry developments - 1990; Audit risk alerts" (1990). *Industry Developments and Alerts*. 35.
https://egrove.olemiss.edu/aicpa_indev/35

This Article is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Industry Developments and Alerts by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

AUDIT RISK ALERTS

Construction Contractors Industry Developments—1990

Update to the AICPA Audit and Accounting Guide *Construction Contractors*

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 *Construction Contractors Industry Developments—1990* and *Audit Risk Alert—1990,* is intended to provide auditors of financial statements of construction contractors 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.

Gerard L. Yarnall
Director, Audit and Accounting Guides

Copyright © 1990 by the
American Institute of Certified Public Accountants, Inc.
1211 Avenue of the Americas, New York, N.Y. 10036-8775
1234567890 AudS 99876543210

Table of Contents

Page

Construction Contractors Industry Developments—1990 5
Industry and Economic Developments 5
Audit and Accounting Developments 7

Appendix—Audit Risk Alert—1990 13
Introduction 13
Economic Developments 13
Regulatory and Legislative Developments 15
New Auditing Pronouncements 16
Audit Reporting and Communication Issues 18
Recurring Audit Problems 19
Pitfalls for Auditors 22
Accounting Developments 22
Audit Risk Alerts 24
AICPA Services 25

Construction Contractors Industry Developments—1990

Industry and Economic Developments

Construction contracting is a very competitive industry with relatively low profit margins. Contractors are also extremely sensitive to changes in economic conditions. During recessionary periods, economic resources are often diverted from construction activity to the maintenance of current operations. Historically, downturns in the overall economy have resulted in unusually high failure rates among construction contractors.

Predictions are for a recessionary period in late 1990 and continuing into 1991, stemming from the situation in Kuwait, higher interest rates, and falling consumer confidence. Generally, drastic cuts in construction budgets by state and local governments and by commercial corporations are expected to be felt by the end of 1990 and during 1991. Housing starts at the end of 1990 were already at historic lows. However, there were regional variations, with the Northeast and West experiencing significant difficulties and the Midwest and South showing modest upward activity.

During recessionary periods, construction contractors are more likely to become involved in riskier and less profitable contracts. Some contractors may be motivated to accept marginal contracts to avoid losing experienced workers and to pay fixed overhead costs. However, involvement in less profitable contracts may not immediately become evident in operating results. Existing contracts may be completed at normal profit margins, but new contracts started during the same period are bid with narrower margins and have a greater risk of becoming loss contracts. Involvement in less profitable contracts may also be obscured by the front-end-loading billing practices of contractors that accelerate cash flow in the earlier stages of projects. When contractors incur substantial losses on contracts that have been front-end loaded, the results are usually a cash deficiency toward the end of those contracts and an even greater need for new contracts as a source of cash flow.

Contractors are also experiencing significant cost increases. In many parts of the country, insurance premiums for workers' compensation are rising significantly. This cost is becoming a major indirect cost for many contractors. Another source of significant cost increases for some

contractors is the so-called impact fee charged by some municipalities. Many municipalities are now assessing significant impact fees on all new projects. Still other increases result from the need to obtain environmental impact studies in conjunction with such projects. These cost increases are further reducing already strained profit margins.

Soft real estate markets increasingly are causing problems for contractors. Speculative projects are more difficult to justify, and such projects started in earlier years are experiencing significant losses. Project owners are becoming less liquid and contractors are experiencing increased difficulty in collecting receivables. Also, many financial institutions are slowing the frequency of progress draws on existing contracts and are unwilling to extend credit to contractors for new projects. Surety companies that provide performance, bid, and payment bonds are also tightening their credit policies, and, as described in more detail in the section on audit and accounting developments, these sureties can be expected to require more detailed financial information before writing bonds. In many cases, the sureties may require personal guarantees from contractors and cross-collateralization agreements from related entities.

Thus, in 1991, construction contractors are more likely to experience cash flow deficiencies, increased costs, and operating losses. The downturn in the economy will mean fewer contracts, and there will be increased economic pressure for contractors to accept riskier and less profitable contracts.

Overall and Specific Risks

Because of the nature of construction contractors' operations and the methods used in accounting for contracts, audits of construction contractors' financial statements can be relatively complex. Subjective estimates relating to future events affect the determination of contract costs, revenues, and gross profit.

An assessment of the degree of overall audit risk involved in construction contractor audits can be made by comparing total gross profit, gross profit from contracts completed in the period, and gross profit from contracts in progress. As the percentage of gross profit subject to the estimating process increases, there is greater reliance on estimates and a commensurate increase in audit risk.

The following specific conditions generally indicate increased audit risk:

- Increased frequency of loss contracts
- Inconsistent gross profit rates realized on completed contracts

- Declining rates of gross profit recognized on contracts in progress compared to rates of gross profit realized from completed contracts during the period
- Deteriorating gross profit rates toward the end of the accounting period
- Lack of controls over bidding and estimating projects
- Inadequate monitoring of projects in progress
- Apparent incompetence, lack of skill, or poor training of field personnel estimating contract progress and costs to complete
- Participation in joint ventures that are not audited

Because of the critical importance of contractors' estimating systems and the fact that the systems are not as susceptible to traditional substantive testing, auditors generally need to rely on analytical procedures to a greater extent in contractor audits. Thus, obtaining an understanding of contractors and their internal control structures, and designing effective analytical tests, assume relatively more importance in audits of construction contractors. Chapter 2 of the AICPA Audit and Accounting Guide *Construction Contractors* and paragraphs 23 through 25 of AICPA Statement of Position (SOP) 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts,* discuss circumstances in which an inability to make reasonable estimates would preclude the use of percentage-of-completion accounting for certain contracts.

Audit and Accounting Developments

Audit Issues

Supplemental Disclosure for Sureties. Among the primary users of the financial statements of construction contractors are surety companies that underwrite performance, bid, and payment bonds. Because of generally unfavorable economic and industry conditions, sureties are tightening their credit policies and are requiring more detailed supplemental financial information from contractors. Sureties are particularly interested in information that permits an assessment of the profitability of individual contracts, including work in progress and finished jobs. Usually they also are interested in details of related-party transactions, business plans, and other information such as accounts receivable aging statistics and ratios.

The amount of information provided in supplemental schedules to the financial statements may significantly influence a contractor's ability to obtain bonding. In such circumstances, it is prudent for the

client or auditor (with the client's consent) to call the surety at the start of the engagement to inquire about the nature and extent of financial information that should accompany the basic financial statements. If financial information accompanies the basic financial statements in an auditor-submitted document, the auditor should report on the information in accordance with AICPA Statement on Auditing Standards (SAS) No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents.* The auditor's responsibility for other information in client-prepared documents that contain audited financial statements is described in SAS No. 8, *Other Information in Documents Containing Audited Financial Statements.*

Audit Reporting Requirements and Contractor Claims Against Owners. Paragraph 65 of SOP 81-1 provides that recognition of revenue relating to a contractor's claim against an owner for an amount in excess of the agreed contract price is appropriate only in certain circumstances. Recognition of revenue is appropriate if it is probable that the claim will result in additional contract revenue and the amount can be reliably estimated. The auditor assesses the likelihood of the claim's resulting in additional contract revenue by considering factors such as whether there is a legal opinion stating that, under the circumstances, there is a reasonable basis to support the claim, and stating whether the evidence to support the claim is objective and verifiable.

In some cases, the conditions specified in SOP 81-1 are not met and the auditor concludes that the likelihood of additional contract revenue is less than probable. In those circumstances, some auditors have treated the matter as an uncertainty and issued an unqualified opinion with a fourth explanatory paragraph describing the uncertainty concerning realization of the claim. Such reports are not appropriate.

Paragraph 21 of SAS No. 58, *Reports on Audited Financial Statements,* points out that there are situations in which the inability to make a reasonable estimate may raise questions about the appropriateness of the accounting principles used. If the auditor believes there is sufficient uncertainty concerning the likelihood that a contractor's claim will result in contract revenue such that the revenue is not probable, the requirements of SOP 81-1 are not met, and there is a departure from generally accepted accounting principles (GAAP). This is not the type of uncertainty that can be described in an explanatory paragraph without qualification of the opinion.

Lawyers' Letters and Claims Against Contractors. Because of the nature of construction activities, disputes and litigation between contractors and owners tend to be relatively common. For this reason, the evidence obtained from lawyers' letters concerning claims and assessments is

particularly important in audits of construction contractors. Paragraph 8 of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments,* indicates that a letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments.

Contractor Qualification Reports. Many federal, state, and local governmental agencies require contractors to file qualification reports as a condition of bidding on or performing construction projects for the government. Auditors should obtain copies of the form of qualification report required and determine whether there are any unusual auditing or reporting considerations. In some cases, the qualification reports include financial statements prepared on a basis of accounting prescribed by the governmental agency that differs from GAAP.

Guidance on reporting on financial statements prepared in accordance with comprehensive bases of accounting other than GAAP is provided by SAS No. 62, *Special Reports.* An example of the type of report that might be appropriate for reporting on financial statements presented in conformity with a regulatory basis of accounting for inclusion in a state prequalification report follows:

Independent Auditor's Report

[*Addressee*]

We have audited the accompanying statement of assets, liabilities, and surplus of [*contractor company*] as of December 31, 19X1, and the related statements of income and surplus for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note A, these financial statements for state prequalification filing were prepared in conformity with the accounting practices prescribed or permitted by the state in which they were filed, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and surplus of [*contractor company*] as of December 31, 19X1, and the results of its operations for the year then ended, on the basis of accounting described in Note A.

This report is intended solely for the information and use of the management of [*contractor company*] and for filing with [*name of government agency*] and should not be used for any other purpose.

[*Signature*]
[*Date*]

A qualification report may need to include financial information in addition to the basic financial statements. The auditor's report should indicate the degree of responsibility assumed for all information included in the qualification report if the qualification report can be considered an auditor-submitted document. If audited financial statements are included in a client-prepared qualification report, the auditor should consider the responsibility described in SAS No. 8. If the government agency requirements specify that the auditor should audit and express an opinion on the accompanying information, the auditor may need to perform additional procedures to be associated with the qualification report. If the government agency requirements do not specify an audit of the additional information, the auditor may report on it in accordance with SAS No. 29 if it is included in an auditor-submitted document. If such information is included in a client-prepared document, SAS No. 8 applies.

Accounting Issues

Disclosure Requirements Under FASB Statement No. 105. Financial Accounting Standards Board (FASB) Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* may require additional disclosures in a contractor's financial statements. For example, concentrations of credit risk may occur if the same owner is involved in several projects of the contractor.

Among the examples of financial instruments with off-balance-sheet risk identified in FASB Statement No. 105 are financial guarantees. Because contractors normally purchase guarantees such as performance, bid, and payment bonds, questions have arisen about whether such bonds are subject to the disclosure requirements of FASB Statement No. 105. The guarantees may be very significant in relation to the contractor's financial position. For example, a performance bond protects the owner against losses resulting from a contractor's failure to perform in accordance with the terms of the contract. The surety issuing the bond has recourse against the contractor's assets. Normally,

a construction company must pledge all of its assets to indemnify the surety company against losses under the performance bond guarantee.

When a contractor posts a bond, a financial instrument is not created under the definition of such instruments in FASB Statement No. 105. A construction company improves its creditworthiness by purchasing a bond, but the bond is not a financial instrument to the purchaser of the bond. The bond imposes no contractual obligations on the contractor that did not exist before the bond was posted. For example, a contractor incurs a risk of failure to perform under a contract, but that risk is not increased by purchasing a performance bond. Thus, FASB Statement No. 105 does not apply to the bid, performance, and payment bonds typically posted by construction contractors.

Postretirement Benefits Other Than Pensions. The FASB is expected to issue a final statement, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* by the end of 1990. The statement is expected to specify the accounting for the costs of health care, health insurance, and all other benefits except pensions that are provided to retired employees and their beneficiaries and covered dependents. The statement is expected to require that postretirement benefits be accrued during the active service periods of employees to the date they attain full eligibility for the benefits.

The statement will not be effective until calendar-year-1993 financial statements are issued, and there will be an additional two-year delay for non-U.S. plans and those of certain small employers. Affected contractors can effectively use the transition period to consider how to minimize implementation problems. Those contractors with a unionized work force should not be seriously affected by the statement. In a unionized environment, there generally is a union-run multi-employer trust fund, and contractor-employers pay the union a specified amount per employee-hour for benefits and the union is then responsible to the employees. Accordingly, such employers will have no liability.

A nonunion environment may cause significant implementation problems. A contractor with a nonunion work force usually has different postretirement benefit arrangements for different jobs. This lack of uniformity in benefit arrangements and greater variability in future arrangements will make the estimation of the expected future cost of promised benefits more difficult and complex. Contractor-employers may want to modify their approach to negotiating benefits in the period prior to the effective date to facilitate implementation of the statement.

Tax Issues

The 10 Percent Method and Gross Profit Deferral. The Revenue Reconciliation Act of 1989 created an elective provision that allows deferral of long-term contract income on certain contracts that are less than 10

percent complete by the end of the taxable year. This provision is sometimes called the Cliff Rule. The election applies only to contracts that are entered into after December 31, 1989. This election also applies to the look-back calculation (discussed later) and the alternative minimum tax. If a contractor client makes this election, the practitioner should be aware of the effect that differences between computation of percentage of completion for tax and financial statement purposes may have on the gross profit recognized. For tax purposes, the computation of percentage of completion by the cost-to-cost method includes the cost of materials shipped to the job site, whether or not these materials have been installed. Installation is required for recognition in the cost-to-cost calculation for financial statement purposes. Thus, a job for which the only costs are for materials shipped to the job site may be 10 percent complete for tax purposes before any work actually begins on the job.

Look-Back Regulations. Internal Revenue Code Section 460(b)(3) introduced the so-called look-back requirement for many construction contractor taxpayers. Under the look-back rules, the taxpayer is required to "look back" at prior taxable years and recompute the gross profit for those prior years based on the actual gross profit realized at the completion of the project. If the prior year's gross profit on the completed contract was overestimated or underestimated, taxable income and alternative minimum taxable income for the prior period must be restated and the tax liability recomputed. If the prior year's tax liability was understated, interest on the understatement is due. If the tax liability was overstated, the taxpayer receives interest. In other words, the look-back method involves the computation of interest for hypothetical underpayments or overpayments of tax liability attributable to the use of estimated gross profit rather than actual gross profit in prior years.

In November 1990, the Treasury Department issued final look-back regulations. The look-back rules can be burdensome for small contractors. Typically, a small contractor is faced with compliance with the look-back provisions only for purposes of the alternative minimum tax. Often, the cost of compliance to the small taxpayer is greater than the look-back interest due. Practitioners should obtain the final regulations if they provide tax preparation or advisory services to contractor clients.

* * * *

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.

Call toll free: (800) 334-6961 (USA)
(800) 248-0445 (NY)

AICPA Services

Technical Hotline

The AICPA Technical Information Service answers inquiries about specific audit or accounting problems.

Call toll free: (800) 223-4158 (USA)
(800) 522-5430 (NY)

Ethics Division

The AICPA's Ethics Division answers inquiries about the application of the AICPA Code of Professional Conduct. Auditors may call at any of the following numbers:

(212) 575-6217
(212) 575-6299
(212) 575-6736

990220