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Audit risk alert - 1989; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

CURRENT INDUSTRY DEVELOPMENTS

Audit Risk Alert – 1989

General Update on Economic, Industry, Regulatory, and Professional Developments

Issued by the
Auditing Standards Division

AICPA
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NOTICE TO READERS

This audit risk alert is intended to provide auditors with an overview of recent economic, professional, and regulatory developments that may affect audits they perform. This document has been prepared by the AICPA staff in consultation with members of the AICPA Auditing Standards Board. This document has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

Patrick L. McNamee
Director, Audit and Accounting Guides

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Audit Risk Alert—1989*

Introduction

This alert is intended to help you in planning your 1989 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 the audit, an appropriate level of professional skepticism, and allocating 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 new professional standards and current developments in business and government.

This alert identifies areas that, based on current information and trends, may affect audit risk on many 1989 year-end audits. Although it isn't a complete list of risk factors to be considered, and the factors listed won't affect risk on every audit, you can use this alert as a planning tool for considering factors that may be especially significant for 1989 audits.

Expectation-Gap SASs

The Auditing Standards Board issued nine Statements on Auditing Standards (SASs)—Nos. 53–61—that are commonly called the expectation-gap SASs. Except for SAS No. 55 on internal control, all are effective for calendar-year 1989 audits (SAS No. 55 becomes effective next year); they all impose a number of new requirements. This summary highlights the new requirements that are expected to have the greatest effect on your audits. Remember though, this alert presents only highlights; there's a lot more material in the actual SASs that you'll need to consider in planning, performing, and reporting on your 1989 audits.

New Planning Requirements

Misstatements. SAS No. 53 restates the auditor's responsibility for detecting material misstatements. It requires the auditor to design the audit to provide *reasonable assurance of detecting errors and irregularities that are material* to the financial statements.

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Identifying Illegal Acts. SAS No. 54 changes the auditor's responsibility for detecting illegal acts. It says that the auditor's responsibility for detecting illegal acts that have a direct and material effect on the financial statements is the *same as for detecting material errors and irregularities* (see the item on SAS No. 53, above). The auditor's responsibility for identifying illegal acts with only an *indirect* effect on the financial statements differs: the auditor must be aware that such illegal acts may have occurred and follow up when they have been identified, but is not required to design the audit to detect these other illegal acts. (Certain types of illegal acts that may be of concern in 1989 audits are discussed later in this alert.)

Required Analytical Procedures. SAS No. 56 requires the application of analytical procedures in *planning* the audit. These procedures are intended to enhance the understanding of the client's business and activities and to identify areas of specific risk.

Auditing High-Risk Areas. The auditor should design the audit approach based on an assessment of risk. (See SAS No. 53.) The auditor should respond to increased risk of material misstatement by—

a. Assigning more experienced personnel to the engagement or increasing the level of supervision.

b. Changing the nature, timing, or extent of planned audit procedures.

c. Exercising a higher degree of professional skepticism.

New Performance Requirements

Heightened Professional Skepticism. SAS No. 53 says that the auditor should perform the audit with an attitude of professional skepticism—assuming *neither* management honesty nor dishonesty. This is an important change. The previous standard (SAS No. 16) assumed management integrity in the absence of evidence or circumstances to the contrary.

Required Analytical Procedures in Evaluation. SAS No. 56 requires that analytical procedures be applied at the *overall review* stage of the audit to assess the conclusions reached and the overall financial statement presentation.

Evaluating the Going-Concern Assumption. SAS No. 59 requires the auditor to evaluate in *every audit* whether there is a substantial doubt about the client's ability to continue as a going concern for one year beyond the balance sheet date. If, after considering information about management's plans for the future, a substantial doubt about the ability to continue remains, the auditor would add an explanatory paragraph to the audit report *regardless* of whether the assets and liabilities are appropriately valued or classified.

New Communication Requirements

New Auditor's Report. SAS No. 58 requires a new form of standard auditor's report.

Communication of Irregularities and Illegal Acts. SAS Nos. 53 and 54 require communication of all irregularities and illegal acts, except inconsequential ones, to the client's audit committee or, when the client doesn't have an audit committee, to persons with equivalent authority and responsibility, which, in a small business, may be the owner-manager.

Reporting Control Weaknesses. SAS No. 60 requires the auditor to report significant control weaknesses to the client, preferably in writing. SAS No. 60 sets a new benchmark for reporting on internal control: *"reportable condition"* replaces "material weakness."

Required Communications With Audit Committees. SAS No. 61 requires that certain matters be communicated whenever the client is a publicly held company *or* has an audit committee or oversight group, even if it's not public.

Applicability of SAS No. 63 on Compliance Auditing

Among other things, SAS No. 63 applies to reports on compliance with laws and regulations and internal control in engagements covered by government auditing standards (the GAO "Yellow Book"), but the *applicability is broader* than it might first appear. You may unexpectedly find yourself under government auditing standards and SAS No. 63.

Private Organizations

Due to federal laws, agency regulations, federal audit guides, and contractual agreements, the Yellow Book applies to *many private organizations*. For example, it might apply to the audit of a trade school because student financial aid is provided by the U.S. Department of Education, to a construction company because of financial guarantees provided by HUD, or to a financial institution because it processes government-guaranteed loans.

State Agencies

Some states have adopted the Yellow Book for all audits of their political subdivisions or agencies.

Illegal Acts

Certain types of illegal acts recently have caused audit concerns.

Environmental Issues

The reach of the federal Superfund legislation is greater than it might first appear. Under that law, anyone who ever owned or operated a hazardous waste site or generated or transported hazardous material to the site may be held responsible for cleaning it up. Thus, for example, a client that acquires through foreclosure property designated a hazardous waste site can be held responsible for the cleanup *even if it had nothing to do with creating the waste* or if the waste was present when the property was acquired.

Independent Contractors

The IRS has stepped up enforcement against abuses in classifying workers as independent contractors, rather than employees. Misclassification of workers as independent contractors may misstate the employer's liability for employment taxes and lead to *fines or penalties.*

Governmental Investigations

Recent governmental inquiries and investigations into some industries and practices (such as defense contractors or insider trading) may result in legal or regulatory challenges to customs or practices previously accepted in an industry.

Questionable Accounting and Fraudulent Financial Reporting

In recent years, the following situations have resulted in misstatements that auditors failed to detect. Consider whether they apply to your clients.

Revenue Recognition Issues

- Improper sales cutoffs
- Recording sales under bill-and-hold agreements, which cast doubt on whether a sale actually has taken place
- Recording as sales shipments to third parties "authorized" to accept goods on behalf of buyers
- Recording sales with written or oral rights of return when the chance of such return is not remote

- Treatment of operating leases as sales
- Nonrecording of sales returns
- Improper application of the percentage of completion method
- Undisclosed "side agreements" on sales, leases, etc.

Other Accounting Matters

- Improper deferral of costs
- Improper off-balance-sheet financing or transactions designed to disguise the substance of the transactions—especially when there are undisclosed "side agreements"
- Changing inventory count sheets

Red Flags of Possible Misstatements

- Unusually heavy sales volume near the end of the year
- Transactions that seem unnecessarily complex
- Aggressive growth of a company with a poor internal control structure
- Growth in sales or earnings shortly before an initial public offering

Highly Leveraged Companies (Including LBOs) and Holders of Junk Bonds

If you audit highly leveraged companies, such as those resulting from leveraged buyouts (LBOs), or clients that hold junk bonds, you may face these audit risks.

Highly Leveraged Companies

An economic slowdown in the client's industry or geographic area could strain the company's liquidity or cause loan covenant violations. In those cases, auditors need to consider: amounts and classification of liabilities; going-concern issues (the auditor's new responsibility for evaluating going concern was discussed earlier in this alert); and the entity's plans (such as asset dispositions or deferral of expenses) and their effects on operations, in light of expected economic conditions.

Holders of Junk Bonds

The market value of junk bonds may be affected by current events, such as extreme market fluctuations and new requirements for savings and loan institutions to dispose of their junk bonds. The value of the bonds may depend entirely on the creditworthiness of the issuer and the holder's ability to keep the bonds until maturity.

Loan Agreements

Current lending practices may affect classification of debt for clients that depend on credit provided by others.

Due-on-Demand Clauses

Some debt agreements have due-on-demand clauses even though future maturity dates are stated.

Subjective Acceleration

Some debt agreements have covenants that accelerate debt payments based on subjective criteria, such as "material adverse changes." Adverse developments in the financial-services industry or the economy may cause lenders to judge these criteria differently than in the past and seek to exercise their rights under these covenants.

Specialized Industries

While most of the items in this audit risk alert affect clients in many industries, there have been developments in specific industries that you may need to be aware of.

Financial Institutions

Recent congressional testimony and other developments indicated that risk may be increased in the following areas this year:

- Negative effects of local economies on real estate values and the resulting effects on the collateral underlying real estate loans and on collectibility of the loans
- Weak underwriting policies and procedures (particularly for home-equity loans) and their effect on ultimate collectibility
- Transactions that appear to lack economic substance

- Carrying value of securities
- Adequacy of allowances for credit losses on loans to less-developed countries (guidance is provided in the AICPA Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks*—product number 021050)

Pension Plans

A recent Department of Labor report disclosed findings that many independent auditors of employee benefit plans' financial statements failed to follow the AICPA guide *Audits of Employee Benefit Plans* and failed to properly disclose known violations of ERISA regulations. The report also noted that benefit plans' poor internal controls have led to understatements of employer contributions, improper disbursement of plan assets, and excessive administrative costs.

Current Environments in Specialized Industries

The AICPA has prepared four other updates that address the current environments in the savings and loan, credit union, property and liability insurance, and health care industries; each of these contains this audit risk alert as an appendix.

Savings and Loan Industry Developments—1989 (product number 022051), *Credit Union Industry Developments—1989* (022053), *Property and Liability Insurance Industry Developments—1989* (022054), and *Health Care Industry Developments—1989* (022052) are available from the AICPA order department at $2.50 each; $2.00 to members. Additional copies of this audit risk alert are also available at $2.00 each; $1.60 to members. Telephone orders can be placed by calling (800) 334-6961 (US), (800) 248-0445 (NY).

Recurring Audit Problems

Certain problems have been identified in more audits than others. Some areas where auditors may fall short are described below.

Attorney Letters

Attorneys' replies to requests for information about litigation, claims, and assessments at times appear complete but in actuality contain vague or ambiguous language and are of little real use to the auditor. (An auditing interpretation of SAS No. 12 at AU 9337.18 in the AICPA *Professional Standards*, vol. 1, discusses what constitutes an acceptable reply and what to do when an unacceptable reply is received.) Also, replies may not be dated sufficiently close to the date of the audit report; additional inquiries may be needed.

Audit Programs

Written audit programs are required in all audits. They help your staff understand the work to be done and—together with other working papers—help you evaluate whether work has been performed adequately and whether the results of that work are consistent with the conclusions reached. It's important to be sure your audit programs are *adequately tailored* to reflect each *client's circumstances* and areas of greater *audit risk.*

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Technical Hotline

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

Call toll-free: (800) 223-4158 (Except New York)
(800) 522-5430 (New York Only)

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