University of Mississippi
eGrove

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

2006

Construction contractors industry developments - 2006/07; 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 - 2006/07; Audit risk alerts" (2006). *Industry Developments and Alerts*. 50.
https://egrove.olemiss.edu/aicpa_indev/50

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—2006/07

Strengthening Audit Integrity
Safeguarding Financial Reporting

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA®

AUDIT RISK ALERTS

Construction Contractors Industry Developments—2006/07

Strengthening Audit Integrity
Safeguarding Financial Reporting

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA®

Notice to Readers

This Audit Risk Alert is intended to provide auditors of construction contractors with an overview of recent economic, industry, technical, and professional developments that may affect the audits they perform.

This publication is an Other Auditing Publication as defined in AU section 150, *Generally Accepted Auditing Standards* (*AICPA, Professional Standards*, vol. 1). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA, and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Written by J. Russell Madray, CPA
Edited by Christopher Cole, CPA
Technical Manager
Accounting and Auditing Publications

Copyright © 2006 by
American Institute of Certified Public Accountants, Inc.
New York, NY 10036-8775

All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please visit www.copyright.com or call (978) 750-8400.

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

Table of Contents

Construction Contractors Industry Developments—2006/07 ... 1

How This Alert Can Help You ... 1

Industry and Economic Developments ... 1
- General Industry Trends and Conditions ... 2
- Private Construction ... 5
- Public Construction ... 11
- Surety Industry Trends ... 13
- Construction Cost Trends ... 17

Legislative and Regulatory Issues ... 19
- New Tax Credit for Homebuilders ... 19
- AGCxml Project ... 20

Current Audit and Accounting Issues and Developments ... 21
- Assessing Audit Risk in the Current Environment ... 21
- Accounting and Auditing Issues Related to Construction Contracts ... 25
- Job Performance ... 29
- Estimating Costs to Complete ... 30
- Accounting Systems and Controls ... 31
- Affiliated Entities ... 32
- Variable Interest Entities ... 32
- Recent Technical Practice Aids (TPAs) Related to FASB Interpretation No. 46(R) ... 42
- Using the Work of a Specialist ... 45
- Important Information for Review Engagements ... 47

Recent Auditing and Attestation Pronouncements and Related Guidance ... 52
- Spotlight on the AICPA Risk Assessment Standards ... 54
- Statement on Auditing Standards No. 103 ... 57
- Staff Accounting Bulletin No. 108 ... 57

Recent AICPA Independence and Ethics Pronouncements........59

Recent Accounting Pronouncements and Related Guidance..... 59

On the Horizon........60

Auditing Pipeline........62

Accounting Pipeline........63

AICPA Resource Central........66

Audit and Accounting Manual........68

AICPA reSOURCE: Online Accounting and Auditing Literature........68

Educational Courses........68

Online CPE........70

Webcasts........71

Member Satisfaction Center........72

Technical Hotline and Ethics Hotline........72

Conferences........72

Web Sites........72

APPENDIX A—HELPFUL WEB SITES........75

APPENDIX B—AUDIT CONSIDERATIONS OF VARIOUS TYPES OF CONTRACTS—REVENUE ISSUES........79

Construction Contractors Industry Developments—2006/07

How This Alert Can Help You

This Audit Risk Alert helps you plan and perform your construction industry audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate. This Alert is an important tool in helping you identify the significant risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

This Alert describes trends and issues facing most contractors in many of the construction markets in the country. National trends and industry-wide benchmarks can help you understand financial statement relationships and how they may affect your client. However, broad national trends have their limitations. Keep in mind that your client will be affected much more by local economic, political, and industry conditions that exist in the specific markets your client serves.

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert–2006/07* (product no. 022337kk).

References to Professional Standards. When referring to the professional standards, this Alert cites the applicable sections of the codification and not the numbered statements, as appropriate. For example, SAS No. 54 is referred to as AU section 317 of the AICPA *Professional Standards.*

Industry and Economic Developments

Read the AICPA general *Audit Risk Alert—2006/07* for an overview of the current U.S. and global economic environment.

General Industry Trends and Conditions

After a string of years of solid construction growth, analysts are predicting no slowdown, and in many cases, even more growth in commercial construction jobs. Analysts agree that single-family residential construction will soften in the remainder of 2006 and into 2007, but they believe commercial construction will pick up the pace, replacing residential work with commercial work. The 2006 U.S. construction market amounts to $1.2 trillion, of which single- and multi-family residential construction accounts for just over $642 billion. Most construction economists believe that as residential construction tails off, commercial projects will pick up the slack, resulting in a 5 percent increase in total put-in-place construction in the U.S. in 2007. Forecasters at FMI, a consultant group to commercial contractors and the construction industry, predict growth in nonresidential construction of 8 percent in 2006 and 9 percent in 2007. Ed Sullivan, chief economist at the Portland Cement Association, sees an even brighter picture for nonresidential construction in 2007. He predicts a growth rate of 8.5 percent, up from 6.4 percent in 2006 and only 1.5 percent in 2005. According to Sullivan, the nonresidential market turned in 2005 after five years of decline. But despite the large percentage gains for 2006, most markets could still be considered weak from a historical perspective, he says.

While the economy is chugging along, inflationary pressures have market watchers at the Federal Reserve Board concerned. According to Ken Simonson, economist at the Associated General Contractors, the inflation level in the general economy is 3 to 4 percent, but building materials costs have increased nearly 8 percent and transportation costs have gone up 16 percent. This is spurring the Federal Reserve to increase prime interest rates, and the general consensus is that the economy may see the prime lending rate touch 6 percent in 2007. This will further dampen residential work, but commercial work will continue, barring any unforeseen event, economists predict.

Most economists believe inflationary fears will ease and business growth will slow enough by the second half of 2007 that the Federal Reserve will ease up on interest rates. This should keep the

fire cooking under the economy without it boiling over to feed inflation into 2008.

Construction Put in Place

One of the most widely used measures of construction activity is *construction put in place*, which is tracked monthly by the Bureau of Statistics at the U.S. Department of Commerce. The *value of construction put in place* (value-in-place) is a measure of the value of construction installed or erected at the site during a given period. For an individual project, this includes:

- New buildings and structures.
- Additions, alterations, major replacements, and so on, to existing buildings and structures.
- Installed mechanical and electrical equipment.
- Installed industrial equipment, such as boilers and blast furnaces.
- Site preparation and outside construction, such as streets, sidewalks, parking lots, utility connections, and so on.
- Cost of labor and materials (including owner-supplied).
- Cost of construction equipment rental.
- Profit and overhead costs.
- Cost of architectural and engineering (A&E) work.
- Any miscellaneous costs of the project that are on the owner's books.

The total value-in-place for a given period is the sum of the value of work done on all projects under way during this period, regardless of when work on each individual project was started or when payment was made to the contractors. For some categories, estimates are derived by distributing the total construction cost of the project by means of historic construction progress patterns.

Exhibit 1, "New Construction Put in Place," presents details of construction put in place for various market segments. (Note that

the amounts are in billions of dollars and represent seasonally adjusted annual rates.) To add some perspective, in January 1992, at the start of the current construction boom, the total new construction put in place was $452 billion, as compared with the estimated 2006 amount of $1,200 billion—a gain of more than 165 percent during the period.

EXHIBIT 1 New Construction Put in Place

(Billions of Dollars—Seasonally Adjusted Annual Rate, in Current Dollars)

	July 2005	*July 2006*
Private construction	856.1	930.9
Public construction	243.2	269.1
Total construction	**1,099.3**	**1,200.0**
Residential building	615.8	627.4
Nonresidential building		
Office	33.9	45.1
Power	24.8	34.7
Commercial	65.4	77.2
Lodging	11.7	21.0
Other nonresidential	104.5	125.5
Total nonresidential	240.3	303.5
Total private construction	**856.1**	**930.9**
Highways and streets	63.9	76.6
Infrastructure	35.1	36.9
Educational	63.7	69.9
Other public buildings	23.8	24.6
Other public construction	56.7	61.1
Total public construction	**243.2**	**269.1**

The U.S. Census Bureau of the Department of Commerce announced that construction spending during July 2006 was estimated at a seasonally adjusted annual rate of $1,200.0 billion, 1.2 percent below the revised June 2006 estimate of $1,214.2 billion. The July 2006 figure is 5.1 percent above the July 2005 estimate of $1,141.2 billion. During the first seven months of 2006,

construction spending amounted to $680.4 billion, 8.0 percent above the $630.2 billion for the same period in 2005.

Spending on private construction was at a seasonally adjusted annual rate of $930.9 billion, 1.3 percent below the revised June estimate of $943.2 billion. Residential construction was at a seasonally adjusted annual rate of $627.4 billion in July, 2.0 percent below the revised June estimate of $640.5 billion. Nonresidential construction was at a seasonally adjusted annual rate of $303.5 billion in July, 0.3 percent above the revised June estimate of $302.7 billion.

In July, the estimated seasonally adjusted annual rate of public construction spending was $269.1 billion, 0.7 percent below the revised June estimate of $271.1 billion. Educational construction was at a seasonally adjusted annual rate of $69.9 billion, 1.0 percent above the revised June estimate of $69.2 billion. Highway construction was at a seasonally adjusted annual rate of $76.6 billion, 0.6 percent below the revised June estimate of $77.0 billion.

Help Desk—You can access current statistics of construction put in place and other construction industry information at www.census.gov.

Private Construction

Residential Building

The residential building segment of the construction industry includes new single- and multi-family housing as well as residential repairs and improvements. Conditions with the most impact on the demand for residential construction include the following:

- *Housing affordability.* Housing affordability is the extent to which potential buyers have the means to purchase a home. Affordability can be measured in several ways by considering average home prices and income levels. For example, some analysts create an "affordability index" by comparing median home prices to household income levels. As income levels get closer to housing prices, the average home becomes affordable to more local residents.

- *Interest rates.* Most homes are financed, and interest rates therefore have a tremendous effect on the affordability of housing. As interest rates rise, the cost of home financing increases; as they fall, the cost of financing decreases. However, interest rate changes do not have an immediate impact on home-buying markets—usually rates have to be in effect for several quarters to reverse home-buying trends.
- *Land availability/pricing.* As one of the major costs of residential building, land availability and pricing have a major impact on the affordability of housing. With land suitable for residential building becoming scarce in certain parts of the country, housing prices will be affected.
- *Demographics.* Shifts in demographics can have a significant impact on housing demand. For example, the aging of the U.S. population has increased demand for low-maintenance and multifamily housing. A large number of baby boomers are now entering their peak earning years, which is expected to affect the affordability and demand for single-family homes.
- *Market velocity.* According to industry sources, more than half of all home improvements occur within 18 months after a new owner moves in, or within 12 months before the home is sold. Thus, during times when new and used home markets are active, residential remodeling and improvement activity also increases.

The consensus forecast for 2007 U.S. housing starts is 1.775 million units, down from an estimated 1.902 million units this year. This forecast matches the current activity level, which was 1.795 million units in July 2006. If this forecast is accurate, the damage by "leaking bubbles" to construction volume is now almost entirely in the past, although the damage to home prices will not be over for another year. For 2008, most forecasters expect starts to decline a further 30,000 to 70,000 units but this is the consequence of weaker economic growth and not any developments specific to the housing market.

The Reed Construction Data 2007 housing outlook has been lowered from nearly 1.9 million units earlier this year, because of a weaker-than-expected economic environment. Energy and other commodity inflation continued well into the summer, sapping both consumer buying power and the confidence to spend. According to economists, the impact of bad news on consumer spending is geometric, not linear. Consumers ignore the first reports of bad news because rising commodity prices are often random and quickly reversed. With the next wave of news that commodity prices are still rising, consumers are forced to partially adjust spending to accommodate the higher prices, whether or not they believe that the price spike will be reversed. With the third wave of news that commodity prices are still rising, more accommodation is needed to balance household budgets. Many consumers begin to believe that the world has changed and that there will be no price reversal soon. As a result, their spending cuts are now larger than the recent price rises require, in order to restore used-up savings and set aside money to cover future price increases.

The shrinking of the housing market from 2.1 to 1.8 million units is due primarily to cuts at the top and bottom of the market, rather than across the board. At the top, speculative investment buying has been reduced sharply because prospects for quick capital gains have disappeared. The futures market for the housing price index expected home prices to stop rising this past summer and then fall 3 percent to 4 percent by next summer. Longer term investors are also leaving the housing market. Investor carrying costs are higher with higher mortgage and vacancy rates. Currently, there is little prospect of widespread double-digit home price appreciation for perhaps four to five years, according to industry analysts.

At the bottom of the market, prospective entry-level buyers are being increasingly priced out of the market by higher mortgage rates, fewer subsidized mortgage rates, and tighter credit approval standards. At the same time, homebuilders who specialize in entry-level homes are now competing with a rising number of homes they built in 2004 and 2005 that are coming back on the

market. Variable interest rate mortgages have adjusted higher, meaning buyers who were only marginally qualified financially to buy a new home have found themselves unable to afford the monthly payments. Now they are putting their newer homes up for sale.

These developments at the bottom of the market were expected. However, the unexpected changes in the inflation environment have severely worsened buying conditions in this segment of the housing market. This situation is a repeat of what happened in the early 1980s. High inflation in a growing economy impacts the low end of the income distribution curve much more heavily than the high end because low income households are less able to cushion against the impact of higher prices by drawing on savings or easily available credit. Wage gains lag inflation, so their household financial situation progressively worsens.

As of mid-2006, one of the keys to increased construction activity for 2006 and 2007 was rebuilding after Hurricane Katrina. However, the rebuilding in the affected areas has gone much more slowly than anticipated, as can be documented with residential construction trends. Almost 136,000 homes were lost in the Katrina-affected areas of Louisiana, according to Red Cross estimates. In 2004, there were almost 5,800 new housing permits in these areas. In the first nine months after the hurricane, there were fewer than 2,500 new housing permits in these areas, so construction levels were not even back to pre-Katrina levels, much less at levels that serve to replace any homes lost.

The situation is not much better in Mississippi. Over 64,000 homes were lost in this state to Katrina, and there were over 3,600 new homes permitted in 2004 in the area eventually affected by Hurricane Katrina. In the first nine months after Katrina, fewer than 3,000 new homes were permitted in these areas, so residential construction in these areas was barely back to its pre-Katrina pace, with almost nothing added to compensate for lost units.

Inflation is the key variable in the housing outlook — not because it will change mortgage rates but because it will change

confidence. In the absence of hurricanes or new political disputes that threaten oil supplies, Reed Construction Data believes that inflation is ebbing. However, too much damage to confidence may already have been done to see housing starts rise over 1.8 million units in 2007.

Nonresidential Building

Despite several concerns with the fundamentals of the nonresidential construction market—including rising short-term interest rates, ongoing inflation in key construction materials prices, and recent concerns over the economic outlook—the American Institute of Architects Consensus Construction Forecast Panel (AIA Panel) is expecting solid levels of activity through the remainder of 2006 and through 2007. After adjusting for inflation, the AIA panel is anticipating a 6.3 percent increase in nonresidential activity in 2006, and an additional 6.2 percent in 2007 with growth evenly balanced between the commercial/industrial and institutional sectors. If achieved, this would be the best two-year period for nonresidential construction activity since this market grew by about 30 percent in 1997 to 1998.

The optimism of the AIA Panel comes despite recent evidence of softening in the broader economy. The Federal Reserve Board has raised short-term interest rates by 4 percentage points since 2004, which has cooled off the stock market and other interest-sensitive sectors of the economy, such as housing and auto sales. Overall inflation in consumer and producer prices has begun to increase while it continues for several key building commodities.

Office Market

Office construction—almost 11 percent of total nonresidential activity—has benefited from falling office vacancy rates nationally. Vacancy rates peaked nationally in early 2004 at almost 15 percent in downtown locations, and about 18 percent in suburban locations. The most recent readings from CB Richard Ellis show rates declining to 13.6 percent overall—12.3 percent downtown and 14.3 percent in the suburbs. Metro areas with the lowest office vacancy rates (Orange County, California; New York City; Palm Beach, Florida; Honolulu; and Fort Lauderdale)

are heavily concentrated in coastal areas, whereas areas with the highest vacancy rates (Detroit; Dallas-Fort Worth; Columbus, Ohio; Louisville; and Cleveland) are heavily concentrated in the interior regions, particularly the industrial Midwest.

Retail and Other Commercial Markets

Retail construction, the largest commercial sector, accounting for over 20 percent of all nonresidential construction, has seen steady growth in recent years. With the unemployment rate falling and disposable personal income rising, the AIA panel is projecting an almost 4 percent increase in retail construction in 2006, and over 4 percent in 2007.

Hospitality Market

Hotel construction, at just over 3 percent of total nonresidential activity, has seen a dramatic improvement in construction levels in recent years. The AIA panel is projecting an increase of almost 11 percent in 2006, followed by another 6.5 percent in 2007.

Institutional Market

Education construction is the largest institutional construction category, accounting for about 16.5 percent of total nonresidential building activity. Strong growth in enrollments, particularly at the high school and college levels, has pushed up construction levels. The AIA panel is projecting a 4.4 percent increase in educational construction levels in 2006, and an additional 7.4 percent in 2007.

Healthcare construction, the other major institutional sector, accounts for over 7 percent of nonresidential construction activity. The aging of the population coupled with a modernization of existing healthcare facilities—often spurred by industry consolidation—has produced strong numbers in recent years in this sector. The AIA panel is projecting a 6.3 percent increase in 2006 in the construction of healthcare facilities followed by an additional 5.0 percent in 2007.

The overall nonresidential construction sector is seeing the healthiest business conditions this decade. The AIA's

Architectural Billings Index indicates somewhat slower growth in design activity in recent months, which will translate into a slower pace of growth in nonresidential construction activity as we get into 2007. However, given that the broader economy continues to expand and given the current strong levels of construction activity in the planning and design stages, most analysts expect healthy levels of nonresidential construction activity to continue at least through 2007.

Help Desk—The demand for construction can vary significantly among different geographic regions. One of the most comprehensive analyses of commercial real estate demands and construction activity is published by the Society of Industrial and Office Realtors (SIOR). Annually, SIOR publishes *Comparative Statistics of Industrial and Office Real Estate Markets*, which provides detailed real estate and construction statistics on all the country's larger cities. You can purchase and download this publication directly from the publications section of the SIOR Web site at www.sior.com.

Public Construction

Public construction spending rises rapidly when state and local governments have generous financial reserves and they are meeting or beating their revenue targets. There is a strong correlation between public construction spending and state budget reserves two years earlier.

State budgets underestimated receipts for income and sales taxes by 4.2 percent in the last fiscal year. This conservative budgeting boosted reserves to 6.9 percent of annual spending as of June 30, 2005, the end of the fiscal years for all but four states. This assures above-average spending growth well into 2007. That strength is expected to extend into 2008 because state income and sales tax receipts in the first quarter of the 2006 fiscal year (July to September 2005) were up 9.2 percent from a year earlier. The gain was 9.5 percent excluding tax cuts. This is far above the aggregate 3.3 percent sales and income tax receipts gain that states have budgeted for fiscal year 2006.

State budgets expect a 4 percent rise in sales tax receipts during the 12 months ending on June 30th, 2006. Receipts were 7.5 percent above the previous year in the first three months. Similarly, personal income tax receipts were up 9.2 percent compared to the budgeted 2.8 percent and corporate income tax receipts were running at a 25.9 percent annual rate of increase instead of the expected 2.0 percent. State budget reserves at the end of the current fiscal year are likely to be 7 percent to 8 percent of annual spending.

State budget reserves vary considerably from no reserves at all in Michigan, Wisconsin, and Arkansas to 75 percent in Alaska. According to the National Association of State Budget Officers, the following states have more than double the national average of budget reserves.

State	*Reserves as a percent of spending*
Alaska	75.0 percent
Delaware	30.1 percent
Georgia	23.7 percent
Montana	21.7 percent
Nebraska	21.3 percent
North Dakota	18.7 percent
Texas	15.8 percent
Florida	15.7 percent
Massachusetts	15.5 percent

The budget balances of the following states are less than half of the national average, according to the National Association of State Budget Officers.

State	*Reserves as a percent of spending*
New Jersey	3.4 percent
Pennsylvania	3.0 percent
Maine	2.9 percent
Ohio	2.9 percent
Mississippi	2.9 percent
Colorado	2.4 percent
Wisconsin	0.1 percent
Michigan	0.0 percent
Arkansas	0.0 percent

Surety Industry Trends

The surety industry is critical to the well-being of the construction industry. Nearly half of all work performed by contractors is bonded, so any change in the surety market will have a significant effect on the construction industry.

Surety bonding is a rigorous process in which surety companies prequalify contractors and then guarantee that the contractors will complete their projects and pay first-tier subcontractors, laborers, and materials suppliers (those hired directly by the general contractors). Construction projects can involve three types of surety bonds:

- *Bid bonds* provide financial assurance that the bid has been submitted in good faith and that the contractor intends to enter into the contract at the bid price.
- *Performance bonds* protect the owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions.
- *Payment bonds* guarantee that the contractor will pay subcontractors, laborers, and suppliers associated with the project. (Government property is not subject to mechanic's liens, meaning that laborers, suppliers, and subcontractors would be without redress if the contractor defaulted and there were no payment bond.)

Section 270 of the Miller Act, enacted in 1935, governs performance and payment bonds on federal construction projects.

Additionally, each of the 50 states, the District of Columbia, Puerto Rico, and almost all local jurisdictions have enacted legislation requiring surety bonds on public works projects. Generally referred to as "Little Miller Acts," these laws often set minimum thresholds for which state agencies and local governments may require surety bonds. Sometimes no threshold is set and the local entities themselves determine what minimum project value necessitates surety bonding.

While surety credit is similar to obtaining bank credit, it still is a form of insurance. Surety bonds and insurance both are risk transfer mechanisms that are regulated by state insurance commissioners, and both provide protection against financial loss.

Unlike other lines of insurance, however, surety actually is a form of credit. Whereas bankers either lend money or extend a line of credit, a surety grants a "pledge guarantee." The surety does not lend the contractor money but instead allows the surety's financial resources to be used to back the commitment of the contractor; if the contractor defaults the surety pays for completion of the contractor's work.

The basic function of surety is prequalification. That process involves a surety underwriter taking an in-depth look at the contractor's entire business operation and thoroughly analyzing the contractor's financial strength and capacity to perform before credit is extended. The underwriter will concentrate on the three "C's" —character, capacity, capital—when making bond credit decisions.

To issue a surety bond, the surety must be confident that the contractor has good character, experience matching the requirements of its contracts, financial strength, an excellent credit history, an established banking relationship and line of credit, and ownership of (or the ability to obtain) the equipment to carry out the contract.

Although there have been a number of high-profile mergers in the surety market, there have been instances of surety company failures. In most cases, capacity remains sufficient to support the nation's construction needs. However, contractors in different market sizes may see changes in the near future and those contractors considered "marginal" may be dropped by their surety.

- Capacity for small and emerging contractors remains available, although they will be subject to the same underwriting standards as their larger peers. Small and start-up contractors who have difficulty meeting today's underwriting standards may opt to explore the U.S. Small Business Administration's (SBA's) Surety Bond Guarantee Program.

The SBA has proposed changes in the program in an effort to renew interest by sureties and to encourage sureties to extend credit to companies that have no surety bond history. The proposed improvements include allowing sureties to charge prevailing rates under state law, a reduction in the frequency of required audits of participating surety companies, and increased loss coverage guarantees on bonds for companies owned by veterans.

- The mid-market contractor is least likely to be affected by capacity issues. This segment is the primary target of the industry, and qualified contractors will continue to receive strong support. However, in some cases, contractors are being required to provide audited financial statements instead of reviewed financial statements, and some sureties are requiring quarterly reporting. The same back-to-basics underwriting standards apply: quality financials, capital retention, and personal and corporate indemnity are all required.

- Contractors in the $250 million-and-over market may need to address changes in the industry. Surety companies are less likely to assume the risks of massive, multiyear projects on their own. Co-sureties, segmented bonding, and joint ventures may be more common, due to the fact that approximately 80 percent of the reinsurers from the 1990s are gone because of the massive surety losses incurred in the past few years. The tightened reinsurance market is a factor in the need for more creative surety solutions on mega-projects.

There are also alternatives to surety, generally referred to as alternate products. These insurance products were originally designed to protect a general contractor from subcontractor default. Unlike a surety bond, an alternate product has a deductible and guarantees payment in the event of default, but not performance. Although this is a relatively new concept, some think it may be a way to circumvent some of the limitations of the surety industry.

In some parts of the country sureties are requiring clients to upgrade from reviews to audits. Other sureties are willing to accept reviewed financial statements when accompanied by a review of the client's internal controls. In some cases, sureties are also requiring quarterly financial statements, in addition to year-end statements. In addition, some smaller contractors are being required to strengthen their financial position with personal guarantees and additional indemnity.

Contractors can expect sureties to look at their work programs more closely, which can lead to changes in the amount of capacity sureties are willing to offer. Although many surety companies have the capacity to support an increased work program, they may not have the same appetite for risk they had in the past. Nevertheless, a contractor with a solid reputation and sound financials should have no problem obtaining the surety credit it needs. Overall, the surety industry is attempting to return to a healthy state and will continue to respond to the challenges in the construction industry.

At this critical juncture in the surety industry's life cycle, the following steps may be helpful to ensure that your client's surety relationship remains free from any dramatic exposure to the surety industry's changes. Your client may need to:

- Meet regularly with its surety underwriters and bond agents and foster a partnering relationship.
- Know its surety—its results, reinsurance, capacity limitations, credit, and AM Best (a worldwide insurance rating and information agency) ratings.
- Plan for more lead time for larger or unique projects and major decisions.
- Provide high-quality and timely financial information.
- Understand the working capital and equity requirements for the bonding program.
- Understand the adjustments that the surety makes to the financial statements to arrive at bonding capacity. You

should be aware that this can be one of the biggest pressures on a contractor and recognize the associated audit risk.

- Involve its surety in major financial decisions.
- Understand the working capital and equity requirements for its bonding program (single and aggregate limit).
- Use a CPA and an attorney who specialize in construction contractors and relationships with sureties.
- Use a professional surety broker who specializes in surety, and have a "backup" surety available in case the current surety is unable to provide proper coverage.

The Surety & Fidelity Association of America (SFAA) provides information about the Surety Bond Authenticity Program. This process allows interested parties to verify a contractor's bond coverage directly with the insurance provider and might be a useful audit tool. Instructions can be obtained at the SFAA Web site link www.surety.org.

Construction Cost Trends

Contractors should get used to higher prices for building materials. Experts across the country see strong world demand and increased shipping costs affecting supply and boosting costs for most building supplies. The rate of increase for building material costs is generally leveling off. Some experts see this as a new plateau, but don't see the costs coming down.

Cement availability continues to be an issue in many parts of the country and will be a concern in 2007, according to Portland Cement Association chief economist Ed Sullivan. Cement consumption will grow in excess of 3 percent of the record consumption in 2005. Tight market conditions will reappear in 2007 as plants are operating at high rates, inventories are lean, and our dependence on imports increases, according to Sullivan.

Lumber is one building supply that has tempered its price increases. Prices have opened up some as a tariff on Canadian lumber

was reduced, which has increased supply. Lumber prices have gone down in the near term and should remain stable through 2007.

Associated General Contractors economist, Ken Simonson, reports double-digit price increases in several building supplies. According to Simonson, contractors and building owners should get used to it because it may level off but won't drop to past levels. The average Producer Price Index (PPI) for construction materials jumped 7.8 percent from June 2005 to June 2006. Material costs reached as high as 16 percent for highway construction. There have also been increases as high as 87 percent for copper and brass mill shapes, 48 percent for asphalt, 40 percent for diesel fuel, 26 percent on gypsum products, 18 percent for plastic construction products and 15 percent for cement. Simonson expects a few of these increases to level off as the housing market cools, but most are tied to strong U.S. and world demand for materials and freight transportation.

All sectors of the construction industry are concerned about finding qualified labor as the market improves in 2007. The present workforce is getting older and replacement workers aren't coming up through the ranks in great enough numbers to meet coming demand.

Unemployment remains low, worker availability is low, and labor rates are increasing. Some believe that as residential housing slows, it will free up more workers for nonresidential and commercial work, but not all skills and trades are transferable. That's why analysts believe the unemployment rate will rise to 4.9 percent in 2007.

The U.S. Department of Labor Bureau of Labor Statistics reports job opportunities in the construction field will remain strong for experienced workers. As demand increases and the labor supply stays the same, wage rates will increase, especially for more experienced workers who already are paid higher than average wages. Plumbers and electricians are two groups most affected by this trend, according to research conducted by FMI, Inc.

In fact, the concern for construction labor is so great in hurricane-damaged areas that the Biloxi suburb of D'Iberville, Missis-

sippi is courting China-based construction companies to import Chinese construction workers to build shopping malls, condominiums, and casinos in a city where 35 percent of the real estate was damaged by Hurricane Katrina. Given the debate over immigration and American labor law constraints, this may be a difficult undertaking, but it is a sign of the lengths that developers and others are considering to meet the looming labor shortage. The firms, which propose to partner with private developers in the United States, plan to use Chinese materials to avoid paying higher post-Katrina prices for American materials.

To a large extent, Latino workers are filling the gap of needed workers. Sources report that as much as 45 percent of the workers at some nationally-based construction companies are Hispanic. However, growing sentiment to make sure these workers are registered aliens could greatly affect worker availability and increase labor costs for those contractors who rely on short-term workers or day laborers to get their portion of the project completed.

> **Help Desk**—The *Engineering News Record* publishes detailed quarterly cost studies that track average prices for a wide variety of materials and labor classifications in major cities across the country. You can access summaries of the studies at the magazine's Web site at www.enr.com.

Legislative and Regulatory Issues

New Tax Credit for Homebuilders

The Energy Policy Act of 2005 included many provisions regarding coal, natural gas, renewable energy, and energy efficiency and distribution. It also enacted a new tax credit under Internal Revenue Code (IRC) section 45L—the energy-efficient home credit—available to eligible contractors. Depending on the energy savings achieved, the credit is $1,000 or $2,000 per home.

Under section 45L, a home qualifies for the credit if it has all the following characteristics:

- It is located in the United States.

- Its construction was substantially completed after August 8, 2005.
- It meets the energy-saving requirements specified in section 45L.
- It is acquired from an eligible contractor in either 2006 or 2007 for use as a residence.

The Internal Revenue Service (IRS) issued IR news release 2006-32 and notices 2006-27 and 2006-28 to explain how homebuilders can qualify newly constructed homes for the credit. Notice 2006-28 provides procedures for manufactured homes; notice 2006-27 for all other homes. They include information about the certification process a builder must undergo to qualify and a public list of software programs that can help calculate energy consumption to obtain the proper certification.

The credit is reported by the taxable entity or, for pass-through entities (for example, S corporations and partnerships), on the shareholder's or partner's individual return. It cannot be applied against the alternative minimum tax; thus, it may be limited and carried forward. It is not refundable. The credit can be significant; thus, obtaining the proper certification is important.

Help Desk—For more information, see Tax Clinic, "Tax Credit for Home Builders," by Joel Ackerman, CPA, in the October 2006 issue of *The Tax Adviser.*

AGCxml Project

The Associated General Contractors of America (AGC) recently undertook an industry-wide initiative aimed at enabling the efficient and reliable exchange of electronic construction project information among all building construction and design professionals. The project, known as the AGCxml Project, is managed by the National Institute of Building Sciences (NIBS) under a contract to AGC. This project will result in a set of extensible markup language (XML) schemas that will enable design and construction professionals to exchange electronically the information contained in common construction and communica-

tion documents, such as owner/contractor agreements, schedules of values, requests for information (RFI), requests for proposals (RFP), architect/engineer supplemental instructions, change orders, change directives, submittals, applications for payment, and addenda.

XML schemas will enable the exchange of information among dissimilar and proprietary software applications, without requiring the reengineering or redesign of those applications, by establishing a common, nonproprietary data format and classification system for the information to be exchanged. Software developers will be able to modify their applications with minimal effort to reliably import and export data in AGCxml format, without having to change or share their proprietary software code and data formats.

AGC also extended a nationwide invitation to architects, building owners, contractors, engineers, material suppliers, software developers, and subcontractors to serve as volunteer members of a Review and Validation Committee (RVC) for the AGCxml Project. The role of the RVC is to review and validate the development work of the NIBS technical team.

Current Audit and Accounting Issues and Developments

Assessing Audit Risk in the Current Environment

The proper planning and execution of an audit has always required you to have a thorough understanding of the construction industry and the nature of your client's business.

Professional Skepticism

The third general audit standard stipulates that due professional care be exercised in planning and conducting an audit engagement. Due professional care requires that you exercise professional skepticism in gathering and evaluating audit evidence.

As a result of perceived external pressures, companies may be tempted to manage earnings by using nonrecurring transactions or through changes in the method of calculating key estimates,

such as reserves, fair values, or impairments. Companies may also adopt inappropriate accounting practices resulting in improper recognition or omission of financial transactions. Material nonrecurring transactions may require special disclosure to facilitate the readers' understanding of the reported financial results, and the guidance in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*, should be applied in reporting the effects of changes in estimates. Auditors of public companies should see the section titled "Staff Accounting Bulletin No. 108" in the "Recent Auditing and Attestation Pronouncements and Related Guidance" section of this Alert. Inappropriate transactions or accounting practices that may result in errors requiring adjustments of financial statements might include premature recognition of revenue, failure to appropriately accrue for contingent liabilities that are probable and estimable, and failure to record unpaid purchase invoices. Additionally, you should be particularly skeptical of fourth-quarter events that result in significant revenue recognition, loss accrual, or noncash earnings.

The appropriate level of professional skepticism is needed when corroborating management's representations. Management's explanations should make business sense. Additionally, you may need to consider corroborating management's explanations with members of the board of directors or audit committee.

Other indicators of potential increased accounting and reporting risk calling for increased professional skepticism include:

- Bonuses for estimators, project managers, purchasing agents, or supervisors depend on specific criteria (such as budgets, targets, or performance).
- Tax-motivated income or loss goals exist.
- There are ownership disputes, potential sale of business, or a contemplated or current divorce situation.
- Management has been unable to accurately project gross profit in the past.

- Loan covenants or bonding equity requirements have either been closely met or barely failed in the past.
- The company is committed (awarded or notified as low bidder) to a large contract in excess of capacity.
- The company is involved in construction projects subject to significant regulatory restrictions (the Environmental Protection Agency, Federal Emergency Management Agency, or federal or state projects).
- The company is undercapitalized, relying heavily on bank loans and other credit, and is in danger of violating loan covenants.
- The company is having difficulty obtaining or maintaining financing or surety bonding.
- The company is changing significant accounting policies and assumptions to less conservative ones.
- There are increasing amounts of underbillings on the balance sheet.
- The company is generating profits but not cash flow.
- The company has a consistent gross profit fade.
- The company has been entering into new types of projects or new geographic areas.
- The company has been awarded a job that has a dramatic difference in bid spread.
- There has been a significant change in senior management or the board of directors.

Evaluating Audit Risks

Your evaluation of audit risk should start with a good understanding of your client's business. To develop this understanding, you should be knowledgeable about the entity's strategies for dealing with business conditions—both current conditions and those most likely to exist in the near future. In the construction

industry, business conditions vary greatly across contractor types and from region to region. The risks associated with building office buildings are different from those faced by a homebuilder; a contractor in the Northeast may face different issues than a similar contractor located on the Pacific Coast. For this reason, you must be knowledgeable about contractor types and the location in which the entity operates.

Evaluating Control Deficiencies

In May 2006, the AICPA Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended. The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006.

The Statement requires that auditors (1) evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses and (2) communicate, in writing, significant deficiencies and material weaknesses to management and those charged with governance. This communication includes significant deficiencies and material weaknesses identified and communicated to management and those charged with governance in prior audits but not yet remediated.

Some examples of potential control deficiencies you might find in construction companies are:

- Lack of segregation of duties in the cash management function due to a small number of administrative staff and without effective compensating controls

- Management override of controls by owners of privately held companies or by project managers in the invoice approval process
- Inadequate monitoring of the financial accounting process to detect deficiencies in internal control by management
- Improper revenue recognition through recording change orders that have not been approved
- Estimates regarding job completion percentage or costs to complete not reviewed and approved by a person in the company competent to evaluate the estimates
- Lack of client expertise in preparing financial statements including the process for identification, consolidation and disclosure of variable interest entities (VIEs)

The AICPA has published the Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in the implementation of this Statement.

Accounting and Auditing Issues Related to Construction Contracts

Auditors of construction contractors should recognize that the traditional balance sheet approach to auditing usually is not adequate when performing an audit of a contractor. The financial statements of a contractor are built from the financial results of individual contracts. The more effective audit approach requires you to focus on the terms, financial estimates, and results of individual contracts, rather than the contract-related balance sheet that accounts for the company as a whole.

The authoritative guidance on auditing contractors is contained in the AICPA Audit and Accounting Guide *Construction Contractors*. Included in the Audit and Accounting Guide is a copy of Statement of Position (SOP) 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, which is the primary authoritative accounting guidance for construction contractors.

Auditing construction contractors is complex. Such businesses rely on accurate and reliable estimates to operate their business as well as to prepare financial statements. Therefore, it is critical that you gain an understanding of the contractor's significant estimates and the assumptions that are used in operating the business. Remember that the audit of a construction contractor's financial statements is an audit of the contractor's ability to estimate. There are several things to consider when auditing estimates: understand the internal control structure surrounding the estimate, consider the contractor's history of accurate estimates, compare actual to budgeted figures, and review subsequent events.

The Professional Issues Task Force of the AICPA has identified certain procedures that should be considered in performing an audit of a construction contractor. They are as follows:

- Read significant contracts. This procedure may seem obvious, but it is necessary to identify the terms of the contract, any guarantees, penalties, or incentives, as well as cancellation and postponement provisions. For example, reading the contract might identify the party responsible for additional expenses incurred as a result of weather delays.

- Identify unique contracts and increase the amount of testing and professional skepticism related to such contracts. These contracts increase the risk of improper estimates and thus improperly stated financial statements. If a company cannot reasonably estimate the cost or progress of a contract, it should be accounted for under the completed-contract method.

- Understand the company's cash flow and how it will manage expenses. Often, expenses are payable prior to receiving the related cash from the contract revenue. Some companies win long-term contracts, but cannot fund the project long enough to realize the revenue on the contract.

- Recognize that the longer the contract period, the greater the risk that an estimate will be incorrect. Also, the farther along a contract is toward completion, the less risk there is

of an incorrect estimate. Finally, with more variables inherent in an estimate there is a greater risk that the estimate will be incorrect.

- Confirm the terms and conditions of the contract as well as the normal billing procedures. When confirming a receivable, you should strongly consider confirming the original contract price, total approved change orders, total billings and payments, retainage held and whether it accrues interest, detail of any claims, back charges, or disputes, and estimated completion date or the estimate of percentage to complete.
- Review the unapproved change orders of significant contracts. Change orders often arise during the life of a contract and estimated revenue and cost should be adjusted for changed orders that have been approved, both as to scope and price. However, when a change order has been approved as to scope but not as to price, carefully evaluate the specific facts and circumstances prior to including in estimated contract revenues. To the extent that change orders are disputed or are unapproved as to both scope and price, they should be evaluated as claims. Generally, if there is no verifiable evidence to support recognition of revenue on an unapproved change order or claim, it should not be recognized.
- Visit construction contract sites. Visiting contract sites can be a very useful audit procedure. Such a visit can provide an opportunity to view the progress of a contract. Consideration of a site visit might include significant contract sites in which the work is in the very early stages of the contract. Such a visit may identify the complexities of performing the contract. The site visit may also provide you with the opportunity to interview operational personnel and to gain a better understanding of the responsibility the company has for performing the contract. At the site visit, you should also speak with available subcontractors to get additional information about the progress of the

contract. Furthermore, you should consider observing equipment and uninstalled inventory at the site.

- Meet with project managers. Project managers play an important role in controlling and reporting job site costs. They are also close to the facts and are likely to provide more prompt and accurate information than the accounting personnel. Meeting with the project managers will also assist you in developing expectations for use in performing analytical procedures.

- Identify and understand the significant assumptions and uncertainties. This procedure is fundamental to performing an effective audit of an entity using contract accounting.

- Test contract costs to make sure that costs are matched with appropriate contracts. In some instances companies may shift costs from unprofitable contracts to profitable ones in order to defer losses.

- Audit estimated costs to complete. The focus should be on the key factors and assumptions, such as those that (1) are significant to the estimate, (2) are sensitive to variation, (3) deviate from historical patterns, and (4) are subjective and susceptible to bias or misstatement. It is also useful to review revised or updated estimates of costs to complete and compare estimates with actual costs incurred after the balance sheet date.

- See that losses are recorded as incurred, regardless of whether the entity is using the percentage-of-completion or the completed-contract method of recognizing revenue.

- Analytically review contracts completed and in progress. A detailed analytical review of completed contracts and contracts in progress will provide meaningful information in helping to focus your efforts on potential problem areas.

- See that there are appropriate disclosures relating to SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. Entities using contract accounting should have more

than generic disclosure about the use of significant estimates used in the preparation of financial statements.

- Review the aging of receivables on contracts. This procedure will provide evidence that the company is collecting funds on a timely basis.

For additional guidance on auditing construction contracts, see Appendix B of this Alert.

Job Performance

It is difficult for contractors to be profitable when projects are not completed on time. A number of contracts may even require the contractor to pay penalties if the job is not completed by a specified date. Jobs that are significantly behind their established timetable may require additional audit attention and procedures to determine that the original estimates of gross profit have not deteriorated (called "profit fade") and that the job has not incurred a loss (which should be recognized immediately).

The tight labor market and the difficulty in scheduling subcontractors may result in your clients failing to complete jobs according to their pre-established timetables. For example, a key operational employee may leave the company before the job is completed, and finding a competent replacement may require some time. A number of contractors may also be forced to use less experienced personnel in certain positions, including management, and a lack of experience can result in the job taking longer to complete than originally anticipated. Consider making inquiries of management to determine how they have factored these circumstances into their estimation process.

A disruption in the supply of key materials can also affect the ability of the contractor to complete the project on time. During the past year, many construction materials were in short supply. In addition, the events of recent years have shown that an unexpected or continuing surge in demand for materials can quickly outpace supply and create shortages and delays. The lead time required for specifically fabricated items may affect the contractor's ability to deliver the project on time. You may also perform pro-

cedures to identify price hikes in your client's vital materials. Determine whether those price hikes are the result of inadequate supply. If so, assess your client's vulnerability to delays caused by the inability to obtain these materials on a regular and timely basis. You can make inquiries to discover what steps the client has taken to mitigate these risks.

Estimating Costs to Complete

A contractor's ability to estimate job costs is critical both from an operational and a financial reporting standpoint. Contractors that cannot accurately estimate job costs will be unable to manage their working capital and maintain consistent levels of profitability over an extended period of time. For most contractors, the estimate of costs to complete a project drive revenue recognition. For that reason, inaccurate or unsupported estimates of costs to complete jobs in progress can result in materially misstated financial statements.

When auditing construction estimates, you should be familiar with SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), and SOP 94-6.

Because of the economic uncertainty, estimates may be difficult for management to make and for auditors to evaluate. Pay close attention to the underlying assumptions used by management when auditing accounting estimates. Management is responsible for making estimates included in the financial statements, and those estimates may be based, in whole or in part, on subjective factors such as judgment based on experience about past as well as current events and about conditions expected to exist. You should be alert to the possibility of management's overreliance on economic information based on favorable conditions to predict future outcomes.

Help Desk—Marshall and Swift is a consulting firm that provides comprehensive cost data for the construction industry. Included on its Web site is a cost estimator that allows the user to estimate the cost of a project based on current costs in the users' geographic area. You may find these estimates helpful in

performing analytical procedures on client estimates. You can access the cost estimator at www.construction.com.

Accounting Systems and Controls

Companies that expand quickly frequently outgrow the capabilities of their accounting systems and controls. Contractors with a large backlog and demand for their work tend to focus primarily on completing existing projects and bidding on new ones. Little thought may be given to whether the accounting system and related controls are capable of handling the new volume of business. In the current environment, this problem is exacerbated by the lack of sufficient staffing, the high turnover rate of employees, or both. You should not underestimate the importance of accounting systems and controls in the operation of your client's business.

When clients rely on technology to manage and analyze information, audit strategies change. For example—

- Audit evidence that previously existed in paper form may only be available electronically. Accessing electronic audit evidence may require you to become proficient in the use of data extraction or other audit software tools.

- The design and operation of internal control in a computer environment differs greatly from a predominately manual environment.

As more construction contractors expand their use of information technology, you may need to become aware of the unique audit issues in a highly computerized environment. In addition, you should identify the risks of material misstatement that can arise during the transition from a highly manual environment to a more computerized operating environment.

For further information and guidance on auditing in this paperless environment, see SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

Affiliated Entities

In the construction industry, contractors frequently participate in joint ventures or have a direct or indirect affiliation with other entities and, as a result, are frequently involved in related party transactions as that term is defined in FASB Statement No. 57, *Related Party Disclosures.* The prevalence of such arrangements in the industry can be attributed to factors such as legal liability, taxation, competition, ownership and operating arrangements, labor and labor union considerations, and regulatory requirements.

You should review your contractor client's participations in joint ventures to evaluate whether investments in joint ventures are reported properly. You should also review joint venture agreements and document your client's participation.

The audit considerations for a contractor's participation in a partnership are similar to those for participation in corporate joint ventures. They may differ primarily in relation to the contractor's unlimited liability as a general partner for partnership obligations.

For any type of venture, you should consider the nature of the venture, the scope of its operations, and the extent of involvement of each participant.

Variable Interest Entities

For a variety of legitimate business reasons, many construction companies create and utilize affiliated entities to facilitate, among other things, leasing arrangements and joint ventures. These separate entities are often created for asset protection, limitations on bonding capacity, and income and estate tax planning purposes. Typically, these entities have multiple owners and, very commonly, the entities are owned by related parties. In the past, reporting entities have not been consolidating these affiliated entities into the financial statements unless the entities were controlled through owning a majority of stock. Since many of the affiliated entities are not formed as voting interest entities, the accounting literature did not require entities to consolidate the affiliated entities. As a result, in many circumstances, commonly-

controlled (and other related) entities were not reflected in one set of financial statements. Essentially, rather than reflecting assets, liabilities, revenues, and expenses within the financial statements, notes to financial statements included a disclosure of transactions between and among the related entities.

Principles for Consolidation

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities*. Many variable interest entities had commonly been referred to as special-purpose entities or off-balance sheet structures, but the guidance applies to a larger population of entities (referred to as VIE). In December 2003, the FASB issued a revision to FASB Interpretation No. 46 (with the same title) to clarify some of the provisions in the original document. The revised document (FASB Interpretation No. 46(R)) was issued in response to input received from constituents regarding certain issues arising in implementing the original FASB Interpretation No. 46. Examples of "connects" between and among reporting entities that could trigger the consolidation provisions within this literature include:

- Equity investments in the affiliated entity
- Guarantees of the value of assets or liabilities of the affiliated entity
- Contracts to purchase assets or equity from the affiliated entity
- Contracts for services with the affiliated entity
- Synthetic lease agreements involving the affiliated entity
- Transfers or sales of assets to the affiliated entity
- Structures designed to house assets in the affiliated entity
- Providing administrative services for the affiliated entity
- Having loans to or from the affiliated entity

Essentially, FASB Interpretation No. 46(R) contains the requirement that we "look through" the form of transactions and

arrangements and analyze the substance of the "connects" between and among affiliated entities. If there is an effort to structure a deal to circumvent the spirit of this accounting guidance, the odds are significant that a variable interest in an affiliated entity exists and the entity would be a VIE subject to consolidation. FASB Interpretation No. 46(R) became effective for private companies in calendar year 2005.

Importance in Construction

FASB Interpretation No. 46(R) already has had, and will continue to have, a significant impact on accounting in the construction industry. Some of the more common arrangements that may be affected in implementing this literature include:

- Real estate developers frequently form separate legal entities to own property to be developed. The purpose of the separate legal entity is to isolate the developer's other assets from the project to be developed in the event the project is unsuccessful.
- The owners of closely-held construction contractors may establish separate legal entities to acquire equipment that is then leased to the contractor. Often, these type entities are created for estate-planning purposes.
- Contractors also may form joint ventures to develop a project. Joint venture partners could include another party with unique capabilities in some facet of the project. In some circumstances (for example, when the bid documents require that a prime contractor perform more than half of the work) two or more contractors may form a joint venture to become the prime contractor in order to meet the contractual requirements.

Overview of the Guidance in FASB Interpretation No. 46(R)

Issued in 2003 as a result of the negative fall-out of the failure of Enron (and other entities), the guidance in FASB Interpretation No. 46(R) was intended to clarify and expand the requirements of existing consolidation guidance. However, unlike previous

guidance, which based consolidation requirements on voting control, this Interpretation requires an analysis and consideration of consolidation in circumstances where "substantive control" is evidenced by attributes and factors other than direct equity ownership. FASB Interpretation No. 46(R) expands the definition of related parties, and requires the consolidation of certain insufficiently capitalized entities that are connected to the reporting company through certain contractual or other interests. The literature incorporates a "principles based" model that is utilized in determining when entities need to be consolidated.

Fundamentally, the objectives associated with FASB Interpretation No. 46(R) are to explain how to identify VIEs and how to determine when a reporting entity should include the assets, liabilities, noncontrolling interests, and results of activities of VIEs in consolidated financial statements. In developing this guidance, the FASB noted that some entities have entered into arrangements using VIEs that appear to be designed to avoid reporting assets and liabilities for which they are responsible, to delay reporting losses that already have been incurred, or to report gains that are illusory.

In general, a VIE is a corporation, partnership, trust, or any other legal structure used for business purposes where any of the following conditions exist:

- Equity investors do not have voting rights.
- Equity investors do not provide sufficient financial resources for the entity to support its activities.
- Equity investors have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest.

A VIE often holds financial assets, including loans or receivables, real estate, or other property. A VIE may be essentially passive or it may engage in research and development or other activities on behalf of another company.

What Is a VIE and Who Needs to Consolidate a VIE?

Technically, a VIE is an entity subject to consolidation utilizing the accounting guidance in FASB Interpretation No. 46(R). An entity (VIE) must be consolidated into the financial statements of the primary beneficiary when, by design, either of the following conditions exist:

- The VIE does not have enough equity investment.
- Equity investors in the VIE lack any one of three characteristics of controlling financial interest.

For a VIE not to be subject to consolidation by a primary beneficiary, the general rule is that at least 10 percent of the fair value of the assets of a VIE must be provided as equity by unrelated third parties. The equity provided by these unrelated third parties cannot be provided or financed by the primary beneficiary (that is, there must be a legitimate equity investment on the part of unrelated third parties). In some cases, there may be a need for greater than a 10 percent investment so that the VIE can be determined to have sufficient equity to permit financing of activities without additional support from other parties.

Equity investors in voting interest entities have at least three characteristics associated with ownership. These investors participate in the decision-making processes of the entity (they can vote their shares), they expect to share in returns generated by the entity, and they are subject to losses should the entity incur those losses. For purposes of analyzing VIEs to determine whether these entities need to be consolidated, if the equity investors lack any of these three characteristics, the primary beneficiary of the VIE will need to consolidate the entity.

The primary beneficiary (the entity that should consolidate the VIE) associated with a VIE is the entity that will receive a majority of expected returns from the VIE (if they are generated), absorb a majority of expected losses from the VIE (if they are incurred), or both. In those cases where "shared decision making" exists between and among investors (decision-making is not the primary criterion utilized in deciding which entity should

consolidate), where one entity receives the majority of expected returns and another entity absorbs the majority of expected losses, the entity that absorbs the expected losses is considered to be the primary beneficiary (expected losses is the "tie breaker" in deciding which entity will consolidate). In other words, if things "go bad" for the VIE, which entity is subject to absorbing the losses? These losses could be in the form of losing invested amounts, fulfilling commitments to advance funds, or fulfilling commitments related to guarantees related to the VIE.

Related Parties

For purposes of determining whether it is the primary beneficiary of a VIE (whether the VIE needs to be consolidated), an entity with a variable interest must treat variable interests in that same entity held by its related parties as its own interests. For purposes of this guidance, the term related parties includes those parties identified in FASB Statement No. 57, *Related Party Disclosures,* and certain other parties that are acting as de facto agents or de facto principals of the variable interest holder. The following are considered to be de facto agents of an entity:

- A party that cannot finance its operations without subordinated financial support from the entity.
- A party that received its interests as a contribution or a loan from the entity.
- An officer, employee, or member of the governing board of the entity.
- A party that has (1) an agreement that it cannot sell, transfer, or encumber its interests in the entity without the prior approval of the reporting entity, or (2) a close business relationship like the relationship between a professional service provider and one of its significant clients. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party's ability to manage the economic risks or to realize the economic rewards from its interests in a VIE through the sale, transfer, or encumbrance of those interests.

If two or more related parties, including de facto agents, hold variable interests in the same VIE, and the aggregate variable interest held by those parties would, if held by a single party, identify that party as the primary beneficiary, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary. The determination of which party within the related party group is most closely associated with the VIE requires judgment and must be based on an analysis of all relevant facts and circumstances, including:

- The existence of a principal-agency relationship between or among parties within the related party group.
- The relationship and significance of the activities of the VIE to the various parties within the related party group.
- A party's exposure to the expected losses of the VIE.
- The design of the VIE.

Impact on Construction Companies

When it has been determined that a company is the primary beneficiary of a VIE, the affiliated entity (the VIE) needs to be consolidated. Consolidation may improve or diminish financial results, and therefore impact credit analyses and a variety of other things. Consolidation not only will have an impact on total assets, liabilities, revenues, expenses, and net income, but also will potentially impact factors such as working capital, working capital ratios, debt-to-equity ratios, gross margins, and operating cash flows. In addition, presentation of consolidated financial statements may impact disclosures with respect to contingencies and litigation, as well as various other disclosures regarding lease commitments and commitments of cash flows for debt service. In certain circumstances, consolidation may force a rethinking of wording incorporated into buy-sell agreements between and among shareholders where those agreements set transaction values based upon book value (or otherwise use book value as a starting point for determining the value of a transaction).

As mentioned previously, it is not uncommon for construction companies to have arrangements with affiliated entities for a variety of reasons. Since guarantees constitute one of the more frequently-encountered variable interests that "trigger" the applicability of FASB Interpretation No. 46(R), the following examples focus on guarantee issues.

Example 1. A construction company has only one shareholder. The shareholder owns the real estate that is used by the construction company outside the company, and the real estate is housed in a single-member limited liability company (LLC) (where the single member is the owner of the construction company). The real estate LLC initially was "thinly" capitalized (5 percent equity contribution). The LLC borrowed funds associated with the acquisition of the real estate, and the lending institution required a guarantee from the construction company. The construction company leases the real estate from the LLC and the terms of the lease parallel the 15-year time period associated with the loan. Because the LLC did not have sufficient equity at risk (or perhaps in order to just secure a reduced interest rate associated with the borrowing), the lending institution required a guarantee of the loan. The construction company has a variable interest (in the form of the guarantee) related to the real estate LLC. In this circumstance, it is relatively clear that the construction company is the primary beneficiary of the LLC since there is no other entity available to absorb any expected losses attributed to the LLC. Therefore, the construction company should consolidate the LLC.

Example 2. Assume the same facts as Example 1, except that the guarantee is provided by the owner of the construction company rather than through the construction company. As in the first example, because the LLC did not have sufficient equity at risk, the lending institution required a guarantee of the loan. The shareholder has a variable interest in the real estate LLC through the guarantee of the loan of the LLC. In applying the provisions of FASB Interpretation No. 46(R), related parties need to be "collapsed" with the primary reporting entity in an effort to determine the primary beneficiary, if any, associated with any affiliated

entities. Since the shareholder is, by definition, a related party of the construction company, the LLC would be considered a VIE. Since the only user of the asset housed in the LLC is the construction company, the construction company would be considered the primary beneficiary and should consolidate the LLC (even though the guarantee was provided by the shareholder).

Example 3. A construction company has only one shareholder. The shareholder owns the real estate that is used by the construction company outside the company, the real estate is housed in a single-member LLC, and the single member is the owner of the construction company. The real estate LLC initially was "heavily" capitalized (40 percent equity contribution). The construction company only utilizes 30 percent of the facility that is housed in the LLC; the other 70 percent of the facility is utilized by unrelated third parties. The LLC borrowed funds associated with the acquisition of the real estate, and the lending institution did not require a guarantee from either the shareholder or the primary reporting entity (the construction company). The construction company and the third-party lessees lease the real estate from the LLC and the terms of the lease parallel the 15-year time period associated with the loan. Since (1) the real estate LLC was designed to have sufficient equity at risk, (2) the entity was able to secure the loan from the financial institution without help from either the construction company or the shareholder, and (3) the LLC is not a single-lessee entity (the LLC is not economically dependent on the construction company) the LLC has demonstrated the ability to operate on a stand-alone basis without help from related parties. In this circumstance, there would be no requirement for the construction company to consolidate the LLC.

Other Construction Industry Examples

Refundable Deposits. It is common practice in the homebuilding industry for a builder to place a nonrefundable deposit on a land parcel to secure the land for the company's future homebuilding operations. The deposit, along with the provisions on the land option contract, may run afoul of the FASB Interpretation No. 46(R) rules because (1) the deposit may represent a significant portion of the land owner's total equity and (2) the option

contract may contain provisions that restrict the land owner's activities. Either of these issues may cause the landowning entity to be considered a VIE. This is true even though the homebuilder's financial risk is strictly limited to the amount of the nonrefundable deposit. If it is determined that the landowning entity is a VIE and the homebuilder is the primary beneficiary, the homebuilder will be required to place the entire cost of the land and all debt of the landowning entity onto its balance sheet.

Project Special Purpose Entities (SPEs). Often an investor in a project SPE receives its investment for nominal equity and in consideration for other services (for example, construction, input supply, output purchase or marketing, or operations and maintenance services). Note that such equity will not count for the "sufficient equity" purpose to the extent that it is received and/or financed by the transaction. In addition, in many projects interested parties will receive compensation that includes participations in profits (for example, a bonus payable to an operator for exceeding specified financial targets), which can cause the equity to have insufficient participation in profits. Similarly, in many projects risk of loss will be borne under project contracts by third parties with the possible result that equity will not sufficiently participate in losses for purposes of FASB Interpretation No. 46(R), making the project SPE a VIE.

Primary Beneficiary Determination. In many construction projects, there is a party that performs day-to-day operations and maintenance under an operations and maintenance agreement. If the operations and maintenance contractor is the "decision maker" of the project VIE, fees payable to such contractor will count disproportionately in the determination of the primary beneficiary, making it more likely that the contractor will be the primary beneficiary. Similarly, many equipment vendors to project VIEs will provide performance and other guarantees with respect to the equipment. If periodic fees are payable to such a vendor they will also be weighted disproportionately in the primary beneficiary determination.

Consolidation Issues. In addition to the complexities associated with evaluating the application of FASB Interpretation No.

46(R), the Interpretation requires the resolution of many practical issues as well. For example, should a contractor be required to consolidate an entity whose financial information has not been audited, it will be necessary to audit the entity being consolidated as well. Although such an audit may not be difficult and time-consuming for certain types of assets and liabilities, it may be extremely challenging for others. On the other hand, information that now requires consolidation may be readily available in audited form, but it might not suit the comparative analysis needs of those using the financial statements. This situation may require the use of supplemental disclosure of consolidating information.

Conclusion. While FASB Interpretation No. 46(R) has had, and will continue to have, a significant impact on reporting entities throughout various industry sectors, reporting entities within the construction industry might feel the greatest impact in financial reporting. Because of the variety of arrangements that are commonly encountered within the construction industry, there exists a variety of "connects" between and among reporting entities and parties that are related to those entities and those "connects" easily could be considered variable interests in applying FASB Interpretation No. 46(R).

Recent Technical Practice Aids (TPAs) Related to FASB Interpretation No. 46(R)

The AICPA staff recently issued the following technical questions and answers related to FASB Interpretation No. 46(R).

TPA 1400.29: Consolidated Versus Combined Financial Statements Under FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*

TPA 1400.29 addresses the question of whether it would be appropriate to issue combined financial statements rather than consolidated financial statements. The TPA points out that Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, paragraph 22, permits combined financial statements in certain situations in which consolidated financial

statements are not required. However, FASB Interpretation No. 46(R) states in paragraph 14 that "an enterprise shall consolidate a variable interest entity if that enterprise has a variable interest (or combination of variable interests) that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both." Furthermore, the starting point for the preparation of combined financial statements is two or more sets of financial statements that are prepared in accordance with generally accepted accounting principles (GAAP); in the case of a primary beneficiary of a VIE, financial statements prepared in accordance with GAAP would be consolidated financial statements. Therefore, combined financial statements would not be an appropriate alternative when consolidated financial statements are required by GAAP.

TPA 1400.30: Stand-Alone Financial Statements of a Variable Interest Entity

TPA 1400.30 addresses the question of whether it is appropriate to present stand-alone financial statements of a VIE. The TPA points out that FASB Interpretation No. 46(R) does not specifically address this issue. However, subsidiary-only financial statements are appropriate under GAAP and, by extension, it may be appropriate to present stand-alone financial statements of a VIE.

TPA 1400.31: GAAP Departure for FIN 46(R)

TPA 1400.31 addresses the implications for the auditor's report if the reporting entity does not consolidate a VIE. The TPA points out that AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), addresses departures from generally accepted accounting principles. AU section 508 states that when financial statements are materially affected by a departure from GAAP and the auditor has audited the statements in accordance with generally accepted auditing standards (GAAS), he or she should express a qualified or an adverse opinion. In deciding whether the effects of a departure are sufficiently material to require either a qualified or adverse opinion, the auditor should use qualitative as well as quantitative judgments. The significance of an item to a particular entity, the pervasiveness of the

misstatement (such as whether it affects the amounts and presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality.

If you conclude that a qualified opinion is appropriate, you should disclose the GAAP departure in a separate explanatory paragraph(s) preceding the opinion paragraph of the report. Furthermore, the opinion paragraph of the report should include the appropriate qualifying language and a reference to the explanatory paragraph(s). The explanatory paragraph(s) should disclose the principal effects of the departure on financial position, results of operations, and cash flows, if practicable. If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the explanatory paragraph(s) may be shortened by referring to it.

TPA 1500.06: Application of FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, to Income Tax Basis Financial Statements

TPA 1500.06 addresses the question of whether the consolidation or disclosure provisions of FASB Interpretation No. 46(R) apply to financial statements prepared under the income tax basis of accounting. The TPA points out that, for income tax basis financial statements, consolidation is based on the IRC. Therefore, the consolidation requirements of FASB Interpretation No. 46(R) would not apply to financial statements prepared under the income tax basis of accounting. However, SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, AU sec. 623.09-.10), as amended, and Interpretation No. 14, "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.90-.95), discuss disclosures in financial statements prepared using an other comprehensive basis of accounting (OCBOA). The literature states that if OCBOA financial statements contain elements, accounts, or items for which GAAP would require disclosure, the statements should either provide the relevant

disclosure that would be required for those items in a GAAP presentation or provide information that communicates the substance of that disclosure.

The TPA points out that a VIE that is not consolidated under the income tax basis of accounting is analogous to a 60-percent-owned subsidiary that would be consolidated under GAAP but is not consolidated under the income tax basis of accounting because the threshold for consolidation under the IRC is 80-percent ownership. Therefore, the primary beneficiary of the VIE should perform the same analysis in determining which disclosures are appropriate as would the parent company of the 60-percent-owned subsidiary. Examples of matters that might require disclosure are related-party transactions, guarantees, and commitments.

TPA 1400.32: Parent-Only Financial Statements and Relationship to GAAP

TPA 1400.32 addresses the question of whether there are any circumstances in which an entity may prepare parent company-only financial statements without preparing related consolidated financial statements and state that the parent company-only financial statements are in accordance with GAAP. The TPA states that paragraph 1 of ARB No. 51 notes the presumption in GAAP that consolidated financial statements are more meaningful than parent company-only financial statements. Paragraph 3 of ARB No. 51 states that all majority-owned subsidiaries shall be consolidated, with few exceptions. Paragraph 24 of ARB No. 51 adds that parent company financial statements may be needed in addition to consolidated financial statements, but it does not suggest that parent company financial statements may be prepared in place of consolidated financial statements. Therefore, parent company-only financial statements would not be appropriate when consolidated financial statements are required by GAAP.

Using the Work of a Specialist

It may be necessary to use a specialist (such as a construction engineer) to perform or assist in job site visits or other audit

procedures. The specialist may help you gain assurance as to percent complete, identify problems on the job, and identify possible uninstalled materials or items to be classified as inventory. In addition, the specialist will generally be able to "talk shop" with your client's job site personnel.

Engaging a specialist for gaining an understanding of internal controls, tests of controls, substantive tests, and analytical procedures requires awareness of guidelines available in the authoritative literature. According to paragraph .06 of AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), specialized assistance is advisable for auditors who:

> ...may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain competent evidential matter.

The use of an outside specialist[1] does not absolve the auditor from a certain level of understanding about the construction contractor. Audit planning comes into play because of the lead time necessary to contract for a specialist's services and the time required for the auditor to obtain the minimum knowledge necessary to supervise the specialist. According to paragraph .10 of AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1):

> If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who may be either on the auditor's staff or an outside professional. If the use of such a professional is planned, the auditor should have sufficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditor's objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit

1. Note that AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1) does not apply to specialists who are employed by the firm and are part of the engagement team. AU section 336 indicates that the auditor uses the work of the specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions. The specialist does not, however, perform the substantive tests or analytical procedures.

procedures. The auditor's responsibilities with respect to using such a professional are equivalent to those for other assistants.

The use of a specialist is an excellent way to learn the construction contractor's business and can be helpful from initial planning through site visits and fieldwork.

Important Information for Review Engagements

The majority of CPA practitioners serving construction contractors perform a higher number of reviews than audits. Readers interested in guidance for review engagements should refer to the AICPA *Compilation and Review Alert—2006/07* (product no. 022307kk). However, a brief overview of Statement on Standards for Accounting and Review Services (SSARS) No. 12, *Omnibus Statement on Standards for Accounting and Review Services—2005* (AICPA, *Professional Standards*, vol. 2, AR sec. 100 and 200) is provided in this Alert due to its impact on review engagements.

SSARS No. 12, *Omnibus Statement on Standards for Accounting and Review Services—2005*

In July 2005, the AICPA Accounting and Review Services Committee (ARSC) issued SSARS No. 12, *Omnibus Statement on Standards for Accounting and Review Services—2005*. SSARS No. 12 includes revisions to existing SSARS that were accumulated over a period of time and addresses the following issues.

Consideration of Fraud and Illegal Acts in a Compilation or Review Engagement

Guidance in SSARS No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100.05), stated that the accountant should, among other things, establish an understanding with the entity that provides that the accountant will inform the appropriate level of management of any fraud or illegal acts that come to his or her attention, unless they are clearly inconsequential. SSARS No. 12 revised SSARS No. 1 by requiring the accountant to:

1. Establish an understanding with the client, preferably in writing, that the accountant will inform the appropriate

level of management of any evidence or information that comes to the accountant's attention during the performance of compilation or review procedures that fraud or an illegal act may have occurred.

2. Report, to the appropriate level of management, any evidence or information that comes to the accountant's attention during the performance of compilation or review procedures that fraud or an illegal act may have occurred.

Obtaining an Updating Representation Letter

SSARS do not provide guidance on when an accountant should obtain an updating representation letter from management. SSARS No. 12 revised SSARS No. 1 to provide such guidance, by adding a paragraph in the section titled "Management Representations" and an illustrative updating management representation letter.

The new guidance states that there are circumstances in which you should consider obtaining an updating representation letter from management. For example, if you obtain a management representation letter after completion of inquiry and analytical review procedures but do not issue your review report for a significant period of time thereafter, or if a material subsequent event occurs after the completion of inquiry and analytical review procedures, including obtaining the original management representation letter, but before the issuance of the report on the reviewed financial statements. In addition, if a predecessor accountant is requested by a former client to reissue his or her report on the financial statements of a prior period, and those financial statements are to be presented on a comparative basis with reviewed financial statements of a subsequent period, the predecessor accountant should obtain an updating representation letter from the management of the former client.

The updating management representation letter should state (1) whether any information has come to management's attention that would cause management to believe that any of the previous representations should be modified and (2) whether any events

have occurred subsequent to the balance-sheet date of the latest financial statements reported on by the accountant that would require adjustment to or disclosure in those financial statements.

The following is an example of an updating management representation letter:

> [*Date*]
>
> To [*Accountant*]
>
> In connection with your review(s) of the [*identification of financial statements] of [name of entity*] as of [*dates*] and for the [*periods of review*] for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements for them to be in conformity with generally accepted accounting principles, you were previously provided with a representation letter under date of [*date of previous representation letter*]. No information has come to our attention that would cause us to believe that any of those previous representations should be modified.
>
> To the best of our knowledge and belief, no events have occurred subsequent to [*date of latest balance sheet reported on by the accountant or date of previous representation letter*] and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.
>
> ______________________________
>
> [*Name of Owner or Chief Executive Officer and Title*]
>
> ______________________________
>
> [*Name of Chief Financial Officer and Title, where applicable*]

Restricting the Use of a Compilation or Review Report

SSARS No. 12 revised SSARS No. 1 to provide guidance to accountants on restricting the use of reports issued pursuant to SSARS. The term *general use* applies to compilation and review reports that are not restricted to specified parties, while the term *restricted use* applies to reports intended only for one or more specified third parties. The need for restriction on the use of a report may result from a number of circumstances, including, but not limited to, the purpose of the report and the potential for the report to be misunderstood when taken out of the context in which it was intended to be used.

You should restrict the use of a report when the subject matter of your report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with GAAP or an OCBOA.

You should also consider informing your client that restricted-use reports are not intended for distribution to nonspecified parties, regardless of whether they are included in a document containing a separate general-use report. The new guidance does not preclude you, in connection with establishing the terms of the engagement, from reaching an understanding with the client that the intended use of the report will be restricted, and from obtaining the client's agreement that the client and the specified parties will not distribute the report to parties other than those identified in the report. However, you are not responsible for controlling a client's distribution of restricted-use reports. Accordingly, a restricted-use report should alert readers to the restriction on the use of the report by indicating that the report is not intended to be and should not be used by anyone other than the specified parties.

An accountant's report that is restricted as to use should contain a separate paragraph at the end of the report as follows:

> This report is intended solely for the information and use of [the specified parties] and is not intended to be and should not be used by anyone other than these specified parties.

Restated Prior-Period Financial Statements

Guidance in the section titled "Changed Prior-Period Financial Statements" in SSARS No. 2, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 200.25–.26), required that either the predecessor or successor accountant report on changed prior-period financial statements, as restated. The successor accountant was precluded from reporting on the restatement adjustment only. SSARS No. 12 revised SSARS No. 2 to allow the successor accountant to report on the restatement adjustment while indicating that a predecessor accountant reported on the financial statements of the prior period before restatement.

The following is an example of a successor accountant's compilation report when the predecessor accountant's report is not presented and the successor accountant compiles the restatement adjustment(s):

> I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. I (we) also compiled the adjustment(s) [described in Note X, if applicable] that were applied to restate the 20X1 financial statements. The financial statements of XYZ Company as of December 31, 20X1, before the adjustments [described in Note X, if applicable] [2] that were applied to restate the 20X1 financial statements, were compiled by other accountants whose report dated March 31, 20X2, did not express an opinion or any other form of assurance on those financial statements.
>
> [*Same second paragraph as the standard report*]

2. In the situation where management elects to omit substantially all disclosures, the accountant should follow the guidance in Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100.16-.18), as amended.

The following is an example of a successor accountant's review report when the predecessor accountant's report is not presented and the successor accountant has reviewed the restatement adjustment(s):[3]

> I (we) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company. The financial statements of XYZ Company as of December 31, 20X1 before the adjustment(s) described in Note X that was (were) applied to restate the 20X1 financial statements were reviewed by other accountants whose report dated March 31, 20X2, stated that they were not aware of any material modifications that should be made to those financial statements in order for them to be in conformity with generally accepted accounting principles.
>
> [*Same second and third paragraphs as the standard report*]
>
> I (we) also reviewed the adjustment(s) as described in Note X that was (were) applied to restate the 20X1 financial statements. Based on my (our) review, nothing came to my (our) attention to indicate that the adjustment(s) is (are) not appropriate and properly applied.

SSARS No. 12 was effective for compilations and reviews of financial statements for periods ending after December 15, 2005.

Recent Auditing and Attestation Pronouncements and Related Guidance

Presented below is a list of auditing and attestation pronouncements, guides, and other guidance. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/

3. The accountant should follow the performance requirements in SSARS No. 1 (AICPA, *Professional Standards*, vol. 2, AR sec. 100.26-.38), as amended.

members/div/auditstd/technic.htm. The Public Company Accounting Oversight Board (PCAOB) sets auditing and attestation standards for audits of public companies. See the PCAOB Web site at www.pcaobus.org for information about its activities. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org.

SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (December 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	These standards established two categories of professional requirements that are identified by specific terms. The words *must* or *is required* are used to indicate an unconditional requirement. The word *should* is used to indicate a presumptively mandatory requirement. (The words *may, might, could,* and *should consider* represent actions that auditors have a professional obligation to consider.) The provisions of SAS No. 102 and SSAE No. 13 were effective upon issuance. It is the ASB's intention to make conforming changes to AICPA literature over the next several years to remove any language that would imply a professional requirement where none exists.
SAS No. 103, Audit Documentation (December 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	SAS No. 103 supersedes AU section 339, *Audit Documentation*, (AICPA, *Professional Standards*, vol. 1) and amends SAS No. 1, *Codification of Auditing Standards and Procedures*, AU section 530, "Dating of the Independent Auditor's Report" (AICPA, *Professional Standards*, vol. 1). It is effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted. This SAS establishes standards and provides guidance to an auditor of a nonissuer on audit documentation.
SAS Nos. 104-111, *Risk Assessment Standards*	See "Spotlight on the AICPA Risk Assessment Standards" section, below.

(continued)

SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (May 2006) (Not applicable to audits conducted in accordance with PCAOB standards)	The new standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 325), as amended. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	This standard applies if auditors report on the elimination of a material weakness in a company's internal control over financial reporting. The standard establishes a voluntary engagement that would be performed at the election of the company.
PCAOB Conforming Amendment to AT 101.04f, *Attest Engagements* (February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	*Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4* This standard states that Auditing Standard No. 4 must be used for reporting on whether a material weakness continues to exist for any purpose other than a company's internal use.

Spotlight on the AICPA Risk Assessment Standards

In March 2006, the AICPA's Auditing Standards Board (ASB) issued eight SASs that provide extensive guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial

statements under audit. The following table lists the eight SASs and their effect on existing standards.

Statement on Auditing Standards	*Effect on Existing Standards*
SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures (*"Due Professional Care in the Performance of Work"*)	Amends AU section 230, "Due Professional Care in the Performance of Work," as amended, of SAS No. 1, *Codification of Auditing Standards and Procedures*
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards	Amends SAS No. 95, *Generally Accepted Auditing Standards* (AU sec. 150), as amended
SAS No. 106, *Audit Evidence*	Supersedes SAS No. 31, *Evidential Matter* (AU sec. 326), as amended
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*	Supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU sec. 312), as amended
SAS No. 108, *Planning and Supervision*	Supersedes AU section 310, "Appointment of the Independent Auditor," as amended, of SAS No. 1; and supersedes SAS No. 22, *Planning and Supervision* (AU sec. 311), as amended
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*	Together with SAS No. 110, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU sec. 319), as amended
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*	Supersedes AU section 313, "Substantive Tests Prior to the Balance-Sheet Date" of SAS No. 45, *Omnibus Statement of Auditing Standards—1983* ; and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU sec. 319), as amended
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling	Amends SAS No. 39, *Audit Sampling* (AU sec. 350), as amended

Key Provisions of the New Standards

The SASs emphasize the link between understanding the entity, assessing risks, and the design of further audit procedures. The SASs introduce the concept of risk assessment procedures, which

are deemed necessary to provide a basis for assessing the risk of material misstatement. Risk assessment procedures, along with further audit procedures which include of tests of controls and substantive tests, provide the audit evidence to support the auditor's opinion of the financial statements. According to the SASs, the auditor should perform risk assessment procedures to gather information and gain an understanding of the entity and its environment, including its internal controls. These procedures include inquiries, analytical procedures, and inspection and observation. Assessed risks and the basis for those assessments should be documented; therefore, auditors may no longer default to maximum control risk for an entity's risk assessment without documenting the basis for that assessment. The SASs also require auditors to consider and document how the risk assessment at the financial statement level affects individual financial statement assertions, so that auditors may tailor the nature, timing, and extent of their audit procedures to be responsive to their risk assessment. It is anticipated that generic audit programs will not be appropriate for all audit engagements, as risks vary between entities.

Effective Date and Implementation

The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. In most cases, implementation of the SASs will result in an overall increased work effort by the audit team, particularly in the year of implementation. It also is anticipated that to implement the SASs appropriately, many firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. Readers can obtain the SASs and the related AICPA Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) at www.cpa2biz.com.

New Companion Audit Guide

In December 2006, the AICPA will publish an Audit Guide titled *Assessing and Responding to Audit Risk in a Financial Statement Audit.* This guide will help practitioners understand and

implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Statement on Auditing Standards No. 103

The ASB has issued SAS No. 103, *Audit Documentation*, which supersedes SAS No. 96 of the same name (AICPA, *Professional Standards*, vol. 1, AU sec. 339) and amends AU section 530, "Dating of the Independent Auditor's Report," of SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1). SAS No. 103 is effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted. One key provision of this standard is the amendment of paragraphs .01 and .05 of AU section 530. AU section 530.01 now requires that "the auditor's report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion" and the footnote to this paragraph describes sufficient appropriate audit evidence as "evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them." Application of the rules may require revising the process used by your firm at the end of fieldwork to include a field review of audit workpapers and financial statements. For some firms an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

Staff Accounting Bulletin No. 108

On September 13, 2006, the Securities and Exchange Commission (SEC) released Staff Accounting Bulletin (SAB) No. 108, Topic 1N, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.* The issuance provides interpretive guidance on how the effects of

the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement.

There have been two common approaches used to quantify such errors. Under one approach, the error is quantified as the amount by which the current year income statement is misstated (rollover approach). The other common approach quantifies the error as the cumulative amount by which the current year balance sheet is misstated (iron curtain approach). Exclusive reliance on an income statement approach can result in a registrant accumulating errors on the balance sheet that may not have been material to any individual income statement, but which nonetheless may misstate one or more balance sheet accounts. Similarly, exclusive reliance on a balance sheet approach can result in a registrant disregarding the effects of errors in the current year income statement that result from the correction of an error existing in previously issued financial statements.

The SEC staff believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The SEC staff believes that this can be accomplished by quantifying errors under both a balance sheet and an income statement approach and by evaluating errors measured under each approach. Thus, a registrant's financial statements would require adjustment when either approach results in quantifying a material misstatement after considering all relevant quantitative and qualitative factors.

If, in correcting a prior year error in the current year, the amount is material to the current year's income statement, the prior year financial statements should be corrected, even though such a revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements. However, registrants electing not to restate prior periods should follow the disclosure requirements specified in the SAB. In general, SAB No. 108 is effective for financial statements for fiscal years ending

after November 15, 2006, with earlier application encouraged in any report for an interim period of the first fiscal year ending after November 15, 2006, and filed after the SAB's publication date of September 13, 2006. For additional accounting and transition information, see the issuance at www.sec.gov/interps/account/sab108.pdf. It is possible that guidance similar to that found in SAB No. 108 will be developed for nonissuers in the future as a result of FASB projects that are currently underway.

Recent AICPA Independence and Ethics Pronouncements

The AICPA *Independence and Ethics Alert—2006/07* (product no. 022477kk) contains a complete update on new independence and ethics pronouncements. This Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this Alert to be aware of independence and ethics matters that will affect their practice.

The AICPA general *Audit Risk Alert—2006/07* and other AICPA industry-specific Alerts contain summaries of recent pronouncements not included here. To obtain copies of AICPA standards and Guides, contact AICPA Service Center Operations at (888) 777-7077 or go online at www.cpa2biz.com.

Recent Accounting Pronouncements and Related Guidance

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy.*

FASB Statement No. 155	*Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*
FASB Statement No. 156	*Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*
FASB Statement No. 157	*Fair Value Measurements*
FASB Statement No. 158	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Interpretation No. 48	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB EITF Issues (Various dates)	Go to www.fasb.org/eitf/ for a complete list of EITF Issues.
FASB Staff Positions (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FASB Staff Positions (FSPs). Some of the recently issued FSPs address issues relating to FASB Statements No. 143 and No. 150, among others, and FASB Interpretation No. 46(R).
AICPA Technical Practice Aids TPA section 2130.09-.37 (Nonauthoritative)	Various topics on the application of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, to debt securities
AICPA Technical Practice Aids TPA section 5600.07-.17 (Nonauthoritative)	Various lease topics
AICPA Technical Practice Aids TPA section 6910.16-.20 (Nonauthoritative)	"Nonregistered Investment Partnerships"

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance

to the construction industry or that may result in very significant changes. Read the AICPA general *Audit Risk Alert —2006/07* for a more complete list of ongoing auditing and accounting projects. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

Standard-Setting Body	***Web Site***
AICPA Auditing Standards Board (ASB)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org or www.pcaob.com
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm
Securities and Exchange Commission (SEC)	www.sec.gov

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to service@aicpa.org. Indicate "exposure draft

e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address, and, if known, your membership and subscriber number in the message. The AICPA Web site also has connecting links to the other standard-setting bodies listed above.

Auditing Pipeline

Proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Over Financial Reporting* (AT section 501)

In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE would establish standards and provide guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). In May 2006, the PCAOB announced plans to amend certain aspects of PCAOB Auditing Standard No. 2 to improve its implementation. Because the forthcoming changes to the PCAOB Standard will be relevant to the revision of AT section 501, the ASB has decided to defer the issuance of final revised AT section 501 until the PCAOB issues its amendments and the ASB has time to consider them.

Proposed Amendment to SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities

The ASB has issued an exposure draft introducing a proposed SAS entitled *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities.* This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards entitled *The Hierarchy of*

Generally Accepted Accounting Principles. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69, AICPA, *Professional Standards,* vol. 1, AU sec. 411) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the FASB proposed statement, which can be obtained at www.fasb.org.

Accounting Pipeline

Proposed FASB Statement, *The Hierarchy of Generally Accepted Accounting Principles*

This proposed Statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, who is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final Statement.

Proposed FASB Statement, *Accounting for Transfers of Financial Assets*

The exposure draft *Accounting for Transfers of Financial Assets* (Transfers Project) is a revision of a June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets*, and would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* The proposed Statement seeks to (1) clearly specify the permitted

activities of a qualifying special-purpose entity (QSPE), (2) address practice issues related to which arrangements should be considered and how they should be considered in the legal isolation analysis, (3) eliminate the prohibition on a QSPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor, (4) revise the methodology used to initially measure at fair value interests related to transferred financial assets held by a transferor, and (5) clarify guidance related to when rollovers of beneficial interests are permitted within a QSPE. At its July 26, 2006 meeting, the FASB decided to combine the Servicer Discretion Project (which addressed issues relating to the waiver of due-on-sale, collateral substitution, and foreclosed asset activities) into the Transfers Project. The FASB expects to issue a final Statement, which would amend FASB Statement No. 140, in the second quarter of 2007. See the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*

The fair value option project has two phases. This proposal represents Phase 1, which addresses the fair value option for certain financial assets and financial liabilities. Phase 2 will consider permitting the fair value option for certain nonfinancial assets and nonfinancial liabilities and some of the financial assets and financial liabilities excluded from the scope of Phase 1.

The proposed Statement would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur. The proposed Statement has specific financial presentation requirements to display fair values and those values that are measured using other measurement techniques. The proposed Statement would amend FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* to require that securities reported at fair value in accordance with FASB Statement No. 115 satisfy the specific financial statement presentation

requirements. The planned effective date is for years beginning after December 15, 2006. Visit the FASB Web site at www.fasb.org for additional information.

Proposed FASB Statements, *Business Combinations* and *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*

In these proposed Statements, the FASB plans to revise the existing guidance on the application of the purchase method. The following are among the main proposals:

1. That all acquisitions of businesses be measured at the fair value of the business acquired.
2. That substantially all the assets acquired and liabilities assumed of the acquired business are recognized and measured at their fair values at the acquisition date.
3. That entities following U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

Exposure drafts on business combinations—purchase method procedures and noncontrolling interests—were issued on June 30, 2005. The target effective date for the two proposed Statements is for fiscal years beginning on or after December 15, 2006.

FASB Project on Derivative Disclosures

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, has been criticized by certain analysts, auditors, investors, and others for lacking transparent disclosures, allowing a user of the financial statements to assess the overall risk of derivatives on a reporting entity from both a quantitative and qualitative perspective. An exposure draft on derivative disclosures is expected in the fourth quarter of 2006. The objective is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133. Additionally, the project is expected to reconsider the existing disclosure requirements under FASB Statement No. 133 for rele-

vance and applicability. It is also expected that derivative loan commitments will fall under the scope of this project and could have a significant impact on the financial statements of entities with derivative loan commitments.

Proposed FASB EITFs and FASB Staff Positions

Proposed FASB EITF Issues. Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

Proposed FASB Staff Positions (FSPs). A number of proposed FSPs are in progress addressing issues related to financial institutions. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

AICPA Resource Central

The following publications deliver valuable guidance and practical assistance as potent tools to be used on your construction engagements.

- Audit and Accounting Guide *Construction Contractors* (product no. 012586kk). The Audit and Accounting Guide, as of May 1, 2006, summarizes applicable practices and delivers "how to" advice for handling almost every type of financial statement. It describes relevant matters, conditions, and procedures unique to the construction industry, and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems. This Audit and Accounting Guide is available as a CD-ROM or online subscription.

- Checklist Supplement and Illustrative Financial Statements *Construction Contractors* (product no. 008926kk). Developed by AICPA's Accounting and Auditing Publications staff as a supplement to *Checklists and Illustrative Financial Statements for Corporations* (product no. 008936kk), this practice aid is invaluable to anyone

who prepares financial statements and reports for construction contractors.

- *Accounting Trends & Techniques, 60th Edition* (product no. 009898kk). This is the must-have resource for any CPA who frequently creates or uses financial reports. Filled with current reporting techniques and methods used by the nation's top organizations, this 650-page AICPA bestseller will provide the guidance you need to improve your accounting preparation and procedures.

- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk). Authoritative guidance on cash- and tax-basis financial statements is rather vague and leaves a great deal to professional judgment. Section One of this publication provides nonauthoritative, practical guidance on preparing and reporting on cash- and tax-basis financial statements. Section Two includes example financial statements, disclosures, and other engagement practice aids. The appendix provides an example checklist to be used for cash- and tax-basis financial statements.

- Audit Guide *Auditing Derivative Instruments, Hedging Activities and Investments in Securities* (product no. 012526kk). *The Auditing Derivative Instruments, Hedging Activities and Investments in Securities* guide has been updated with conforming changes as of May 1, 2006. In it you'll find an overview of derivatives and securities in addition to case studies to help you better understand auditing derivative instruments.

- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012516kk). This publication, as of May 1, 2006, assists auditors in fulfilling their professional responsibilities with regard to auditing assertions about revenue.

- Audit Guide *Analytical Procedures* (product no. 012556kk). Receive guidance on the effective use of analytical procedures with an emphasis on analytical procedures as substantive tests.

Audit and Accounting Manual

The *AICPA Audit and Accounting Manual* (product no. 005136kk) is developed exclusively for small- and medium-size CPA practices. This unique manual explains and demonstrates useful techniques and procedures for conducting compilation, review, and audit engagements — from planning to internal control to accountants' reports.

AICPA reSOURCE: Online Accounting and Auditing Literature

AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that's available too! Get access—anytime, anywhere—to the AICPA's latest *Professional Standards,* Technical Practice Aids, Audit and Accounting Guides (more than 20!), Audit Risk Alerts (more than 15!), and *Accounting Trends & Techniques.* To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Educational Courses

The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the construction industry. Those courses include:

- *Construction Contractors: Accounting, Auditing and Tax* (product no. 736430kk). Master the fundamentals of the construction industry with this highly effective course. An outstanding value, it provides a thorough industry overview and includes AICPA authoritative publications. Content is tailored to the needs of both practitioners and industry financial professionals.
- *Construction Contractors Advanced Issues* (product no. 731992kk). Delve beyond the basics of many issues the construction industry brings to the accounting profession. Get hands-on advice on the accounting, audit, and tax issues that make construction industry clients high-risk. Address difficult issues such as look-back calculations,

measuring progress of construction contracts, and overhead allocations. Enhance your skills today to reduce the risk of your next construction engagement.

- *Real Estate Accounting and Auditing* (product no. 730606kk). This course provides an in-depth study of the unique requirements that apply at each stage of the real estate life cycle. It gives practical, how-to-do-it coverage of accounting considerations related to the development, ownership, and operation of real estate assets.

Accountants in the construction industry, as well as in other industries, may also find the following courses helpful:

- *FASB Review for Industry* (2006-2007 edition) (product no. 730563kk). Comprehensive coverage of recent FASB, AcSEC, IASB, and EITF pronouncements is provided in this course geared to the specific interests of the CPA in corporate management.
- *Accounting Update: A Review of Recent Activities* (2006 edition) (product no. 732762kk). This course keeps you current and shows you how to apply the most recent financial accounting and reporting standards. Highlights include FASB Statement No. 154 on accounting changes and error corrections, fair value concepts and measurements, and the revised FASB Statement No. 123 on share-based payment.
- *AICPA's Annual Accounting and Auditing Update Workshop* (2006 edition) (product no. 736182kk, text; also available in video and DVD formats with a manual). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Accounting for Income Taxes—Applying SFAS No. 109/FIN 48: A Whole New Ballgame!* (product no. 732792kk). No other area in accounting is as far reaching, and requires knowledge of a vast number of topics in financial and tax accounting, as accounting for deferred taxes. This course addresses the application of this complex standard to many

common differences between financial accounting and tax compliance. You will gain a sound knowledge of the theory of deferred taxes and how this theory can be applied to practical situations. Many practical examples are included to illustrate the theory, and the information is presented so you will be able to apply this theory to any situation you may encounter.

- *The AICPA's Guide to Business Consolidations, Goodwill and Other Consolidation Issues* (product no. 735134kk). Learn how FASB Statements No. 141 and No. 142 have changed the rules for business combinations and goodwill accounting. Develop standards for applying purchase accounting and how to allocate the acquired entity now that it's the only game in town under FASB Statement No. 141. Identify variable interest entities' impact under FASB Interpretation No. 46(R). Learn how FASB Statement No. 142 deals with goodwill from initial recognition to the annual impairment review requirements.

For a listing of additional courses available, please download the *Fall/Winter 2006 AICPA CPE Catalog* at www.cpa2biz.com/CPE/default.htm.

Online CPE

AICPA CPExpress (formerly InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to construction company auditors are:

- *Construction Contractors: Internal Controls and Substantive Auditing Procedures*

- *Construction Contractors: Sureties and Applying the Audit Risk Model*
- *Revenue Recognition: Income Statement Presentation and Disclosures*

To register or learn more, visit www.cpa2biz.com.

Webcasts

Stay plugged in to what's happening and earn CPE credit right from your desktop. AICPA Webcasts are high-quality two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in on the discussion. If you can't make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

The CFO Roundtable Webcast Series—brought to you each calendar quarter—covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting, to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

The SEC Quarterly Update Webcast Series—brought to you each calendar quarter—showcases the profession's leading experts on what's "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and CorpFin activities, these hard-hitting sessions will keep you "plugged in" to what's important. A must for both preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Satisfaction Center

To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Technical Hotline and Ethics Hotline

Do you have a complex technical question about GAAP, OCBOA, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. You can reach the Technical Hotline at (888) 777-7077.

In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

Conferences

Among the many interesting conferences the AICPA offers, there is one that might interest you. Held late each fall, the AICPA National Construction Industry Conference presents a comprehensive program revealing latest trends and developments in the construction industry. The conference offers a national perspective and addresses the newest trends in conducting business, among other topics.

For additional information, contact CPA2Biz at its Web site, www.cpa2biz.com.

Web Sites[4]

AICPA Online and CPA2Biz

Here is a unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online, at aicpa.org, informs you of

[4] Additional helpful Web sites are presented in Appendix A.

developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, cpa2biz.com offers you all the latest AICPA products, including more than 15 Audit Risk Alerts, more than 20 Audit and Accounting Guides, the professional standards, and CPE courses.

* * * * * * * *

Construction Contractors Industry Developments is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to ccole@aicpa.org or write to:

Christopher Cole
AICPA
Palladian Corporate Center
220 Leigh Farm Road
Durham, NC 27707-8110

APPENDIX A

Helpful Web Sites

Here are some useful Web sites that may provide valuable information as you plan your client engagements. In addition to these Web sites, be sure to review those listed in the "On the Horizon" section of this Alert.

General Web Sites of Interest

Name of Site	*Content*	*Internet Address*
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com
American Institute of CPAs	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org
Ask.Com	Useful search engine	www.ask.com
Associated Builders and Contractors	A national association representing all specialties within the construction industry and primarily comprising firms that perform work in the industrial and commercial sectors of the industry	www.abc.org
Associated General Contractors of America	An organization of qualified construction contractors and industry-related companies	www.agc.org
AuditNet	Electronic communications among audit professionals	www.auditnet.org
Construction Financial Management Association	The only nonprofit organization dedicated to serving the construction financial professional	www.cfma.org

(continued)

Construction Industry Compliance Assistance Center	The source for plain language explanations of environmental rules for the construction industry	www.cicacenter.org
Construction Owners Association of America	A focal point and voice for the interests of owners in the construction industry	www.coaa.org
Construction.com	A McGraw-Hill company that unifies the resources of Dodge, Sweets, *Architectural Record*, ENR, and regional publications and includes market analysis and forecasting, industry trends, and insights	www.construction.com
Contractor's License Reference Site	Information about state license requirements, with search functions to find out if a contractor is licensed in a particular state	http://contractors-license.org/index.html
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com
Cybersolve	Online financial calculators, such as ratio and breakeven analysis	www.cybersolve.com/tools1.html
Disaster Contractors Network	Facilitating information sharing and resource matching among government, the construction community, and home and business owners before, during, and after disasters strike	www.dcnonline.org
Engineering News Record	Source of important information for owners, contractors, and design and engineering professionals	www.enr.com
FedWorld.Gov	U.S. Department of Commerce-sponsored site providing access to government publications	www.fedworld.gov

Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
Home Builders Institute	Dedicated to the advancement and enrichment of education and training programs serving the needs of the housing industry	www.hbi.org
Hoovers Online	Online information on various companies and industries	www.hoovers.com
National Association of Home Builders	A trade association that helps promote the policies that make housing a national priority	www.nahb.org
National Association of the Remodeling Industry	Focusing on educating both trade professionals and remodeling-ready homeowners through a variety of formats including education, training, publications, and programs	www.nari.org
Society of Industrial and Office Realtors	Industrial and office real estate information	www.sior.com
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html

APPENDIX B

Audit Considerations of Various Types of Contracts—Revenue Issues[5]

Fixed Price

This type of contract can be considered the riskiest for both the contractor and the auditor. This is generally the type of contract that one has in mind when considering the need for adequate auditing procedures. As the riskiest contract type in an audit, the auditor must employ all of his or her available audit tools to verify the total contract amount, the collectibility and likelihood of contract changes, and the status of the contract as of the balance sheet date. Auditing procedures related to revenue for this type of contract can consist of (1) contract confirmation; (2) testing of the contractor's business functions over estimating, billing, collection, project management, and generally all controls that influence the contractor's ability to manage estimates; (3) use of testing the contractor's subsequent performance; (4) measuring the contract job gain or fade trends by comparing the contractor's ability to estimate by using original estimated contract revenues and costs and comparing these figures to period end amounts and final contract amounts for a period of several years; and (5) using other analytical procedures.

Cost Type

This is a lower risk type of contract. The audit procedures should be focused on the contract provisions concerning the definition of contract costs and the associated revenue entitlements of the contractor. If the contract clearly defines allowable costs, overhead calculations and allocations, agreed-upon profit, and payment terms, the auditor's job is easier and can then be focused on

5. These audit considerations were developed by Eric P. Wallace, CPA, and are used by permission.

the realization of collection and the creditworthiness of the owner. There are many variations of the cost-type contracts that present various degrees of concern and additional audit requirements for the auditor.

Time and Material

These types of contracts are also lower risk revenue issues for the auditor as long as the contractor has identified all of its costs, including its overhead costs, and defined its needed gross profit. The audit focus in this type of contract comes back to the contractor's internal controls and the ability to fully identify and capture its costs—direct, indirect, and overhead. Often, time and material contracts cannot be confirmed due to the contract's length of time. Other auditing procedures can be employed, such as internal control systems testing and/or subsequent billings and collections of the outstanding time and material costs as of the period end.

Unit Price

Unit price contracts are often small variables of fixed price contracts. Under a unit price contract, the contractor knows the amounts that will be due as each unit price is performed. The auditor's procedures in this area should consist of (1) verifying the work performed with outside parties through the use of confirmations, including the terms of the contract; (2) verifying the terms of the contract concerning the provisions for unit prices, their amounts, and contract billing terms by examining the contract; and (3) determining the revenue balance available to be performed and billed under the contract. Other procedures to be applied can be similar to the procedures applied to fixed price contracts.

Service Contract

This category of contract can include a blend of other contract types, such as time and material. The auditor should separate out

these other contract type elements and perform the appropriate testing under those categories. A service contract can consist of the provision of labor only or labor and material. The terms of the contract should be reviewed for the risks that the contract presents to the contractor and to the auditor. For example, does the contract cover maintenance only with breakdowns covered at fixed time and material rates and costs? The risk of loss on such a contract would be minimal. On the other hand, does the service contract provide for the provision of a guaranteed service, such as uninterrupted power (which may be necessary for the function of a hospital)? This type of contract would require more extensive auditing procedures that would involve auditing the contractor's ability to produce reliable estimates similar to a fixed price contract. If a service contract has only provisions for maintenance and the minimal supply of parts, the revenue auditing procedures would consist of (1) scheduling out the earned and unearned parts of the contract and recording the unearned part as deferred revenue; (2) examining the contractor's system that tracks the performance of the required or contractual provision of periodic services, if any, to see that they have been performed (this could result in a liability that would need to be measured); (3) determining whether the contractor has the ability to job cost each service contract in order to determine whether the service contracts require a loss reserve; (4) testing the service revenues and costs analytically to see if the gross profits earned are typical compared to industry averages; and (5) testing the contractor's prior abilities to estimate with reasonable certainty. Service contracts that have provisions that require estimations should be tested in a manner similar to a fixed price contract.

Construction Management

Construction management (CM) contracts can also be a blend of the various types of contracts described and defined above. The particular attributes or details of the contract should be examined to see if these other attributes exist. For example, the contract may call for the CM to act as agent under a fee arrangement, but permit it to perform certain parts of the construction if it deems that it can perform the work for 5 percent less than the lowest bidder. The construction part will need to be tested and audited as a construction contractor. The audit risk that a CM contract presents will depend on the CM contract terms. If a CM contract calls for a fee based upon a percentage of costs, audit risk is lower. On the other hand, if the CM fee is a fixed price, the auditor will need to examine its revenue recognition methods and test the progress to date. An example of this would be where a CM estimates that it will take 1,000 man-hours to earn the CM fee of $500,000 over an 18-month period. The auditor can examine the hours performed to date and the estimate of the hours to complete. In addition, the calculation of hours to date to total estimated hours can be compared to the physical estimate of percentage of completion for reasonableness. Testing of the CM internal controls and prior abilities to estimate with reasonable certainty can also be used to gather audit evidence.

Design Build

This is the newest type of contract and is continuing to be an increasingly popular vehicle for contract performance. The audit risk involved in this type of contract focuses on the detail of the contract terms. Is the contractor going to be reimbursed for its costs under a cost-type arrangement? Is the contract broken out into various pieces where the contractor bid separately on the design and construction work in different phases? The answers to these questions and other facts and circumstances should lead the auditor to make judgment calls about the appropriateness of the use of audit procedures described under the contract types listed above. If a design build contract outcome is uncertain, the

auditor should consider the possibility that the contract should be accounted for under alternative revenue recognition methods such as zero profit or the completed contract method until measurements are reliable and more certain.

The Above Type Contracts With Incentive Provisions

All the contract types can have provisions for incentives. The auditing of contracts that include incentive provisions should consist of but not be limited to the following procedures: (1) an examination of the contract terms to determine the conditions for incentive achievement, (2) a test to see if the conditions for achievement have been met, (3) confirmation of incentive earnings, (4) subsequent billing and collection of incentive revenues, (5) analysis of whether incentive provisions can be earned incrementally or are under "all or none" terms, and/or (6) a determination whether the incentive should be considered a gain contingency properly accounted for under Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies.*

AICPA Member and
Public Information:
www.aicpa.org

AICPA Online Store:
www.cpa2biz.com

ISO Certified

022317