1994

Construction contractors industry developments - 1994

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Construction Contractors Industry Developments—1994

Complement to AICPA Audit and Accounting Guide *Construction Contractors*

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert 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 on by a senior technical committee of the AICPA.

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1 2 3 4 5 6 7 8 9 0 AAG 9 9 8 7 6 5 4

Table of Contents

Construction Contractors Industry Developments—1994

Industry and Economic Developments

The downward spiral in commercial construction that began in 1990 may be drawing to an end. The driving force of the gradual recovery has been, and probably will be, single-family housing starts. The least robust segment of residential construction is multifamily housing, which still suffers from capital constraints and overbuilding of rental units in many areas.

The recent signs of economic upturn in the industry, however, do not signify a boom. Activity seems likely to remain low by 1980s standards. The industry is expected to generate about $90 billion of business in 1994, up 4 percent from 1993. The slow pace of the industry's recovery should permit a sustained period of expansion. Indicators of inflationary pressures, which could stop a recovery of construction, are presently nowhere to be found. However, President Clinton's economic package could have an adverse impact on the industry's recovery.

The President's economic package includes several pieces of legislation that will affect the construction industry on various fronts. Specifically, the proposed increases in personal and other income tax rates, the reduction of permissible deductions, and the increase in excise taxes will only add to the financial problems that have fallen on the construction industry over recent years and could impede the gradual recovery. Construction contractors should be alert to changes in government policies that may expose these companies to higher levels of risk, which, in turn, may increase audit risk.

The impact of economic swings on the industry typically lags behind movement in other segments of the economy. During recessionary periods, construction budgets are generally the first to be cut as an entity's resources are focused on current operations. The effect of an economic downturn, however, is usually not immediately reflected in a construction contractor's financial statements. Instead, the effect is postponed because contracts in progress—some of which may extend over a number of years—are normally completed, providing revenues in the near-term. Moreover, decisions made at the start of periods of economic recovery to undertake new construction will typically not immediately be reflected in a construction contractor's results of operations because of the extended start-up period and the length of the contract period. Therefore, auditors should consider the continuing effects of the general economic downturn experienced in the early 1990s as they plan and perform audits this year.

Competition is keen in all businesses today, but especially so in the construction industry. As a result, construction contractors are more likely to accept less profitable, riskier contracts as a means of using fixed overhead and retaining experienced personnel. Auditors should be attentive to signs that costs may have been underestimated in the bidding process, resulting in a greater likelihood of contract losses.

Auditors of construction contractors should also be alert to certain implications of the current industry climate that may mean added audit risks. For example, certain construction contractors, in an attempt to strengthen their financial position, may be reorganizing or restructuring their business operations. Actions such as these could have a significant effect on an entity's financial statements and should be considered by auditors as they plan their audits in accordance with AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311). SAS No. 22 requires that, in planning the audit, auditors should consider "matters relating to the entity's business and the industry in which it operates."

Many construction contractors are experiencing rapid increases in their costs, particularly in areas such as insurance premiums for workers' compensation, impact fees charged by some municipalities, and costs of obtaining environmental impact studies in connection with some projects. As a result, some construction contractors may experience negative cash flows and operating losses, both on specific contracts and on operations as a whole.

Reduced activity in the industry, coupled with higher costs, may create a high-risk audit environment. Construction contractors' project evaluation and control procedures take on greater importance for auditors under these circumstances. In addition, in the current economic climate, questions of asset impairment may present significant auditing and financial reporting issues. The subjectivity of determining asset valuation allowances, combined with continued economic uncertainty, reinforces the need for careful planning and execution of audit procedures in this area.

Auditors of construction contractors should carefully consider how current industry and economic conditions affect the risk inherent in their audits. In addition, auditors should be alert to the audit-risk implications of practices that may place construction contractors at a high level of risk of loss. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), provides guidance to the auditor in conducting an audit, in accordance with generally accepted auditing standards (GAAS), with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern. As a general rule, information that significantly contradicts the going-concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions. These and other issues are addressed further in the "Audit Issues and Developments" section of this Audit Risk Alert.

Audit Issues and Developments

Auditing financial statements of construction contractors has never been a simple process. However, the task has been made even more difficult due to the impact of today's rapidly changing economic conditions on the construction marketplace. Some additional issues that auditors should address in planning and performing audits of financial statements of construction contractors in today's environment are outlined below.

Acceptance of the Engagement

The losses in recent years incurred by the banking and surety industry due to contractor failure have heightened their sensitivity and increased their reluctance to lend. Therefore, for auditors, there has never been a more important time to assess the client acceptance process.

Some areas that auditors may consider before accepting a construction audit engagement are as follows:

- Financial condition of the company and the owner
- Method of contract acquisition
- Key relationships: surety, bank, prior accountant, attorney
- Status of insurability
- Customer status
- Subcontractor status
- Management style
- Potential going-concern problems based on ability to attract new work

As part of this evaluation, auditors must carefully evaluate a client's characteristics and, in some instances, they may need to conclude that servicing a client may be too risky a venture.

Revenue Recognition

Accounting Research Bulletin (ARB) No. 45, *Long-Term Construction-Type Contracts* (Financial Accounting Standards Board [FASB], *Current Text*, vol. 2, sec. Co4), addresses the accounting problems in relation to construction-type contracts in the case of commercial organizations engaged wholly or partly in the contracting business. Problems in accounting for construction-type contracts arise particularly in connection with long-term contracts as compared with those requiring relatively short periods for completion.

Under generally accepted accounting principles (GAAP), there are two methods of recognizing revenues on construction contracts.

1. The percentage-of-completion method, which allows the contractor to recognize income throughout a contract's life, must be used in most instances. Under this method, a contractor computes the extent of progress toward completion for each contract in progress at a given point in time. For example, if a contract is 75 percent complete on a particular date, the contractor recognizes 75 percent of the contract's revenues, costs, and gross income at that date.
2. The completed-contract method, which defers income recognition until a contract is substantially completed, should be used only in those rare instances when the percentage-of-completion method cannot be used. Under this method, revenues, costs, and gross income are not recognized throughout the life of a contract. Instead, such income statement accounts are recognized only at project completion.

A contractor is not free to choose which method to use. The AICPA's Auditing Standards Division issued Statement of Position (SOP) 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, which establishes a strong preference for the percentage-of-completion method, virtually requiring that it be used as the basic method of accounting by most construction contractors. In fact, the only time the completed-contract method should be used is when either of the following conditions exists:

1. The results do not vary materially from those achieved under the percentage-of-completion method.
2. With persuasive evidence, the contractor can overcome the basic presumption that it has the ability to make reasonable dependable estimates.

To use the percentage-of-completion method, however, a contractor must have the ability to make "reasonable dependable estimates" regarding the extent of progress toward completion for each contract. Since estimating is an essential part of a contractor's business, there is a general presumption that most contractors can make sufficiently dependable estimates.

Auditors should carefully review the contractor's estimated costs-to-complete to determine whether losses may be incurred on the contract. As indicated in the AICPA Audit and Accounting Guide *Construction Contractors*, one of the most important phases of the audit of a construction contractor relates to estimated costs-to-complete contracts in process, since that information is used in determining the estimated final gross profit or loss on contracts. Estimated costs-to-complete involve expectations about future performance. When evaluating the propriety of these estimated costs, auditors should—

- Carefully review representations of management.
- Obtain explanations of apparent disparities between estimates and past performance on contracts, experience on other contracts, and information gained in other areas of the audit.
- Document the results of work in these areas.

Because of the direct effect on the estimated interim and final gross profit or loss on the contract, auditors should evaluate whether the contractor's estimate of costs-to-complete is reasonable. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit of financial statements in accordance with GAAS.

Since construction contractors are operating under the exception mode to revenue recognition, the effect of post-balance-sheet events should be carefully considered, particularly their impact on revenue recognition or loss accrual on construction contracts. Auditors of construction contractors should refer to SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 560, "Subsequent Events"), which provides guidance on events or transactions which occur subsequent to the balance-sheet date, but prior to the issuance of the financial statements and auditor's report, that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements.

Provision of Anticipated Losses

Regardless of the revenue recognition method used by a construction contractor, GAAP requires the accrual of a loss provision whenever it becomes apparent that the total estimated contract cost will materially exceed the contract revenue or price. Generally, to determine if an anticipated loss exists, the construction contractor should assess the following factors for each contract in progress at year end:

- Costs incurred to date
- Estimated costs to complete
- Estimated total contract revenues

SOP 81-1, paragraph 85, provides that "when the current estimates of total contract revenue and contract cost indicate a loss, a provision for the entire loss on the contract should be made. Provisions for losses should be made in the period in which they become evident under either the percentage-of-completion method or the completed-contract method." Provisions for losses should be shown separately as a liability or as a deduction from any related accumulated costs.

Auditors of financial statements of construction contractors should be aware of the guidance contained in SOP 81-1 in connection with the "Provisions for Anticipated Losses on Contracts" section (paragraphs 85–89) and should consider whether the financial statement presentation and associated disclosures are adequate and appropriate in view of the requirements.

Job Site Visits

In certain situations, visits to selected job sites are essential for auditors to understand the construction contractor's operations and to relate the internal accounting information to events that occur at the job sites. In addition, such visits can provide invaluable first-hand information about the physical status of projects and operational problems. Job site visits are required if auditors intend to assess control risk at the site as low or if the related accounts cannot be substantiated by other procedures. Although the level-of-accounting functions (and related control procedures) vary depending on the size of the project, one objective of a site visit is obtaining information and supporting documentation to evaluate the reasonableness of the progress of the project to date. Auditors may perform such procedures as—

- Identifying uninstalled materials that should be excluded when measuring progress toward completion, and noting physical security over such materials.
- Observing contractor-owned or rented material.
- Discussing with job site personnel issues that may affect the estimated total gross margin, such as problems encountered or operational inefficiencies.

- Discussing with job site personnel as to the status of labor hours incurred to date and estimates to complete, including evaluating those estimates by observing the physical progress of the project.

Auditors may wish to consider the use of a specialist in this area; if so, auditors should follow the guidance of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336). SAS No. 73 is effective for audits of financial statements for periods ending on or after December 15, 1994, with earlier application encouraged.

SAS No. 73 provides guidance to the auditor who uses the work of a specialist in performing an audit in accordance with GAAS. The new standard is not expected to dramatically change current practice for auditors who use the work of a specialist in audits performed in accordance with GAAS. It does, however, (1) clarify the applicability of the guidance, (2) provide updated examples of situations which might require using the work of specialists and types of specialists being used today, and (3) provide guidance when a specialist is related to the client.

Related-Party Transactions

Assessing the collectability of related-party receivables is a significant auditing issue. Auditors should obtain sufficient competent evidential matter in accordance with SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), concerning the financial competency of related parties to repay outstanding advances. If the collectability of the receivable balance is in question, offsetting a related-party receivable against equity may be appropriate.

FASB's Statement of Financial Accounting Standards No. 57, *Related Party Disclosures* (FASB, *Current Text*, vol. 1, sec. R36), provides the requirements for related-party disclosures. Certain accounting pronouncements prescribe the accounting treatment when related parties are involved; however, established accounting principles generally do not require transactions with related parties to be accounted for on a basis different from that which would be appropriate if the parties were not related. Auditors should view related-party transactions within the framework of existing pronouncements, placing emphasis on the adequacy of disclosure.

SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 334, "Related Parties"), provides guidance on procedures auditors should consider when they are performing an audit of financial statements in accordance with GAAS to identify related-party relationships and transactions. Auditors should satisfy themselves concerning the required financial statement accounting and disclosure.

Going Concern

Many profitable construction contractors have quickly deteriorated because of lack of work, pinched margins on acquired work, litigation, or one large receivable becoming uncollectable. Auditors should assess the increased risks based on the current conditions in the marketplace and look beyond the presence of profit and net worth.

Auditors of construction contractors should be alert to conditions that may indicate the existence of substantial doubt about the contractor's ability to continue as a going concern. As previously discussed, SAS No. 59 provides guidance to auditors in conducting an audit of financial statements in accordance with GAAS for evaluating whether there is substantial doubt about the entity's ability to continue as a going concern.

As outlined in SAS No. 59, it is not necessary for auditors to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited, as described in SAS No. 31. The following are examples of procedures that may identify such conditions and events:

- Analytical procedures
- Review of subsequent events
- Review of compliance with the terms of debt and loan agreements
- Reading of minutes of meetings of stockholders, board of directors, and important committees of the board
- Inquiry of an entity's legal counsel about litigation, claims, and assessments
- Confirmation with related and third parties of the details of arrangements to provide or maintain financial support

If initial evaluation raises substantial doubt about the entity's ability to continue as a going concern, it may be necessary to obtain additional information about such conditions and events, as well as the appropriate information that mitigates the auditors' doubt. In such circumstances, the auditors should ask management about its plans for dealing with the effects of the conditions or events underlying the going-concern question. The auditors should consider whether it is likely that the adverse effects will be mitigated by management's plans and whether those plans can be effectively implemented. Obtaining management's representations about its plans will not by itself provide sufficient audit evidence to allay doubt about going-concern status.

If the auditors obtain sufficient evidence to alleviate their doubts in connection with going-concern status they should consider the need for financial statement disclosure of the principal conditions and events that initially caused them to believe there was substantial doubt, and any mitigating factors, including management's plans. However, if after considering identified conditions and events and management's plans, the auditors conclude that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph to reflect that conclusion.

Environmental Matters

The U.S. Environmental Protection Agency (EPA) is empowered by law to seek recovery from any party that ever owned or operated a contaminated site, or anyone who ever generated or transported hazardous materials to a site. In view of the liabilities that may result from owning contaminated sites, virtually all real estate transactions entered into today give consideration to environmental liabilities. For the construction industry, which is already plagued with overcapacity, fierce competition, and declining margins, a construction contractor's ability to respond to environmental challenges in a cost-efficient manner may well determine its viability.

In order to properly audit environmental contingencies and liabilities, auditors of construction contractors should evaluate whether the accounting and disclosure requirements of FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59), have been met. Additional guidance is included in the following:

- FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (FASB, *Current Text*, vol. 1, sec. C59)
- FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FASB, *Current Text*, vol. 1, sec. B10)
- FASB Emerging Issues Task Force (EITF) Issue No. 89-13, *Accounting for the Cost of Asbestos Removal*
- EITF Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination*
- EITF Issue No. 93-5, *Accounting for Environmental Liabilities*

Auditors of publicly held construction contractors should be aware of the Securities and Exchange Commission's (SEC's) Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Con-*

tingencies, which provides the SEC staff's interpretation of current accounting literature related to matters such as—

- The appropriateness of offsetting probable recoveries against probable contingent liabilities.
- Recognition of liabilities for costs apportioned to other potential responsible parties.
- Uncertainties in estimation of the extent of environmental liability.
- The appropriate discount rate for environmental liabilities, if discounting is appropriate.
- Financial statement disclosures of exit costs and other items and disclosure of certain information outside the basic financial statements.

Audit Risk Alert—1994 contains further discussion on issues relating to environmental remediation matters.

Accounting Issues and Developments

Impairment of Assets

In November 1993, the FASB issued an exposure draft of a proposed Statement titled *Accounting for the Impairment of Long-Lived Assets.* The proposed Statement addresses the accounting for the impairment of long-lived assets, as well as identifiable intangibles, and goodwill related to those assets. As a final document, it would establish guidance for recognizing and measuring impairment losses and would require that the carrying amount of impaired assets be reduced to fair value.

If finalized under the same approach as proposed, the Statement would also require long-lived assets and identifiable intangibles held and used by an entity to be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. In performing the review for recoverability, entities would estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future net cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss would be recognized.

Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use would be based on the fair value of the asset. Long-lived assets and identified intangibles to be disposed of would be reported at the lower of cost or fair value less cost to sell, except for assets that are covered by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (FASB, *Current Text*, vol. 1, secs. I13, I17, I21, I22).

A final Statement is expected by year end. The exposure draft was proposed to be effective for financial statements issued for fiscal years beginning after December 15, 1994; the FASB has not decided the effective date for any final statement. Until the FASB resolves the issue of impairment of long-lived assets, auditors should assess management's approach to asset impairment.

Restructurings

In attempts to ensure their future viability, many construction contractors have undertaken restructurings over the past few years. Among the actions associated with restructurings have been termination of personnel and reduction in overhead by selling or leasing excess space. The auditors' attention should be focused on the impact of reductions in personnel on operations and the internal control structure, the reserve balance relating to current restructuring plans, and the appropriate period for reporting the costs associated with restructurings.

In evaluating the propriety of restructuring charges recorded by their clients, auditors should refer to EITF Issue No. 94-3, *Liability Recognition for Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring),* which provides guidance on whether certain costs (such as employee severance and termination costs) should be accrued and classified as part of restructuring charges, or whether such costs would be more appropriately considered a recurring operating cost of the company. EITF Issue No. 94-3 provides guidance on the appropriate timing of recognition of restructuring charges and prescribes disclosures that should be included in the financial statements.

In addition, for publicly held construction contractors, SEC SAB No. 67 (Topic 5P), *Income Statement Presentation of Restructuring Charges,* describes "restructuring charges" as charges that "typically result from the consolidation and/or relocation of operations, the abandonment of operations or productive assets, or the impairment of the carrying value of productive or other long-lived assets." Restructuring charges have included such costs as employee benefits and severance costs, costs associated with the impairment disposal of long-lived assets, facility closure costs, and other nonrecurring costs associated with the restructuring. Their inclusion as a component of income from continuing operations is required by SAB No. 67 (Topic 5P).

Investment in Ventures

By combining resources with one or more other contractors, a contractor may be able to bid and complete larger, more complex construction projects. Construction contractors may also move into other geographic areas by forming joint ventures with contractors in those areas. Some joint ventures are designed and created for bidding, negotiating, and performing one specific project. Other ventures are created to be permanent. The purpose of these permanent joint ventures is generally to pool resources and to bid on all contracts of a specific type for an indefinite period of time.

Joint ventures may take the form of any of the following:

1. General partnership
2. Limited partnership
3. Corporation

There are several different methods of presenting a construction contractor's interest in a venture. The more common methods are as follows:

- Consolidation
- Equity method, including the little-used expanded-equity method
- Cost method
- Pro rata combination

The accounting for investments in ventures is influenced by the extent of control the construction contractor has over the operations of the venture. Generally the relationships are as follows:

1. Less than 20 percent: The cost method is normally used for these investments because of the presumption that the contractor will be unable to significantly influence the affairs of the joint venture. Cost is reduced for permanent declines in value, and dividends are treated as income when received.
2. More than 50 percent: A holding of more than 50 percent of the voting stock of another company normally constitutes control and requires presentation of consolidated financial statements.
3. Between 20 and 50 percent: There is a presumption, according to APB Opinion 18, *The Equity Method of Accounting for Investments in Common Stock* (FASB, *Current Text*, vol. 1, sec. I82), that a construction contractor that owns between 20 and 50 percent of a joint venture has the ability to exercise significant influence over the venture and should account for the investment using the equity method.

Accounting for Claims

SOP 81-1, paragraphs 65 and 66 state, in part, the following:

> 65. Claims are amounts in excess of the agreed contract price (or amount not included in the original contract price) that a contractor seeks to collect from customers or others for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs. Recognition of amounts of additional contract revenue relating to claims is appropriate only if it is probable that the claim will result in additional contract revenue and if the amount can be reliably estimated. Those two requirements are satisfied by the existence of all the following conditions:
>
> *a.* The contract or other evidence provides a legal basis for the claim; or a legal opinion has been obtained, stating that under the circumstances there is a reasonable basis to support the claim.
>
> *b.* Additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance.
>
> *c.* Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed.
>
> *d.* The evidence supporting the claim is objective and verifiable, not based on management's "feel" for the situation or unsupported representations.
>
> If the foregoing requirements are met, revenue from a claim should be recorded only to the extent that contract costs relating to the claim have been incurred. . . .
>
> 66. However, a practice such as recording revenues from claims only when the amounts have been received and awarded may be used. . . .

The requirements of paragraph 65 provide competent evidence upon which to base the recording of a claim. If these requirements are met, and there are no extenuating circumstances, the practice of recording claims only when the amounts have been received and awarded should not be an alternative.

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This Audit Risk Alert replaces *Construction Contractors Industry Developments—1993.*

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Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1994* and *Compilation and Review Alert—1994,* which may be obtained by calling the AICPA Order Department at the number below and asking for product number 022141 (audit) or 060668 (compilation and review).

Copies of AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

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