Employee benefit plans industry developments - 1991; Audit risk alerts

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Employee Benefit Plans
Industry Developments—1991

Update to the AICPA Audit and Accounting Guide
Audits of Employee Benefit Plans

Includes Audit Risk Alert—1990

Issued by the Auditing Standards Division

AICPA
American Institute of Certified Public Accountants
NOTICE TO READERS

This document, which contains Employee Benefit Plans Industry Developments—1991 and Audit Risk Alert—1990, is intended to provide auditors of financial statements of employee benefit plans with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Employee Benefit Plans
Industry Developments—1991

Industry and Economic Developments

The Current Economic Downturn

The slowing economy and the volatility of the stock and bond markets are among the most significant factors affecting the financial stability of employee benefit plans today. Widely varying market values of stock and bond portfolios and defaults by issuers of high-risk "junk bonds" may have a significant negative effect on the value of plan assets. Auditors should carefully consider the valuation of and disclosures relating to plan investments in light of the current volatility of financial markets.

Many plans have invested in contracts with insurance companies, banks, and thrifts to provide the plans with a guaranteed rate of return. Auditors should consider the financial stability of such institutions, especially their ability to fulfill their obligations concerning the return guaranteed.

Defined contribution plans provide benefits based on amounts available for distribution as a result of contributions to the plan by the corporate sponsor, the employee, or both, increased or decreased by investment experience and administrative expenses paid. Participants' interests in such plans are more vulnerable to changing economic conditions than are interests in defined benefit plans, which provide for constant benefit amounts over time.

The economic downturn has also had a negative effect on many plan sponsors. During the course of an audit of an employee benefit plan, an auditor may become aware of information that raises substantial doubt about the plan sponsor's ability to continue as a going concern. Although employee benefit plans are not automatically and necessarily affected by the plan sponsor's financial adversities, auditors should consider whether such difficulties pose any significant threat to the plan and should consider the sponsor's plans for dealing with its conditions. If the auditor concludes that there is a substantial doubt about the plan's ability to continue in existence for a reasonable period (generally a year from the date of the financial statements), Statement on Auditing Standards (SAS) No. 59, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, would require the auditor to add an explanatory paragraph to his or her report to disclose that fact.
The Investment Environment

Within the last decade, some plan investment managers have adopted investment strategies that incorporate a variety of techniques or specialized financial products, such as repurchase or reverse repurchase agreements, futures and options, and securitized lending arrangements, to increase investment returns. Collateralized mortgage obligations, real estate mortgage investment conduits (REMICs), and a myriad of securitized portfolio investments are part of the growing list of specialized real-estate-related investment securities that may be found in plan portfolios. The complexity in valuing unique, specialized, or nonreadily marketable securities and real estate investments contributes to the increased inherent risk in many employee benefit plan investment portfolios. In planning the audit of an employee benefit plan, the auditor should possess or obtain an understanding of the plan's investment strategy and policies and their audit risk implications.

Regulatory and Legislative Developments

Form 5500: "Reporting of Realized and Unrealized Gains and Losses on Investments"

For plan years beginning on or after January 1, 1990, plan administrators must report realized and unrealized gains and losses on Form 5500 using revalued cost. Before 1988, many providers of services to employee benefit plans used historical cost as the basis to calculate and report realized and unrealized investment gains and losses in Form 5500. Item 35 of the 1988 Form 5500, however, requires that realized and unrealized investment gains and losses be determined separately on the basis of revalued cost—that is, the current value of the assets at the beginning of the plan year, as carried forward from the end of the prior plan year—or historical cost if the investment was acquired since the beginning of the plan year. Noncompliance in 1988 and 1989 plan years did not result in the rejection of the filing by the Department of Labor (DOL).

Because of the significant record-keeping changes and program changes needed to provide data on the basis of revalued cost, the DOL granted an additional one year's relief to clients of banks who applied for an extension. For a plan to continue to report on the historical cost basis in the 1990 Form 5500, (a) the plan must depend on the banks for certification of the necessary information; (b) the bank must have been granted an extension by June 30, 1990; and (c) the plan must also include statements with the Form 5500 filing indicating the plan's and the bank's inability to report realized and unrealized gains and losses in accordance with the current value requirement. It is important
to note, however, that the DOL has indicated to the AICPA staff that the Schedule of Assets Held for Investment Purposes and any other required supplemental Schedules should present historical cost information rather than revalued cost.

**New Form 5500 Disclosure**

Item 29c of the 1990 Form 5500 requires the plan administrator to determine whether the auditor's report or the related financial statements or both disclose (a) errors or irregularities, (b) illegal acts, (c) material internal control weaknesses, (d) a loss contingency indicating that assets are impaired or that liabilities are incurred, (e) significant real estate or other transactions in which the plan and the sponsor, plan administrator, employer(s), or employee organization(s) are jointly involved, (f) any related-party transactions in which the plan has participated, or (g) any unusual or infrequent events or transactions occurring subsequent to the plan year-end that might significantly affect the usefulness of the financial statements in assessing the plan's present or future ability to pay benefits. Item 29d requires the plan administrator to provide the total amount involved in such disclosures.

If the plan administrator is unsure about whether any such disclosures are made, he or she is instructed to consult with the plan auditor.

**Penalties for Improper Benefit Plan Reports**

By the end of December 1990, the DOL had notified thirty-five employee benefit plan administrators that it intended to assess civil penalties of $50,000 to $90,000 for filing deficient annual reports for the 1988 reporting year. The assessment notices are the first under the DOL's recently implemented reporting-compliance program established to enforce statutory reporting and disclosure responsibilities under section 502(c)(2) of the Employee Retirement Income Security Act of 1974 (ERISA), which authorizes the DOL to assess fines of up to $1,000 a day against plan administrators who fail to file complete and timely annual reports. Penalties vary according to the severity of the violations and run from the date the report was required to be filed.

Approximately 900,000 filings were received for the 1988 reporting year, of which nearly one third required correspondence from the IRS to voluntarily correct errors or omissions. Over 5,000 plan administrators failed to provide the required auditor's report. Notices were sent to those administrators and most corrected the deficiencies. Additional notices were sent to those whose filings remained uncorrected. The civil penalty assessments were imposed on plan administrators who failed to respond to the notices.
The deficiencies that resulted in assessments included the following:

- A report of an independent qualified public accountant was not filed.
- The auditor's opinion did not extend to the required Form 5500 supplemental schedules.
- The Statement of Net Assets/Liabilities was not presented in comparative format.
- Required note disclosures were not made or were incomplete.
- Limited-scope audit reports were filed for plans that did not qualify for the exemption.
- The auditor's report did not comply with the provisions of SAS No. 58, Reports on Audited Financial Statements.
- Unsigned and draft reports were submitted.

Proposed Legislation

In 1990, the DOL completed a comprehensive review of pension-related enforcement issues that resulted in legislative initiatives to provide incentives for participants to exercise their rights to bring private litigation under ERISA, to strengthen the deterrents for unlawful behavior, and to increase plan security through improved audit coverage and quality. The legislative package also included repeal of the limited-scope audit exemption and a mandate that independent auditors undergo a peer review every three years to qualify to conduct ERISA audits. Congress adjourned before enacting these legislative proposals. However, in January 1991 legislation was introduced to the Senate to amend ERISA to repeal the limited-scope audit exemption.

Selection of ERISA Audits in Practice-Monitoring Reviews

The AICPA adopted new practice-monitoring review program requirements pertaining to the selection of ERISA audits during the conduct of quality or peer reviews of firms.

A firm whose partners and employees want to retain membership in the AICPA must participate in one of the three practice-monitoring programs. The AICPA practice-monitoring programs consist of the peer review programs of the SEC Practice Section (SECPS) and the Private Companies Practice Section (PCPS) of the AICPA Division for CPA Firms, and the quality review program carried out in partnership with state CPA societies. In January 1990, the SECPS peer review program was made mandatory for all firms that audit one or more SEC clients. Beginning in 1991, the SECPS and the PCPS require the selection of at least one ERISA audit as part of each peer review. The Quality Review
Program Executive Committee requires that special consideration be given to selecting ERISA audits for review if the firm performs ERISA engagements. ERISA audits will likely receive greater scrutiny in the future by the practice-monitoring review programs of both the AICPA and the DOL. The DOL's pending legislative package would require CPAs performing employee benefit plan audits to have successfully undergone either a peer review or a quality review.

**PWBA Review of Plan Audits**

The Pension and Welfare Benefits Administration (PWBA) of the DOL has established a quality review program for ERISA audits that includes on-site review of independent auditors’ workpapers. The program was initiated in fiscal year 1991 under the authority granted in ERISA section 107, which requires that any person subject to a requirement to file any description or report or to certify any information shall maintain records in sufficient detail concerning the matters on which disclosure is required to permit examination and verification. Also, ERISA Section 504 provides the DOL with the authority to investigate and require the submission of any information “in order to determine whether any person has violated or is about to violate any provision of Title I or any regulation or order thereunder.”

Selections for on-site workpaper review are based on desk reviews of Forms 5500 that indicate potential substandard reporting and on referrals from the PWBA's Office of Enforcement (OE).

If the DOL determines that substandard audit work or deficient reporting has occurred, it has several specific remedies available. If the deficiencies are minor, the PWBA's Office of the Chief Accountant (OCA) will issue a letter to the auditor detailing the findings and requesting correction on future audit engagements. The OCA may cause another auditor to be appointed to perform the audit, and may seek payment from the plan. Major deficiencies may result in the rejection of the auditor's report and the assessment of civil penalties against the plan administrator. The auditor may also be referred to the state licensing boards or to the AICPA's Professional Ethics Division for a review of the alleged substandard work. The OCA has made thirty-five such referrals to the AICPA.

**ERISA Civil Penalty for Participation in Breach of Fiduciary Responsibility**

Section 502(l) of ERISA requires the DOL to assess a civil penalty against a fiduciary who breaches a fiduciary responsibility under, or commits any other violation of, part 4 of Title I of ERISA “or against any
other person who knowingly participates in such breach or violation.” The penalty is equal to 20 percent of the “applicable recovery amount” paid pursuant to any settlement agreement with the DOL or ordered by a court to be paid in a judicial proceeding instituted by the DOL.

Assessments will be made in connection with any breaches of fiduciary responsibility or other violations occurring on or after December 19, 1989. The Secretary may waive or reduce the penalty if the DOL determines in writing that either—

1. The fiduciary or other person acted reasonably and in good faith, or
2. It is reasonable to expect that the fiduciary or other person will not be able to restore all losses to the plan or to any participant or beneficiary of such plan without severe financial hardship unless a waiver or reduction is granted.

Audit and Accounting Developments

Audit Issues

Revision of AICPA Audit and Accounting Guide. The AICPA Employee Benefit Plans Committee is currently revising the 1983 AICPA Audit and Accounting Guide Audits of Employee Benefit Plans. The revised guide is expected to be issued in mid-1991 and will be effective for audits of financial statements for plan years ending after December 15, 1991. Earlier application is encouraged. The guide will address new auditing standards, new types of benefit plans, changes in IRS and DOL reporting requirements, other changes in laws and regulations, and new types of investments available to plans.

The revised guide will incorporate applicable audit and accounting pronouncements that were issued subsequent to the publication of the 1983 guide. The revised guide—

- Will clarify the accounting treatment for loans to participants of 401(k) plans.
- Will provide guidance on the auditor’s responsibility to read the financial information contained in Form 5500 and to consider whether the information and the manner of its presentation are materially consistent with the information and its presentation in the plan’s financial statements.
- Will provide guidance on the auditor’s responsibility if the auditor concludes that a plan has entered into a prohibited transaction with a party in interest and the transaction has not been properly disclosed in the required supplementary schedule.
Appendix A of the guide will include an annual report and audit exemption chart to assist the user in determining whether a plan requires audited financial statements to be filed with its annual report.

Supersession of SAS No. 44. The AICPA's Auditing Standards Board has exposed for public comment a proposed SAS, *Reports on the Processing of Transactions by Service Organizations*. The proposed SAS would supersede SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*, and would provide guidance on the factors an independent auditor should consider when auditing the financial statements of an entity that uses a service organization in connection with the processing of certain transactions. Appendix A of the proposed SAS specifically addresses the application of the proposed SAS to employee benefit plans subject to the requirements of ERISA.

**Accounting Issues**

**Valuation of Insurance and Investment Contracts.** Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, requires that plan investments, excluding contracts with insurance companies, be presented in the financial statements of defined benefit pension plans at their fair value at the reporting date. Contracts with insurance companies, however, may be presented as permitted by the instructions to Schedule A of Form 5500, which, for guaranteed investment contracts (GICs) and other unallocated contracts, is generally at contract value.

The FASB's Emerging Issues Task Force (EITF) addressed issues relating to the financial statement valuation of GICs and other instruments with similar characteristics, such as bank investment contracts (BICs) and savings and loan investment contracts (SLICs) in Issue 89-1.

The EITF did not reach a consensus on the need to change the accounting for GICs or to adopt similar accounting for BICs, SLICs, and similar investments. Some EITF members were concerned about allowing different accounting treatment for similar instruments. However, most EITF members agreed that the exception in FASB Statement No. 35 to allow fair value presentation for investment pension plan financial statements applies only to GICs and not to contracts issued by noninsurance entities. The EITF did not address the valuation of investment contracts of any kind, including GICs, in the financial statements of defined contribution plans or health and welfare benefit plans.

In April 1990, the FASB added to its agenda a project on the accounting by defined benefit and defined contribution pension plans for GICs and similar contracts issued by entities such as banks, savings
and loans, and thrift institutions. The project is expected to result in an amendment to FASB Statement No. 35 to clarify the applicability of the fair value exception and to provide guidance for accounting for these investments by defined contribution plans. In addition, the Board will consider how fair value for these types of contracts should be determined, including what circumstances, if any, might indicate that contract value approximates fair value. The Board expects to issue an exposure draft in the second quarter of 1991.

Health and Welfare Benefit Plans. The AICPA's Employee Benefit Plans Committee is preparing a proposed statement of position (SOP) on accounting and reporting by health and welfare benefit plans. The proposed SOP, which is expected to be exposed for public comment in mid-1991, clarifies several accounting and reporting requirements set forth in chapter 4 of the 1983 Audit and Accounting Guide Audits of Employee Benefit Plans and will, when finalized, update the guide for new statements of financial accounting standards issued by the FASB. Significant proposed changes include clarification of—

1. The objective of financial reporting by defined benefit health and welfare plans.

2. How defined benefit health and welfare plans, both single-employer and multiemployer plans, should account for and report benefit obligations, including postretirement obligations.

3. The requirement to recognize claims incurred but not reported.

4. The stipulation that benefit obligations should not include death benefits actuarially expected to be paid during the active service period of participants.

5. The distinction between defined contribution health and welfare plans and defined benefit health and welfare plans.

6. The requirement that the current insurance premium rates used in determining the obligation for accumulated eligibility credits generally should consider mortality rates and the probability of employee turnover.

*  *  *  *

Copies of AICPA authoritative guidance may be obtained by calling the AICPA Order Department at (800) 334-6961 (USA) or (800) 248-0445 (NY). Copies of FASB authoritative guidance may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.
Audit Risk Alert—1990*

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

Introduction

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

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

Economic Developments

The Current Economic Downturn

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

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

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

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

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

Economic Considerations Relating to Debt

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

**Regulatory and Legislative Developments**

**Environmental Liabilities**

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

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

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

**Notification of Termination of Auditor-Client Relationship**

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

Implementing SAS No. 55 on Internal Control


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

New Financial Institutions Confirmation Form

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

New SAS on Internal Auditing

In January 1991, the ASB will issue a new SAS, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, that will provide practitioners with expanded guidance when considering the work of internal auditors. Many internal audit activities are relevant to an audit of financial statements because they provide evidence about
the design and effectiveness of internal control structure policies and procedures or provide direct evidence about misstatements of financial data contained in financial statements. The SAS is effective for audits of financial statements for periods beginning on or after January 1, 1991, and will include guidance to assist auditors in obtaining an understanding of the internal audit function, assessing the competence and objectivity of internal auditors, and determining the extent to which they may consider work performed by internal auditors. The SAS supersedes SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit*, and incorporates the terminology and concepts of more recent SASs, particularly SAS No. 55.

**Forthcoming Guidance on Circular A-133**

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

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

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

Reporting on Uncertainties

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

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

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

Going-Concern Matters

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

For situations in which the auditor expresses such a conclusion, the ASB recently amended SAS No. 59 to require the use of the phrase “substantial doubt about the entity’s ability to continue as a going concern” (or similar wording that includes the terms *substantial doubt* and *going concern*) in the required explanatory paragraph.
Required Communications to Audit Committees and Others Having Oversight Responsibility

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

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

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

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

Illegal Acts

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

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

Recurring Audit Problems

Questionable Accounting Practices

Managements of companies—public or private—might feel pressure to report favorable results—for example, to maintain a trend of growth in earnings, support or improve the price of the company’s stock,
obtain or maintain essential financing, or comply with debt covenants. This pressure is most likely to affect public companies, but auditors should not underestimate the pressures on nonpublic companies to "stretch" earnings or report a favorable financial condition—particularly in light of the current credit crunch. In most cases, the actions taken are well-intentioned and believed to be appropriate by the company. However, in certain cases, the result is an inappropriate accounting practice.

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

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

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

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

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

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

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

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

**Communications Between Predecessor and Successor Auditors**

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

**Part of Audit Performed by Other Independent Auditors**

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

**Attorney’s Responses**

A letter of audit inquiry to the client’s lawyer is the auditor’s primary means of corroborating information furnished by management concerning litigation, claims, and assessments. Auditors should carefully read all letters from attorneys and ensure that all matters discussed are understood. Ambiguous and incomplete responses should be appropriately resolved with client management and attorneys, and
conclusions should be properly documented. An auditing interpretation of SAS No. 12, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments, presented in the AICPA's Professional Standards, vol. 1, AU sec. 9337.18, discusses what constitutes an acceptable reply. Additional inquiries may be needed if replies are not dated sufficiently close to the date of the audit report.

**Pitfalls for Auditors**

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

- Watch out for large, unusual, one-time transactions, especially at or near year-end, that may be designed to ease short-term profit and cash flow pressures. Scrutinize each transaction to ensure validity of business purpose, timing of revenue or profit recognition, and adequacy of disclosure.

- In performing analytical procedures (for example, analyzing accounts, changes from period to period, and differences from expectations), maintain an attitude of objectivity and professional skepticism. Do not assume that the accounts or client explanations are right. Rather, question, challenge, and compare new information with what is already known about the client and of business in general.

- Make sure that receivables that are supported by real estate as collateral reflect thesoftening of the market. Increases in the allowance for uncollectibles may be needed. Recognize that assets acquired through foreclosure may be overvalued and difficult to sell.

- Pay special attention to the collectibility of significant receivables from debtors that have recently gone through a leveraged buyout (LBO). A company is not the same entity that it was before an LBO.

**Accounting Developments**

**Financial Instruments Disclosure**

In March 1990, the FASB issued Statement No. 105, Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk, effective for fiscal years ending after June 25, 1990. It applies to all entities, including small businesses (due to its requirement to disclose significant concentrations of credit risk arising from all financial instruments, including trade accounts receivable).
The statement applies to all financial instruments with off-balance-sheet risk of accounting loss and all financial instruments with concentrations of credit risk, with some exceptions that are detailed in paragraphs 14 and 15 of the statement. It requires all entities with financial instruments that have off-balance-sheet risk to disclose the face, contract, or underlying principal involved; the nature and terms of the financial instrument; the accounting loss that could occur; and the entity's policy regarding collateral or other security and a description of the collateral.

**Postretirement Benefits Other Than Pensions**

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

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

**Reporting When in Bankruptcy**

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

The SOP recommends that all such entities report the same way while reorganizing under Chapter 11, with the objective of reflecting their financial evolution. To do that, their financial statements should distinguish transactions and events that are directly associated with the reorganization from the operations of the ongoing business as it evolves.
The SOP generally becomes effective for financial statements of enterprises that have filed petitions under the Bankruptcy Code after December 31, 1990.

Audit Risk Alerts

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

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

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

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