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Federal government contractors industry developments - 1994; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

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Federal Government Contractors
Industry Developments—1994

Complement to AICPA Audit and Accounting Guide
Audits of Federal Government Contractors
NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of federal government contractors with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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# Table of Contents

Federal Government Contractors

**Industry Developments—1994** ..................................................... 5  
**Industry and Economic Developments** .......................... 5  
**Regulatory and Legislative Developments** ......................... 6  
**Audit Issues and Developments** .................................... 16  
**Accounting Issues** .......................................................... 19
Federal Government Contractors
Industry Developments—1994

Industry and Economic Developments

In recent years, efforts to reduce the federal deficit have resulted in significant cuts in federal government spending and in fewer and smaller government contracts. At the same time, competition from foreign companies has been increasing. In the face of the spending cutbacks and the increased competition, some government contractors have streamlined their operations either by consolidating their core lines of business and disposing of noncore business lines, or by merging with or acquiring other government contractors. Such restructurings allow contractors to eliminate overlapping engineering and support staff, broaden their technological base and, in some cases, increase their market base. However, recent legislation may result in the disallowance of certain restructuring costs related to acquisitions or mergers. (See the “Regulatory and Legislative Developments” section of this Audit Risk Alert for a discussion of this legislation.) Often, those restructuring costs are substantial. In addition, such reorganizations may call into question the carrying values of certain long-lived assets such as goodwill and other intangibles, and fixed assets. Auditors of financial statements of federal government contractors that have been parties to such transactions should carefully consider whether the carrying values of such long-lived assets have been impaired.

Some government contractors have responded to the declining number and amount of government contract awards by not competing for new government contracts and looking instead to commercial and foreign markets for new business opportunities. With these new opportunities, however, come a number of uncertainties. Certain related industries are also experiencing economic difficulties. For example, the significant losses in the airline industry have resulted in aircraft delivery slowdowns and contract cancellations. While future prospects appear good, sales of U.S. defense items in foreign markets currently are uncertain and unpredictable.

Contractors that have not successfully restructured or moved into new lines of business may be faced with excess capacity and idle-facilities costs. Auditors should evaluate whether the carrying values of idle facilities and the related long-lived assets have been impaired.
Because of government-customer budget constraints, many contractors continue to experience increases in claim activity related to the cancellation of contracts. The claims may result from (1) contract performance problems and concerns, (2) letter contracts or other expedited procurement processes initiated by the government, or (3) government-initiated contract terminations, cancellations, or delays. Some contractors have filed, or are in the process of filing, contract claims to recover additional costs.

AICPA Statement on Auditing Standards (SAS) No. 59, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern (AICPA, Professional Standards, vol. 1, AU sec. 341), states that auditors have a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year from the date of the financial statements being audited. That evaluation is based on the auditor's knowledge of relevant conditions and events that exist at, or have occurred, prior to the completion of fieldwork. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited.

SAS No. 59 requires that if after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about an entity's ability to continue as a going concern, he or she should consider management's plans for dealing with the adverse effects of the conditions or events. As they make the evaluation described in SAS No. 59, auditors should consider the effects that spending cuts and other changes in the economy may have on the ability of contractors to continue as going concerns. Auditors should be cognizant of the fact that, because of recent business restructurings and the entry of many contractors into new lines of business, historical data and trends in the industry may no longer be meaningful indicators of current and future performance. Auditors should consider whether contractors have evaluated the effects of the changes in the business environment, prepared business plans to respond to the changes, and whether they have the ability to execute those plans.

Regulatory and Legislative Developments

Regulatory Developments

Cost Accounting Standards Board Initiatives. In November 1988, Congress reestablished the Cost Accounting Standards Board (CASB) to develop Cost Accounting Standards (CAS) that would provide uniformity and consistency in the accounting principles used by federal government
contractors and subcontractors. Applicable laws and regulations regarding CAS established by the CASB may affect cost allowability, and as a result, the amount of revenue and costs accrued under government contracts, depending on the type of contract involved. SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), requires auditors to consider laws and regulations that are generally recognized to have a direct and material effect on the determination of financial statement amounts. Auditors should carefully evaluate the financial statement effect of CAS and cost allowability (cost principles) on contract revenues and costs.

The CASB is continuing to address issues relating to the measurement of costs, the assignment of costs to accounting periods, and the allocation of costs to objectives. In promulgating new or revised CAS, the CASB must, by law, undertake a four-step process by issuing (1) Staff Discussion Papers, (2) Advance Notices of Proposed Rulemaking (ANPRM), (3) Notices of Proposed Rulemaking (NPRM), and (4) final Rulemakings. This rulemaking process can take several years from the development of a staff discussion paper to the issuance of a final rule.

Below is a summary of current CASB initiatives and their statuses.

<table>
<thead>
<tr>
<th><strong>Staff Discussion Paper</strong></th>
<th><strong>Issued</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract Price Adjustments for Organizational Changes</td>
<td>April 1993</td>
</tr>
</tbody>
</table>

**Advance Notices of Proposed Rulemaking**

<table>
<thead>
<tr>
<th><strong>Notice of Proposed Rulemaking</strong></th>
<th><strong>Issued</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revisions to the CASB Disclosure Statement Form (CASB DS-1)</td>
<td>April 1994</td>
</tr>
<tr>
<td>Treatment of Gains or Losses Subsequent to Mergers or Business Combinations by Government Contractors</td>
<td>May 1994</td>
</tr>
</tbody>
</table>

**Final Rules**

<table>
<thead>
<tr>
<th><strong>Applicability and Thresholds for Cost Accounting Standards Coverage</strong></th>
<th>November 1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Establishment of CAS for Educational Institutions</td>
<td>November 1994</td>
</tr>
</tbody>
</table>

CASB activities are discussed below in relation to other activities and developments affecting their applicability to government contractors.

*Applicability and Thresholds for Cost Accounting Standards Coverage.* Public Law (Pub. L.) 100-679 raised the threshold for individual CAS contract coverage from $100,000 to $500,000. However, the law did not address the issue of an increased threshold for the initiation of CAS coverage.
(the so-called trigger contract) or the provision in the existing regulation that permits more limited or modified CAS coverage to be applied when the net amount of all government contracts awarded to a contractor segment or business unit does not exceed $10 million a year. Those latter thresholds were established approximately fifteen years ago. In November 1993, the CASB issued a final rule (48 Code of Federal Regulations [CFR], Part 9903) that—

- Raised the threshold for full CAS coverage to $25 million from $10 million.
- Established a $1 million trigger contract mechanism for the initiation of full CAS coverage.
- Expanded requirements for modified CAS coverage to include compliance with CAS No. 405, Accounting for Unallowable Costs, and CAS No. 406, Cost Accounting Period.
- Eliminated the alternative 10 percent or more government sales test criterion for initiation of full CAS coverage.
- Eliminated the requirement for a separate CASB waiver when the procuring agency has waived the requirement for submission of certified cost or pricing data.

The final rule is intended to adjust CAS applicability requirements and dollar thresholds to levels reflecting inflation since the thresholds were promulgated by the previous CASB. This change is expected to significantly reduce the administrative burden on smaller contractors, with only a relatively small decrease in total dollars of covered contracts.

The concept of modified CAS coverage was designed to address the problems of application of CAS to smaller government contractors and to contractors for whom government business represented only a relatively small share of total sales volume. Under previous standards, modified coverage was applied to a business unit that received less than $10 million in CAS-covered contracts in the immediately preceding cost accounting period, if the sum of such awards was less than 10 percent of the business unit's total sales during that period. Modified coverage at that time required only that the contractor comply with CAS No. 401, Consistency in Estimating, Accumulating and Reporting Costs, and CAS No. 402, Consistency in Allocating Costs Incurred for the Same Purpose.

The increase of the trigger contract amount is also intended to decrease the burdens associated with the application of full coverage. Under the final rule, a contractor is subject to full CAS coverage if it received $25 million in CAS-covered contracts in the immediately preceding cost accounting period, including at least one CAS-covered contract of $1 million or more. A contractor with $25 million in CAS-covered
contracts valued at $500,000 each, but without a single $1 million contract, is not subject to full coverage.

The final rule provides for the continuation of the trigger contract concept, but limits its application exclusively to full CAS coverage. Therefore, the application of modified CAS coverage to an individual contract or subcontract will be determined without reference to the triggering contract mechanism applicable to full CAS coverage.

Composition, Measurement, Adjustment, and Allocation of Pension Costs. In November 1993, the CASB issued an NPRM proposing to revise CAS relating to accounting for pension costs under negotiated government contracts. The CASB addressed certain problems that have emerged since the original promulgation of the pension standards, CAS No. 412, Cost Accounting Standards for Composition and Measurement of Pension Costs, and CAS No. 413, Adjustment and Allocation of Pension Costs. The CASB proposal includes requirements for the components, measurement, assignment, and allocation of pension costs for qualified and nonqualified defined benefit pension plans. Proposed changes also address the issue of pension cost recognition under qualified pension plans subject to the “full-funding limits” of the Internal Revenue Code (IRC), and problems associated with pension plans that are not qualified under the IRC. The NPRM would (1) incorporate into the CAS the ERISA full-funding limitation, while maintaining the current amortization rules, (2) define what constitutes a segment closing, and (3) provide greater specificity regarding accounting for pension costs when segments are closed or pension plans terminated. It also considers deleting the requirement of funding into a qualified trust to make the cost allowable; however, this requirement would be waived only on contracts awarded without any cost or pricing data for which funding cannot be accomplished due to limitations. The NPRM further proposes to allow accrual of nonqualified pension costs, but only to the extent that those costs are funded into a Rabbi Trust using the complement of the corporate income tax rate multiplied by those costs. The comment period ended January 4, 1994. The NPRM will be effective upon publication as a final rule in the Federal Register.

Gains or Losses Subsequent to Mergers and Business Combinations. The CASB continues to study the treatment of gains or losses attributable to tangible capital assets subsequent to mergers or business combinations of government contractors. The CASB issued an ANPRM on this subject in May 1994. To resolve the problems identified in this area, the CASB proposes to amend CAS No. 404, Capitalization of Tangible Capital Assets. The proposed amendments are based on an approach involving a “no step-up, no step-down” of asset bases and no recognition of gain or loss on a transfer of assets following a business combination.
CAS No. 404-50(d) currently requires that, under the purchase method of accounting, acquired assets be written to fair value, which is consistent with generally accepted accounting principles (GAAP). In other words, asset bases could be stepped down. The ANPRM would replace that section with the following:

For Federal Government contract costing purposes, tangible capital assets after a business combination shall retain their net book value recognized prior to the business combination, provided that the assets had previously generated costs that were chargeable to Federal Government contracts subject to CAS.

The cost of tangible capital assets shall be restated after the business combination at a figure not to exceed the fair value at the date of the acquisition pursuant to a business combination where the assets prior to the business combination did not generate costs that were chargeable to Federal Government contracts subject to CAS.

In addition, CAS No. 409, Depreciation of Tangible Capital Assets, currently requires that gains and losses on disposition of tangible capital assets be considered adjustments of previously recognized depreciation costs and assigned to the period in which disposition occurs. The ANPRM clarifies that the CAS No. 409 provisions dealing with the recapture of gains and losses on disposition of tangible capital assets should not apply when assets are transferred subsequent to a business combination, because it is assumed that the assets will be transferred at their net book values.

The approach involving no “step-up, no step-down” of assets, embodied in the ANPRM, is not consistent with the Federal Acquisition Regulation (FAR) cost principle (section 31.205-52), Asset Valuations Resulting from Business Combinations, which prohibits step-ups but does not rule out step-downs.

Guidance issued by the Defense Contract Audit Agency (DCAA) to its auditors suggests that for business combinations that occurred prior to July 23, 1990 (effective date of FAR 31.205-52), the government contracting officer should examine each situation “on a case-by-case basis to achieve equity or protect the government’s interests . . . .” DCAA auditors are further instructed to advise the contracting officer to enter into an advance agreement if they encounter those prior business combinations, in order to provide equitable treatment to both the government and the contractor and to minimize future disputes.

An appeal from a contracting officer’s final decision on the issue of applicability filed with a board of contract appeals is likely. Independent auditors should be alert to the outcome of any such appeal that may be filed. Auditors should carefully evaluate the allowability of costs under section 31.205-52, including a review of any agreements between the government and contractor on the treatment of such costs.
Proposed Revisions to the CASB Disclosure Statement Form. Contractors with more than $25 million in government contracts covered by CAS are required to file a disclosure statement containing details of the accounting practices of all recognized business segments doing business with the federal government. In April 1994, the CASB issued an ANPRM on a revised draft of CASB DS-1, which solicited views from the government procurement community with respect to the current format of the disclosure statement. Comments were requested by June 20, 1994.

Cost Allowability and Allocability Issues

Contract Claim Certification. Rules addressing the certification of contract claims and requests for equitable adjustments were issued by the Department of Defense (DOD) in May 1993. Those rules state that the person executing the certification must be authorized to bind the contractor and have knowledge of the claim or request, its basis, and the completeness and accuracy of supporting data (Defense Federal Acquisition Regulation Supplement [DFARS] 233.7000; see May 13, 1993, Federal Register). Proper certification may affect the contractor's legal entitlement to a claim.

New DCAA Audit Guidance. New guidance provided to DCAA auditors in the DCAA Contract Audit Manual focuses on several issues addressed by the SWAT Team on Civilian Agency Contracting, including—

- Nonrecurring costs on sales of U.S. products and technology.
- System deficiencies that may affect the reliability of data reported in the contractor's cost/schedule control (C/SC) systems.
- Proper application of penalties statute to subcontractors and inter-divisional work.
- Allocation of state income taxes.
- Employee stock ownership plans.
- Domestic and foreign tax differential allowances.
- Reporting on contractors' internal control structures.
- Disclosure of cost or pricing data.
- Follow-up on internal and external auditor findings.
- Auditing contractor delay-and-disruption submissions.

The DCAA will provide new guidance to its auditors in 1995 in the following areas:

- Costs incurred under the Technology Reinvestment Project
• Deviation from FAR provisions for special tooling
• Penalties based on the results of a statistical sampling review
• Reduction in progress-payment rates and requests for indirect costs applicable to unpaid direct material costs
• New independent research-and-development and bid-and-proposal escalation indices
• General and administrative expenses allocable to unallowable costs
• Environmental cleanup costs attributable to other potentially responsible parties' contamination
• Contractor reorganization and restructuring costs
• Expressly unallowable costs as used in the penalty regulation
• Dividends used to satisfy employee stock ownership plan contribution requirements
• Reasonableness of lease rates
• Allowability of legal costs associated with Qui Tam suits
• Inclusion of cost of money in corporate aircraft costs
• Special business units
• System deficiencies affecting the reliability of data reported in the contractor's C/SC system
• Reliance on the work of other internal and external auditors
• Overpayment of progress billings, and internal controls in the contractor's billing system designed to eliminate expressly unallowable costs and to adapt to changing conditions (for example, unallowable restructuring costs, subcontractor defective pricing, and changing liquidation rates)
• Allowability of employee morale and welfare costs

See the "Audit Issues and Developments" section of this Audit Risk Alert for a discussion of allowable and allocable costs charged to contracts.

DCAA Internal Control Assessments. The DCAA has issued new guidance to help DCAA auditors understand a contractor's internal control structure and assess control risk in the contract audit environment. The guidance is designed to enable DCAA auditors to place reliance on the contractor's internal control structure if appropriate and to identify areas for improvement.

The DCAA has identified the following ten accounting and management systems that it believes are the most important in the contract audit environment:
1. Accounting system
2. Billing system
3. Budget and planning system
4. Compensation system
5. EDP system
6. Estimating system
7. Indirect and other direct cost system
8. Labor system
9. Material system
10. Purchasing system

The new guidance uses a matrix approach—identifying control objectives, control procedures, and audit steps—for understanding and assessing control risk for each control objective within each of the ten systems.

Audits of each of the ten systems are performed on a cyclical basis (for example, every year or every two years) depending on the significance of the system at a particular contractor. The assessed level of control risk for each control objective and for the overall system is documented in an Internal Control Audit Planning Summary (the Summary). The Summary is also used to document the translation of control risk to the audit scope of other planned DCAA audits at the contractor. At large contractors, the DCAA updates the Summary annually. The Summary is provided to, and discussed with, contractor executives in the annual audit planning and risk assessment meetings.

Educational Institutions That Receive Federal Research Awards. In November 1994, the CASB issued a final rule that will require educational institutions awarded negotiated contracts or subcontracts in excess of $500,000 to comply with four new CAS:

1. CAS No. 501, Consistency in Estimating, Accumulating and Reporting Costs by Educational Institutions
2. CAS No. 502, Consistency in Allocating Costs Incurred for the Same Purpose by Educational Institutions
3. CAS No. 505, Accounting for Unallowable Costs—Educational Institutions
4. CAS No. 506, Cost Accounting Period—Educational Institutions

Those new standards prescribe essentially the same practices that are embodied in CAS Nos. 401, 402, 405, and 406. They are set forth in a new FAR Part 9905, Cost Accounting Standards for Educational Institutions, and
are generally effective as of January 9, 1995. The Office of Management and Budget (OMB) has indicated it will amend OMB Circular A-21, Cost Principles for Educational Institutions, to incorporate the CAS requirements. For more information, see the Federal Register, November 8, 1994.

Auditors should consider the financial statement effects of allowable and unallowable indirect costs on revenues, receivables, and income.

Penalties for Unallowable Costs. Under the 1993 National Defense Authorization Act for Fiscal Year 1993 (Pub. L. 102-484), a number of changes were made to the penalty requirements for unallowable costs. The standard for incurring penalties for submission of unallowable costs was changed from "unallowable based on clear and convincing evidence" to "expressly unallowable" under a specific FAR or DFARS cost principle. Under interim implementing rules contained in Defense Acquisition Circular (DAC) 91-5, issued in May 1993 by the DOD, penalties will be assessed only after the initiation of a formal audit. The penalty amount is equal to the amount of disallowed costs allocated to a DOD contract plus any interest on any paid portion. If the amount is determined to be unallowable before submission of the indirect cost proposal, the penalty amount is limited to twice the amount of the disallowed cost. Penalties may be waived under certain circumstances, including those where the amount of the unallowable cost subject to the penalty is insignificant. The DOD has set $10,000 per proposal as a ceiling for determining whether the amount of unallowable cost submitted is "insignificant" (DFARS 231.70).

The revised penalty regulations apply to incurred cost proposals where the government formally initiated an audit of the proposal after October 23, 1992.

Legislative Developments

Allowability of Restructuring Costs. As previously stated, the steep decline in defense spending has caused many government contractors to undergo major business restructurings and to incur substantial costs in those restructurings. For example, contractors might incur costs related to relocating and retraining personnel, fixed asset dispositions, facility closings and lease terminations, and idle facilities.

In July 1993, the undersecretary of defense issued a policy that established a basis for treating restructuring costs incidental to an acquisition or merger as allowable as long as the contractor expected that, over time, those costs would result in overall reduced costs for the DOD or would preserve a critical capability that would otherwise be lost.

In October 1994, the National Defense Authorization Act for Fiscal Year 1995 (the Act), which sets strict review and certification requirements
for the reimbursement of restructuring costs, was signed into law. Section 818 of the Act states that:

The Secretary of Defense may not, under section 2324 of title 10, United States Code, pay restructuring costs associated with a business combination undertaken by a defense contractor until the Department of Defense reviews the projected costs and savings that will result for the Department from such business combination and an official of the Department of Defense at the level of Assistant-Secretary of Defense or above certifies in writing that projections of future cost savings resulting for the Department from the business combination are based on audited cost data and should result in overall reduced costs to the Department.

The requirements for such a review and certification do not apply to any business combination for which restructuring costs were paid or otherwise approved by the secretary of defense before August 15, 1994.

In addition, the Act requires the secretary of defense, by January 1, 1995, to prescribe regulations on the allowability of restructuring costs associated with business combinations under defense contracts. Such regulations must include a definition of the term *restructuring costs*, and address the issue of contract novations under such contracts.

The Act may have a significant effect on certain federal government contractors. Companies that have recently undergone business restructurings may be faced with significant unrecoverable costs. Recent increases in the number of companies recording restructuring charges have resulted in heightened awareness of such charges by the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF). SEC Staff Accounting Bulletin (SAB) No. 67 (Topic 5P), *Income Statement Presentation of Restructuring Charges*, describes restructuring charges as charges that “typically result from the consolidation and/or relocation of operations, the abandonment of operations or productive assets, or the impairment of the carrying value of productive or other long-lived assets.” Restructuring charges have included such costs as employee benefits and severance costs, employee relocation costs, costs associated with the impairment or disposal of long-lived assets, facility closure costs, and other nonrecurring costs associated with the restructuring.

In Issue No. 94-3, *Liability Recognition for Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, the EITF discussed whether certain costs (such as employee severance and termination costs) should be accrued and classified as part of restructuring charges, or whether such costs would be more appropriately considered a recurring operational cost of the company. EITF Issue No. 94-3 also considers the appropriate timing and disclosures for recognized restructuring charges.
Auditors whose clients have recorded, or will be recording, restructuring charges should monitor closely the EITF's continuing discussion of this issue. In addition, differences between GAAP and the FAR related to the accounting treatment of certain items, such as pension curtailments and settlements, still exist. Auditors should be aware of those differences and should consider the related accounting and reporting issues involved in business restructurings of government contractors.

Audit Issues and Developments

Audit Issues

Claims, Change Orders, and Requests for Equitable Adjustment. In the current environment, it is likely that contractors will encounter significantly more claims activity, either with the government or subcontractors. Auditors should discuss with appropriate client personnel the need for an opinion of legal counsel to support claims, Requests for Equitable Adjustment (REAs), and, if necessary, unnegotiated change orders. They should also consider the contractor's history in negotiating similar claims and REAs when evaluating the estimated net realizable value of such amounts. Auditors should refer to the criteria for recognizing claims as set forth in the AICPA Audit and Accounting Guide Audits of Federal Government Contractors. Auditors should also consider the adequacy of financial statement disclosure for significant claims, REAs, and unnegotiated change orders.

Allowable and Allocable Costs Charged to Contracts. Government auditors continue to question or disallow direct or indirect costs charged to government contracts based on whether the costs are reasonable, allocable, and allowable as prescribed by the FAR, provisions of the contract, and other applicable regulations and requirements. Laws and regulations regarding cost allowability and allocability affect the amount of revenue and costs accrued under government contracts depending on the type of contract, and thus compliance with the applicable cost principle or CAS may have a direct effect on the amount of revenue and costs recognized. SAS No. 54 provides guidance on the nature and extent of the considerations the independent auditor should give to the possibility of illegal acts by clients. Auditors consider laws and regulations that are generally recognized to have a direct and material effect on the determination of financial statement amounts. Auditors should carefully evaluate the allowability and allocability of amounts to government contract costs.

High-Risk Contracts. Contractors occasionally experience difficulty in performing on certain contracts and may believe that the government
may be responsible to some extent for the problems. In those instances, contractors may include the effect of claims or other adjustments that they believe will result in additional revenues from the government in their estimates at completion. Such claims and adjustments may reduce the amount of the estimated loss on such contracts or avoid a reduction in the level of profit recognized. As a result, auditors should critically evaluate the evidence supporting the contractor's basis for claims and adjustments, especially in contracts on which the contractor is known to have had difficulty performing. Auditors should also carefully consider the adequacy of the financial statement disclosure of significant claims and unnegotiated change orders.

**Cost in Excess of Contractual Funding.** Many contractors, for various business reasons, will continue to perform on a contract and incur costs in excess of the government's current appropriation of funds. Auditors should carefully review such costs for recoverability and consider the potential need for an allowance against the ultimate collectability of such costs.

**Recoverability of Environmental Liability Costs.** Some federal government contractors have been designated by the Environmental Protection Agency as potentially responsible parties on hazardous waste sites and, as such, are subject to cleanup requirements under the Resource Conservation and Recovery Act. The cleanup costs related to hazardous waste sites often are quite substantial. Federal government contractors may seek to recover all or a portion of those cleanup costs from the federal government. In such cases, the contractors may record a receivable for the amount they expect to recover.

The EITF reached a consensus in EITF Issue No. 93-5, *Accounting for Environmental Liabilities*, that the amounts of the contingent liability and any claim for recovery should be estimated and evaluated independently. In addition, any loss arising from the recognition of an environmental liability should be reduced by a potential claim for recovery only when realization of that claim is probable. In June 1993, the SEC issued SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies*, which states that “separate presentation of the gross liability and related claim for recovery in the balance sheet must fairly present the potential consequences of the contingent claim on the company's resources and is required unless the company has the legal right of setoff as discussed in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* [(FASB, *Current Text*, vol. 1, sec. B10)].” It also states that “registrants should ensure that notes to the financial statements include information necessary to an understanding of the material uncertainties affecting both the measurement of the liability and the realization of recoveries.”
Auditors should evaluate the probability that the contractor will recover environmental costs included in the contract pricing. Auditors should also carefully consider the adequacy of the financial statement disclosure of the contingent costs and the realization of recoveries. *Audit Risk Alert—1994* includes additional information on accounting for, and disclosure of, environmental cleanup costs.

**Audit Development**

*Access to Working Papers by DCAA Auditors.* The recent cutbacks and other cost-control measures have resulted in a number of new and complex laws and regulations that define various areas of contract performance, including the types of costs that are allowable and how contract prices are to be negotiated. In some circumstances, the DCAA may send auditors to a contractor's offices to review activities on government projects. As part of those reviews, DCAA auditors may request access to or photocopies of audit working papers, or both.

Auditors who have been requested to provide such access should refer to Interpretation No. 1 of SAS No. 41, *Working Papers*, titled "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards*, vol. 1, AU sec. 9339). While DCAA auditors are not regulators, and independent auditors are not required by law to provide DCAA auditors with access to their working papers, portions of the Interpretation may be useful to independent auditors if DCAA auditors have requested access to or photocopies of audit working papers. Specifically, the Interpretation provides guidance on steps the auditor should take when a regulator requests the auditor to provide access to (and possibly photocopies of) working papers and the auditor is not otherwise required by law, regulation, or audit contract to provide such access. The Interpretation also provides auditors with guidance on—

- Advising management that the regulator has requested access to (and possibly photocopies of) the working papers and that the auditor intends to comply with the request.
- Making appropriate arrangements with the regulator for the review.
- Maintaining control over the original working papers.
- Considering submitting to the regulator a letter clarifying that an audit in accordance with generally accepted auditing standards (GAAS) is not intended to, and does not, satisfy a regulator's oversight responsibilities. An example of such a letter is illustrated in paragraph 6 of the Interpretation.

In addition, the Interpretation addresses situations in which an auditor has been requested by a regulator to provide access to the
working papers before the audit has been completed and the report released. Also, the Interpretation notes that when a regulator engages an independent party, such as another independent public accountant, to perform the working paper review on behalf of the regulatory agency, there are some precautions auditors should observe.

Accounting Issues

Postretirement Benefits Other Than Pensions (OPEB)

FASB Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions (FASB, Current Text, vol. 1, sec. P40), is likely to create an OPEB cost that is greater than the expense allowed as a contract cost used to determine contract revenue. The full amount of the OPEB liability calculated in accordance with GAAP may be allowable if the contractor elected to fully fund it and used the cumulative-effect method in a prior year to adopt FASB Statement No. 106. A number of issues, including tax laws regarding deductibility of OPEB costs, changes in CAS, funding, negotiation of forward pricing arrangements with respect to OPEB expenses, and the timing of adoption of FASB Statement No. 106, may further complicate the allowability of such costs. In addition, auditors should be aware that the DCAA has taken the position that a change from the pay-as-you-go method of accounting for OPEB costs to that required by FASB Statement No. 106 may result in a change in cost accounting practice for contract costing purposes. Such a change would result in the disallowance of any increased costs allocated to current contracts, including cost-type contracts.

On adoption of FASB Statement No. 106, some contractors recorded a related asset. The future recoverability of such an asset, and the timing thereof, may have a significant degree of uncertainty resulting from—

1. The current industry environment and related business-base concerns when the OPEB expense is projected to be recovered via contract costing.

2. The computations and assumptions used (including the amounts and years in which the amounts are recovered) to support the asset, which may be subjective. For example, given the current environment, questions arise of whether future contract values should include funded backlog, total contract backlog, loss contracts, contracts with small margins, or contract options.

Because of the significance of the uncertainties, auditors should carefully consider the appropriateness of recording any deferred costs (or, alternatively, accrued revenues) by contractors to account for the
difference between FASB Statement No. 106 and CAS requirements related to OPEB costs. The staff of the SEC has indicated that it will scrutinize the realizability of such assets and look for sufficient disclosure in the registrant’s Management’s Discussion and Analysis regarding the uncertainties related to recovery of the asset.

**Commercial Nonrecurring Costs**

Many federal government contractors are moving into commercial markets and increasingly are using the program method of accounting for products manufactured for delivery under production-type contracts, which may result in the deferral of costs. Under this method, costs are accumulated and accounted for by programs rather than by individual units or contracts. A program consists of the estimated number of units of a product to be produced by an enterprise in a continuing, long-term production effort for delivery under existing and anticipated contracts. Auditors should be aware that the Audit and Accounting Guide *Audits of Federal Government Contractors* (the Guide) states that program accounting has had very limited applications because of the significant uncertainties associated with making reasonably dependable estimates of the total number of units to be produced and sold, the length of time to produce and sell them, and the associated production costs and selling prices. Additionally, the recoverability of the deferred costs is subject to a greater degree of risk and, accordingly, becomes more difficult to estimate in the current uncertain business environment. Program accounting is further discussed in paragraphs 3.57 through 3.60 of the Guide.

**Impairment of Long-Lived Assets**

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

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

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

A final Statement is expected by year end.

**Discontinued Operations**

In order to qualify for discontinued operations treatment, an entity must meet all the criteria in APB Opinion 30. These include a formal plan to dispose of a business segment, and the expectation that the plan of disposal will be carried out within a one-year period. In November 1993, the SEC staff issued SAB No. 93, Accounting and Disclosures Relating to Discontinued Operations, which expresses certain views of the SEC staff regarding accounting and disclosures related to discontinued operations. The SAB indicates that an entity’s plan of disposal would not meet the criteria in APB Opinion 30 if the method of disposal of the business segment has not been determined or if the plan of disposal requires more than one year. The SAB also discusses accounting for the abandonment of a business segment, disposal of an operation with a significant interest retained, classification and disclosure of contingencies relating to discontinued operations, and accounting for subsidiaries that an entity intends to sell.

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

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

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