CONT17

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Companion to PPC's Guide to

Construction Contractors

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Companion to PPC's Guide to Construction Contractors

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INTRODUCTION

Companion to PPC's Guide to Construction Contractors consists of three interactive self-study CPE courses. These are companion courses to *PPC's Guide to Construction Contractors* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **cl.thomsonreuters.com/ogs** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **August 31, 2017**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of the services practitioners can provide to construction contractors**.** You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions at the end of the course**. You may either record your answer choices on the **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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Checkpoint Learning is also approved for "QAS Self Study" designation.

The requirements for NASBA Registry membership include conformance with the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. Each course is designed to comply with the *Standards*. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the **Overview** page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

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You may fax your completed **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation** to **(888) 286-9070** or email them to *CPLGrading@thomsonreuters.com*. The mailing address is provided on the Overview and Exam Instructions pages.

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COMPANION TO PPC'S GUIDE TO CONSTRUCTION CONTRACTORS

COURSE 1

CONSTRUCTION CONTRACTS, AUDIT PROGRAMS AND PROCEDURES, AND CONCLUDING THE AUDIT (CONTG171)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course takes a look at two topics that may apply to a practitioner's construction contractor engagements. Lesson 1 examines construction contracts, including discussion of contract documents, the different types of construction contracts, important clauses in such contracts, and how to obtain contract bonds. Lesson 2 discusses issues related to audits of construction contractors, including audit programs, audit procedures, and concluding the audit.

PUBLICATION/REVISION DATE: August 2017

RECOMMENDED FOR: Users of *PPC's Guide to Construction Contractors*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of auditing

CPE CREDIT: 8 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

FIELD OF STUDY: Auditing

EXPIRATION DATE: Postmark by **August 31, 2018**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Construction Contracts

Completion of this lesson will enable you to:

- Identify the contract documents, the different types of contracts, and the important clauses that may appear in construction contracts.
- Recognize how construction contractors obtain contract bonds and the effects of this process on a contractor's business.

Lesson 2—Audit Programs and Procedures, and Concluding the Audit

Completion of this lesson will enable you to:

- Recognize the appropriate organization and structure for a detailed audit plan for the audit of a construction contractor.
- Assess issues related to contract billings and cost-related accounts that might be discovered during the audit of a construction contractor and how the auditor should approach job site visits.

- Identify appropriate audit wrap-up procedures for a construction contractor audit engagement.
- Identify communications that may need to be made when auditing a construction contractor.
- Determine the best methods for dealing with audit workpapers and related documentation, drafting the financial statements and auditor's report, group financial statement audits, supplementary information, and internal auditors.

TO COMPLETE THIS LEARNING PROCESS:

Submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
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See the test instructions included with the course materials for more information.

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Lesson 1: Construction Contracts

INTRODUCTION

Practitioners who provide services to the construction industry and accountants employed by construction contractors need to become familiar with the characteristics of the more common types of contracts used in the industry. A proper understanding of these contracts will enable practitioners to better serve their clients and industry accountants to better serve their employers. This lesson reviews the major types of contracts and the most important clauses within those contracts.

A contract is an agreement entered into voluntarily by two or more parties who promise to exchange money, goods, or services according to an agreed-upon schedule. A construction project is often complex, entailing many variables. Therefore, it is important to document the agreement between contractor and owner with a well-defined contract that clearly identifies the reciprocal promises that form the contract and remain in force until completion of the project.

Organization of This Lesson

This lesson discusses construction contracts and covers the following topics:

a. Contract documents.

b. Types of contracts.

c. Important contract clauses.

d. Obtaining contract bonds.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the contract documents, the different types of contracts, and the important clauses that may appear in construction contracts.
- Recognize how construction contractors obtain contract bonds and the effects of this process on a contractor's business.

THE DOCUMENTS TYPICALLY INCLUDED IN A CONSTRUCTION CONTRACT

Traditionally, construction contracts are not reduced to a single written document. They are usually comprised of a number of items that may include bid documents, the contract agreement, the general conditions of the contract, the project plans, addenda to the plans, and a notice to proceed.

Bid Documents

Competitive bidding is the norm in construction contracting. Negotiated agreements between the owner and the contractor do occur, but they are relatively rare, especially when lump-sum contracts are used. Accordingly, whenever competitive bidding is desired in private work or by government agencies, bid documents are used. The bid documents for commercial projects may include some or all of the items described below.

Invitation to Bid. The owner notifies the contracting community of the proposed project and solicits bids with the invitation to bid. The invitation might be posted online, or published through newspapers, trade publications, or personal notice. It briefly describes the project and explains how the contractor can obtain the plans and specifications to estimate and bid the project.

Instructions to Bidders. This document, sometimes included with the invitation to bid, describes the procedure for submitting the bid and specifies the type of contract to be awarded (lump-sum, cost-plus, or some variation thereon).

Bid Form. This form commits the contractor to the price for which he agrees to perform the work. The bid cannot ordinarily be changed once submitted, so it is important for the form to be properly completed. If there are any deviations from the instructions to bidders, the contractor's bid can be disqualified as nonresponsive.

Notice of Award. The owner indicates his or her agreement to accept the terms and conditions indicated in the contractor's bid form by delivering the Notice of Award to the successful contractor.

Contract Agreement

After the bid process is complete and the bid has been awarded to a specific contractor, the Contract Agreement is entered into by the owner and contractor. Based upon the type of contract entered into (see discussion later in this lesson), the Contract Agreement may also involve other parties. The Contract Agreement is a concise statement of the major contract terms. It typically includes the identification of the owner and contractor, the contract price, a description of the project, a list of all documents that are included in the contract, the duration of the contract, and signatures of the parties.

General Conditions of the Contract

The General Conditions of the Contract for Construction contain what might be referred to as boilerplate language, that is, the clauses generally applicable to virtually all contracts. These clauses might include specifics about such items as change orders, payment terms, use of subcontractors, insurance, arbitration of disputes, and termination of the contract.

Project Plans

The Project Plans include both drawings and specifications. Together these documents should clearly describe and illustrate the desired end result, the specific materials to be used, and the particular details that are important to the structure and its architectural appearance.

Addenda

Addenda are issued by the owner or the architect to supplement, modify, or amend the original project plans. Quite often when the plans are out for bid, contractors will recognize the need to clarify plans or specifications. When the architect is notified about such clarifications, an addendum might be issued. Obviously, it is preferable to have the plans and specifications as clear as possible so that contractors will tender their best bids.

Notice to Proceed

A Notice to Proceed (sometimes referred to as Authorization to Proceed) at the beginning of the project generally establishes the commencement date. For projects with time deadlines, this date may be important for purposes of computing penalties. Notices to Proceed may also apply to change orders.

TYPES OF CONSTRUCTION CONTRACTS

Construction contracts are most often classified as either lump-sum or cost-plus. This section discusses these two types of contracts, as well as the most commonly used standardized versions of each, and their advantages and disadvantages as compared to custom-drafted contracts. (Unit-price contracts are discussed further later in this lesson.)

Lump-sum or Fixed-price Contracts

Under a lump-sum contract (also referred to as a fixed-price or fixed-fee contract), the contractor warrants (except when errors are encountered in the plans and specifications) that he will complete the project for an agreed-upon

price, based on the scope of the project as defined by the owner, regardless of the problems or difficulties that may be encountered. Any inaccuracies in the estimate, oversights or omissions, weather delays, material shortages, or labor strikes can cause the contractor to lose money because these inherent risks are borne by the contractor. Conversely, the contractor retains the profits resulting from his ability to efficiently complete the project or to negotiate for less expensive materials or labor. Nevertheless, the lump-sum contract is considered to be the most risky for the contractor. Owners often prefer a lump-sum contract because they feel it limits their exposure to cost overruns, though the contract price may be increased by change orders for various reasons. (Change orders are discussed later in this lesson.) Additionally, lending institutions may provide construction financing more readily when the total cost of construction is known beforehand.

Depending on the terms of the contract, an adjustment to the price of a lump-sum contract can sometimes be made for items, such as—

a. economic price changes, such as materials prices or labor wage rates;

b. prospective periodic redetermination of price at specified intervals;

c. retroactive redetermination of price within a previously established ceiling price and consideration of the contractor's effectiveness;

d. target cost incentives that are essentially based on a previously established formula for computing final profit and price based on the relationship of actual cost to target cost; and

e. performance incentives that increase or decrease profit based on performance in relation to previously established management performance targets.

A disadvantage of the lump-sum contract to a project owner is that it tends to lengthen the time required to complete a project because the design must be completely finalized before competitive bids can be taken and work can begin.

Contracts. The lump-sum contract is subject to several variations, one of which is the *unit-price contract*. With this type of contract, the contractor bids a set price on a unit item, but the total number of units required has not been determined when the contract is made. The unit-price contract is most often used in public utility and road building where the engineers prepare estimates of quantities of work in each phase of construction and request unit prices for the components, for example, square feet of concrete, cubic yards of excavation, feet of pipe, etc. More often, the lump-sum contract is used with the added provision for unit prices on specified components. This might occur when constructing an office building with speculative space or spaces not leased when the contractor begins work. Unit prices may apply to light fixtures, electrical outlets, lineal feet of partition, air-conditioning outlets, etc., that would be needed as space is leased to specific tenants and the requirements for the number of these units became known. Unit-price contracts are not generally used for entire construction projects, but may be used exclusively for agreements with sub-contractors. Additionally, it is not uncommon to combine a unit-price contract (for specific components or tasks) with another type of contract on the same project.

AIA and Standard Lump-sum Contract. The use of standard contract documents is common in the construction industry. The American Institute of Architects (AIA) has provided standard contract documents to the construction industry for almost 130 years. The AIA documents are generally updated every ten years on a rotational basis unless an earlier update is needed. The AIA contracts are generally believed to provide fair and balanced agreements for all parties involved and the electronic versions are compatible with Microsoft Word and Excel. The AIA contract documents cover the spectrum of design and construction projects, both large and small, and are used on many construction projects. The AIA provides over 180 standard construction contracts and forms. It is a best practice for practitioners servicing construction contractor clients to be familiar with the AIA contract documents most commonly used. The AIA also offers online access to its standard contracts, including the ability to edit, share, and customize those documents, as well as store them in the cloud.

In the lump-sum contract area, AIA document A101-2007, *Agreement Between Owner and Contractor—Stipulated Sum*, is used as a standard form in the industry. (The AIA has now released the 2017 version of this contract document, but the prior version of the document is still available. Information about the differences between the

2017 and the 2007 versions of this document is available on the AIA's website at **www.aia.org**.) This contract documents areas of the agreement that the parties choose to customize, such as the actual work of the contract; date of commencement and substantial completion; contract amount; progress payments and final payment; etc. This form is primarily suited for large or complex projects. Other AIA contract documents are available for projects of a more limited scope or for smaller projects.

AIA document A201-2007, *General Conditions of the Contract for Construction*, is another standard form used in the industry. The general conditions of this document provide for the proper coordination among the varied parties involved in the construction process and set forth the rights, responsibilities, and relationships of the owner, contractor, and architect. The document contains the basic terms and conditions applicable to most contractor-owner relationships, such as use of subcontractors; changes in the work; insurance and bonds; protection of persons and property; termination or suspension of the contract; administration of the contract; etc. The provisions of document A201-2007 are often incorporated by reference into the owner and contractor agreement.

The terms of a standard contract often call for a 10% retainage or hold back of payment by the owner until substantial completion of the project. (The concept of retainage is unique to the construction industry and is discussed more later in this lesson.) Many contractors will resist such provisions and attempt to reduce the retainage to a lesser percentage of the progress payments. The knowledgeable contractor will also request payment within 10 days from the date the application for payment is submitted. A standard contract often has language that calls for final payment 30 days after completion. Many contractors will modify this provision to call for final payment on substantial completion (for example, when a certificate is issued by the architect or when a certificate of occupancy is issued by the municipality). The owner will often try to withhold the amount of money estimated to cover the cost of completing a *punch list* (which is a list made near the completion of the project containing items to be furnished or work to be performed to complete the project in accordance with the contract), and the contractor will try to minimize that amount.

Cost-plus Contracts

The second common type of construction contract is the *cost-plus-fee contract*. When this type of contract is employed, the owner agrees to pay the contractor a fee in addition to the costs the contractor incurs in completing the project. The fee may be fixed or it may be calculated as a percentage of cost. The cost-plus contract is the likely choice when a construction manager or a developer-contractor is engaged by the owner. This type of contract, in contrast to the lump-sum contract, shifts much of the risk to the owner. However, the owner's exposure can be reduced by using a variation of the cost-plus contract called a Guaranteed Maximum Price (GMP) contract. The GMP establishes the project's maximum cost for the owner, with costs that exceed the GMP contracted amount becoming the responsibility of the contractor. Such a contract enables the owner and contractor to share in any savings if the project is completed at less than the maximum price.

Cost-plus contracts are favored by owners when speed and flexibility are important. For example, this type of contract might be used in the following circumstances:

a. *Restoration of a Structure after a Casualty Loss.* The owner may wish to begin construction as quickly as possible so that the structure can be inhabited or put into service in as short a time as possible.

b. *Projects in Which Many Changes Are Expected during Construction.* Cost-plus arrangements provide greater flexibility with regard to changes than do lump-sum contracts, which generally require each change order to be negotiated.

c. *Projects in Which "Fast-track" Construction Is Important.* Fast-track construction is generally employed when rapid completion of the project is a high priority, such as when the cost of funds is high or the deadline is important to the owner.

When a cost-plus contract is used, the owner must have a high degree of confidence in the ability of the general contractor, construction manager, or developer-contractor. This type of contract requires a high level of involvement by the owner and a close working relationship between the owner and whoever is engaged.

As noted, the cost-plus approach provides the opportunity to reduce project time and increase flexibility while placing the burden of risk on the owner. This type of arrangement can also create significant potential for disagreement, especially if the following items are not addressed in the contract:

a. *Reimbursables.* One area that needs to be crystal clear in the contract is the definition of what costs are to be reimbursed to the contractor by the owner. If contractor overhead is a reimbursable item and the contractor has home office overhead that supports a number of different projects, a proper definition of what is reimbursable is of major importance. Similarly, if the contractor's interest costs associated with the work are reimbursable, the contract must specify what rates apply. To avoid disputes, these items should be clearly addressed in the contract.

b. *Subcontracts.* Because the owner will ultimately be paying the bill, disagreements can arise over the approval of subcontractors used and the basis on which they will be paid (fixed-price or cost-plus).

c. *Contractor's Fees.* Prior to entering into a cost-plus contract, the owner and contractor should be in absolute agreement regarding calculation of the contractor's fee and the manner of payment.

d. *Right to Audit.* Costs reimbursable to the contractor are often substantial, and the owner may want the right to audit the contractor's books to verify proper calculations. In fact, it has become common for the terms of cost-plus contracts to grant the owner the right to audit contractor costs within a stipulated time-period following the completion date of the project. Any overcharged costs are reimbursable to the owner and such overcharges found can have negative consequences to both the contractor's bank account and reputation.

Calculating the Cost-plus Fee. One common element of all cost-plus contracts is that the contractor's costs, as defined by the contract, are reimbursable. However, the methods of calculating the fee vary. They include:

a. *Cost-plus Percentage of Costs.* A common method of fee calculation is a straight percentage of reimbursable costs with no limit on the amount of the fee. When the extent of work is not easily determined, this is generally the alternative chosen. However, when this approach is employed, the contractor has no incentive to hold down costs.

b. *Cost-plus Fixed Fee.* Under this contractual arrangement, the contractor agrees to a stipulated fee regardless of the final costs or duration of the project. This arrangement gives the contractor an incentive to complete the job at the earliest possible date. The sooner the contractor completes the job, the sooner he can deploy his overhead and employees to another profit opportunity.

c. *Cost-plus Incentive.* This arrangement generally identifies a targeted cost, agreed to by both owner and contractor, as a ceiling. At the completion of the project, the contractor receives a percentage of the savings, if any. Both owner and contractor can benefit because the contractor has an incentive to complete the project as soon as possible at the least cost with the savings split between owner and contractor.

d. *Cost-plus Award.* Under this arrangement, allowable costs are reimbursed, and there is a fee based on the relationship of either actual costs to previously established target costs or performance to previously established performance targets.

Standard Cost-plus Contract. A standard cost-plus agreement commonly used in the construction industry is AIA Document A102-2007, *Agreement Between Owner and Contractor—Cost of the Work Plus a Fee, With a Guaranteed Maximum Price*. This standard form of agreement between owner and contractor is appropriate for use on large projects requiring a guaranteed maximum price, when the basis of payment to the contractor is the cost of the work plus a fee. This contract is not intended for use in competitive bidding. A102-2007 adopts by reference, and is intended to be used with AIA Document A201-2007, *General Conditions of the Contract for Construction*, discussed previously.

In addition to the types of contracts previously described, there are other variations or combinations of contracts. For instance, a shell office building project may be completed under a lump-sum contract, whereas interior finish may be completed on a cost-plus basis.

Other Standard Contracts

In addition to the standard conventional lump-sum and cost-plus contracts previously discussed in this section, AIA provides other categories of standard contract documents specific for—

- small projects,
- construction management projects,
- design-build projects, and more.

While AIA is recognized as the oldest and most well-known provider of standard construction contracts, it is not the only provider of standard construction contracts. The Engineers Joint Contract Documents Committee (EJCDC) was formed in 1975 as a joint venture of four major organizations of professional engineers and contractors for the purpose of developing standard documents for projects that involve professional engineering services. This group of over 80 documents is geared toward infrastructure projects such as transportation and utility construction. The documents are updated approximately every five years to reflect industry trends, court decisions, and changes in applicable laws and regulations. The documents are available in Microsoft Word format. Additional information is available at **www.ejcdc.org**/.

In 2007, a new entity entered the standard construction contract forms industry and began publishing documents in 2007. Those documents are based on standard forms previously developed by the Associated General Contractors of America (AGC) and the Construction Owners Association of America. The group of over 100 documents, known as ConsensusDocs™ was collaboratively developed by a coalition of 35 construction industry associations. The documents are available in Microsoft Word format. Additionally, ConsensusDocs offers a platform using cloud-based technology that provides immediate access to an entity's contract documents from any computer through a secure web-based portal. More information about ConsensusDocs is available at **www.consensusdocs.org**.

Advantages and Disadvantages of Standard Contracts

As previously noted, standard contracts are commonly used in the construction industry. The advantages of these standard documents include that such contracts:

a. are carefully designed,
b. are based on a collective body of legal experience,
c. are readily available and inexpensive,
d. might be interpreted as more valid in a courtroom due to their extensive use, and
e. are generally familiar to the contracting parties.

The disadvantages of standard contracts include that such contracts:

a. may omit terms or conditions that apply to a specific project,
b. are sometimes based on assumptions that are not valid in all cases, and
c. may contain standard conditions that do not always apply.

Customized Contracts

Contracting parties may prefer customized construction contract documents drafted from scratch, particularly if extensive modifications are required to the standard documents. Of course, it is advisable to solicit the expertise of a contract attorney when a customized or heavily modified standard document is used.

Advantages and Disadvantages of Customized Contracts. Customized or nonstandard contracts provide flexibility to both parties. As with standard contracts, they have advantages and disadvantages. The advantages of original drafted contracts include that such contracts:

a. are more precisely designed to reflect the conditions of the project,

b. may better reflect or define the responsibilities and obligations of the parties, and

c. contain terms and conditions that are more specific to the agreement.

The disadvantages of original drafted contracts include that such contracts:

a. are more costly,

b. may contain untested clauses,

c. generally favor the drafting party,

d. may contain unenforceable clauses, and

e. might be poorly drafted.

IMPORTANT CLAUSES IN CONSTRUCTION CONTRACTS

The clauses requiring the most attention in a construction contract, whether it is a standard or customized contract, are progress payment and retainage clauses. Other clauses also deserve special attention from both the contracting parties and the practitioner because they have financial statement and tax implications. These clauses are discussed in the following paragraphs.

Change Orders

Change order clauses permit additions, deductions, or changes to the contract after work has begun. If the clause is not included in a lump-sum contract, additional work will have to be negotiated or re-let for bid. Generally, that is a situation unfavorable to both the owner and the contractor. Accordingly, change order provisions are generally included in the contract to allow the parties to adapt to new circumstances. Change order provisions often identify (by name or job description) the specific persons authorized to make changes and to bind a contracting party. A change order generally includes the date, a description of the work to be performed, the price of the change (or a method for determining the price), an estimate of how long the work is expected to take, and any exceptions or objections to what is being resolved by the change order.

Many smaller contractors do not have cost control systems or accounting procedures that can readily or easily isolate the additional costs related to a change order. This is aggravated by the fact that change orders are often initiated by owners with little or no advance notice to the contractor. Consequently, the contractor is often unable to clearly identify or control the additional costs associated with the changes. Because the final profitability of a contract often depends on controlling, documenting, and collecting amounts that arise from change orders (and claims, discussed later in this lesson), it is important for contractors to prioritize the development of processes and controls in this area. The accountant can provide a valuable service to the contractor by helping install specific safeguards and provisions to identify and isolate costs associated with changes so those costs can be properly billed.

Changed Conditions

Occasionally, a contractor will encounter a condition that dramatically impacts the project cost but could not have been foreseen. An example of this might be finding substrata rock or underground water, which would greatly increase the cost of the foundation. The importance of a changed condition clause, specifically in a lump-sum contract, is to give the contractor relief when abnormal conditions not identified or provided for in the design

documents are encountered. Such changed conditions may be covered by a *concealed conditions* clause in the contract that allows for the contract amount to be adjusted through a change order upon claim by either party made within a stipulated number of days after the first observance of the conditions.

Retention (Retainage)

The owner typically withholds or retains a percentage of the progress payments due the contractor until project completion. The contractor, in turn, retains a portion of the payments due subcontractors. The purpose of retainage is to provide the owner security for costs incurred to repair defective work, to settle claims from parties not paid by the contractor, and to ensure that work is completed in accordance with the contract. Most often, owner-prepared contracts call for 10% retention, whereas the contractor will ordinarily strive for a lesser percentage. Another common approach starts off with a 10% retainage and reduces it to a lesser percentage (such as 5%) once the project is 50% complete. Additionally, some contracts will carve out material costs from the retainage requirement. Regardless of the approach used to determine retainage, the contractor's cash flow and profitability can be significantly affected if the retention is not received on a timely basis because the retention may be as much as, or more than, the contractor's profit on the project.

Claims

Disputes sometimes arise when plans and specifications are not clear or when a work item not addressed by the plans is encountered. For example, there have been cases when a structure collapsed, resulting in personal injury, loss of life, and ultimately, the bankruptcy of the contractor or owner. In such cases, the owner may believe the installation was incorrectly built and not in accordance with plans and specifications, whereas the contractor may believe the problem was the result of a design flaw.

When a claim occurs, the claim clause describes the procedure for the contractor to follow in settling the dispute. If the claim cannot be settled agreeably, it is generally deferred until job completion, with the contractor proceeding under protest. However, if the contractor stops work, he risks being held in breach of contract, a risk generally not worth taking.

Regardless of the exact reason that a claim is initiated, claims generally result because the contractor has incurred additional, unanticipated cost. Some contracts contain a clause that stipulates procedures the contractor must follow to have a chance of being reimbursed for additional costs. Such contract provisions may require that notice of additional costs be filed with the owner within a certain number of days after the occurrence of the event that gave rise to the claim. Additionally, unless the event that gave rise to the additional costs is an emergency situation that endangers life or property, the contractor may not proceed to execute such work. The contractor's claim will generally be considered invalid unless the provisions of the clause are precisely followed.

Alternative Dispute Resolution

The resolution of claims and disputes through litigation is time-consuming and expensive. Alternative dispute resolution (ADR) is a popular way of attempting to resolve claims and disputes without a lengthy court case. ADR methods, such as arbitration and mediation, are often included in contracts as the means to settle differences. An arbitration clause provides an opportunity for an independent person or group of persons to hear the dispute and to make a decision and award that may be legally binding on the parties, depending on their agreement. Arbitration usually results in faster settlement of claims at less cost, time, and inconvenience to the parties. Arbitration hearings are generally conducted under the auspices of the American Arbitration Association (AAA). Although the arbitration proceedings are typically speedier than court proceedings, it is still a formal and time-consuming process. Mediation may also be used to efficiently settle differences. Mediation seeks to achieve the same objectives as arbitration—avoiding a lengthy court trial. However, mediation is much less formal than arbitration or a court case, and can often be accomplished with less cost than an arbitration hearing. A contractor that wishes to use mediation should replace the arbitration clause with a clause specifying that mediation will be used to resolve any claims or disputes. The AAA's Construction Industry Arbitration Rules and Meditation Procedures specify the procedures for requesting and conducting an ADR session. Visit the AAA's website at **www.adr.org** for more information.

Warranty

The contractor is generally required by contract to warrant that the work done is free of defects in material and workmanship for a period of one year from completion. While the contractor warrants his own work to be free from defects, he does not warrant against failures that may occur prematurely due to design deficiencies.

Bonds

Bonding is an important aspect of contracting because it offers protection to the owner and it represents a significant cost to the contractor. Generally bonds cost between 0.5% and 2% of the contract based upon factors such as the size and bonding capacity of the contractor, geographic area, type of construction, and the specific project.

A bond is a guarantee of the performance of a contract or other obligation. A surety is one who makes himself responsible for another, and a bonding company is a surety. A surety bond is a formal, written instrument whereby one party (the surety) guarantees the performance of another party (the principal) to a third party (the obligee). Thus, a bond is a three-party contract.

Contract Bonds. A contract bond is a specific type of surety undertaking. The term *contract bond* includes bonds relating to construction contracts. The parties to a contract bond are:

a. the bonding company (surety),

b. the contractor (principal), and

c. the owner (obligee).

Types of Bonds. The surety guarantees that the contractors/principals will do what they have contracted to do, and if they do not, the surety will carry out the contractors' responsibilities. The types of bonds used by contractors are as follows:

a. *Bid Bond.* This bond protects the owner from loss if the contractor awarded the project does not sign the contract and furnish the required performance and payment bonds within a specified time. If this occurs, the surety pays the owner the difference between the contractor's bid and the next lowest bid. This amount protects the owner from contractors making a bid without the resources to complete the work and partially protects the owner against the cost of rebidding the job if necessary. Bid bonds may also be used by owners to limit the number of bidders on a project. The bid bond is always a small percentage of the bid (generally 3%). The surety usually does not charge for a bid bond if performance and payment bonds are required on the project.

b. *Performance Bond.* This bond protects the owner from loss resulting from the contractor's failure to complete the work in accordance with plans and specifications. Performance bonds are required for federal public contracts over $100,000 by the Miller Act, but may also be required on contracts of lesser amounts.

c. *Payment Bond (Labor and Materials Bond).* This bond guarantees payment of all bills received by the contractor for labor and materials for the work. In some states, there are statutes requiring a separate payment bond on public contracts, and these bonds may be referred to as Statutory Bonds. Payment bonds are required for federal public contracts over $100,000 by the Miller Act, but may also be required on contracts of lesser amounts. In many cases, the cost of a payment bond is included with the purchase of a performance bond.

d. *Combination Performance and Payment Bond.* This is a single bond used for private contracts that combines the performance and payment bonds mentioned above.

e. *Maintenance Bond.* A maintenance bond normally guarantees against defective workmanship or materials for a specified period of time. In many cases, the cost of a 12-month maintenance bond is included with the purchase of a performance bond.

Obtaining contract bonds is discussed later in this lesson.

Insurance

Insurance is a significant need and a major component of cost in the construction industry. It is needed by both general contractors and subcontractors. The property and casualty insurance coverages, which are important characteristics of contracts, are described as follows.

Workers' Compensation. State laws governing this type of insurance vary, but the basic coverage in all states provides construction workers with on-the-job injury protection. The amounts of compensation for injuries, medical benefits, and coverage that employers must purchase are generally specified in the state laws.

Public Liability. This coverage protects the contractor from legal liability in the operation of the business. Types of coverage needed are:

a. premises operations,

b. products-completed operations,

c. broad form property damage,

d. personal injury liability,

e. contractual liability, and

f. underground damage, collapse, and explosion (only certain types of contractors have this exposure).

Careful consideration should also be given to the need for pollution liability and public liability exposure involving mobile equipment.

Automobile Liability. This insurance coverage provides protection to the contractor for the ownership, maintenance, and use of vehicles in the business or for personal use. The policy should be written to cover *any* vehicle for which there is exposure, whether owned by the contractor or not. The minimum limit should be $500,000 for combined bodily injury and property damage.

Excess Catastrophe Liability (Umbrella). Most general contractors, and many subcontractors, are required to purchase liability insurance in excess of the basic coverages (for example, automobile liability, workers' compensation, public liability, etc.). The excess coverage provides protection beyond the limits provided in a contractor's basic coverage or, at times, provides broader coverage than the primary insurances.

Builders' Risk. An owner of a project will usually want the property insured during the course of construction and will either buy this type of coverage or require the general contractor to purchase it. The insurance is written to protect the owner and contractor should any problems arise with labor or materials used on the job. The carrier will pay if the project is damaged by fire, wind, hail, vandalism, or other covered perils during construction until the project is accepted by the owner.

Subcontractor Default. This insurance coverage provides protection against subcontractor default. The contract is between the insured, usually the contractor, and the insurance company. Thus, subcontractor default insurance is a two-party contract. The insurance company reimburses the contractor for subcontractor default costs subject to limits and a deductible or co-payment. This type of insurance coverage may be known as *subguard* coverage.

Liquidated Damages

Time is critical in construction projects and impacts project economics greatly. The earlier an owner can commence business, the quicker the project can generate operating or rental income. Conversely, delays result in loss of income and greater operating costs. Contracts often include completion dates to which the contractor agrees. In the event completion is delayed, the liquidated damage clause requires the contractor to pay the owner a daily rate

that compensates the owner for lost revenue. In some cases, earlier completion results in a bonus or incentive payment to the contractor.

Extension of Time

The contractor should thoroughly document his construction records, particularly to reflect delays due to weather. This is because most contracts provide for extensions of time if the contractor has no control over the delays. This includes events such as floods, war, riots, and acts of God, and may include delays due to weather or even freight delays and labor strikes.

The issues of liquidated damages and extensions of time are important because they affect the contractor's profitability. In addition to contractor delays, projects can be delayed by owners. This can result in extra costs to the contractor for items such as nonproductive workers and supervisors, additional overhead, and costs associated with starting and stopping work.

Pay-when-paid

This clause permits contractors to pay subcontractors when payment is received from the owner, thereby transferring some of the cash flow risk from the contractor to the subcontractor. For example, if the owner pays the contractor 30 days after receiving the bill for work performed by a subcontractor, payment is due to the subcontractor at the time of receipt by the contractor. However, if the owner declares bankruptcy and does not pay the invoice, the contractor must still pay the subcontractor within a "reasonable time." Individual states' interpretations of pay-when-paid clauses may differ, so contractors and practitioners should be aware of applicable state statutes.

Termination Provisions

Traditionally, termination was an option only for cause, which would include the contractor's breach of one or more contract provisions. However, termination for convenience has now become a fairly common clause in private contracts. Initially, the federal government was able to terminate for convenience as long as it acted in good faith. The contractor was entitled to lost profits, but not the amounts entitled from a breach of contract. An example of a contract terminated for convenience is when the owner loses project funding and chooses to terminate the contract. In such cases, the contractor is entitled to recover the portion of the contract price for the work performed through the date of termination, and possibly the profit that would have been realized if the contact were completed.

Contract Review

Although the contract clauses discussed above are generally the most significant ones, it is important to understand all of the contract terms and the effect they could have on the project and the related financial statements.

The importance of performing an in-depth review of the contract terms cannot be overemphasized. The contractor's accountant, whether internal or a public practitioner, needs to have a thorough understanding of a contract's terms in order to properly account for all activity throughout the contract's life. An auditor also needs to review the basic terms of significant contracts during the planning phase of an engagement to properly plan the audit.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. What type of documentation does a construction contractor use to commit to a price for a particular job during the bidding process?

    a. Bid documents.

    b. Bid form.

    c. Contract Agreement.

    d. Notice of Award.

2. What is an advantage for the contractor of using a lump-sum contract?

    a. Bids can be made earlier.

    b. A limited amount of risk.

    c. Potential for more profit.

    d. Limited exposure to cost overruns.

3. How are a contractor's costs calculated when the cost-plus incentive method is used?

    a. The contractor is paid a straight percentage of all reimbursable costs.

    b. The contractor agrees to complete the job for a specific fee.

    c. Charges are reimbursed, but there is a fee related to target costs or performance targets.

    d. The contractor agrees to a specific fee and gets a percentage of any shortfall.

4. Why might a contractor prefer to use customized contracts?

    a. They are extremely cost-effective to write.

    b. They are more likely to favor the contractor.

    c. They will more accurately reflect the specific project.

    d. They are generally well drafted since they are written new each time.

5. What type of bond helps protect the owner of a construction project from losses due to defective workmanship?

    a. Bid bond.

    b. Maintenance bond.

    c. Payment bond.

    d. Performance bond.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. What type of documentation does a construction contractor use to commit to a price for a particular job during the bidding process? **(Page 4)**

   a. Bid documents. [This answer is incorrect. Competitive bidding is the norm in construction contracting. Whenever competitive bidding is desired in private work or by government agencies, bid documents are used. However, this is an overarching term that includes things such as the invitation to bid, as well as the type of document described above.]

   b. Bid form. [This answer is correct. This form commits the contractor to the price for which he agrees to perform the work. The bid cannot be changed once submitted, so it is important for the form to be properly completed.]

   c. Contract Agreement. [This answer is incorrect. After the bid process is complete and the bid has been awarded to a specific contractor, the Contract Agreement is entered into by the owner and the contractor. The Contract Agreement is a concise statement of the major contract terms. It typically includes the identification of the owner and contractor, the contract price, a description of the project, a list of all documents that are included in the contract, the duration of the contract, and the signatures of both parties. However, this comes later in the process than the document described above.]

   d. Notice of Award. [This answer is incorrect. The owner indicates his or her agreement to accept the terms and conditions indicated in the form described above by delivering the Notice of Award to the contractor who won the bid.]

2. What is an advantage for the contractor of using a lump-sum contract? **(Page 4)**

   a. Bids can be made earlier. [This answer is incorrect. A disadvantage of a lump-sum contract to a project owner is that it tends to lengthen the time required to complete a project because the design must be completely finalized before competitive bids can be taken and work can begin.]

   b. A limited amount of risk. [This answer is incorrect. The lump-sum contract is considered to be the most risky for the contractor. Any inaccuracies in the estimate, oversights or omissions, weather delays, material shortages, or labor strikes can cause the contractor to lose money because these inherent risks are borne by the contractor.]

   c. Potential for more profit. [This answer is correct. With this type of contract, the contractor retains the profits resulting from his ability to efficiently complete the project or to negotiate for less expensive materials or labor.]

   d. Limited exposure to cost overruns. [This answer is incorrect. *Owners,* not contractors, often prefer a lump-sum contract because they feel it limits their exposure to cost overruns.]

3. How are a contractor's costs calculated when the cost-plus incentive method is used? **(Page 7)**

   a. The contractor is paid a straight percentage of all reimbursable costs. [This answer is incorrect. The *cost-plus percentage of costs* method calculates the contractor's costs as a straight percentage of reimbursable costs with no limit on the amount of the fee. This is a different calculation than the cost-plus fixed fee method.]

   b. The contractor agrees to complete the job for a specific fee. [This answer is incorrect. Under a cost-plus contract, when the *cost-plus fixed fee* method (not the cost-plus incentive method) is used, the contractor agrees to a stipulated fee regardless of the final costs or duration of the project. This arrangement gives the contractor an incentive to complete the job at the earliest possible date. The sooner the contractor completes the job, the sooner he can deploy his overhead and employees to another profit opportunity.]

c. Charges are reimbursed, but there is a fee related to target costs or performance targets. [This answer is incorrect. This calculation is different from that used in the cost-plus incentive method. This is the *cost-plus award method,* and when it is used allowable costs are reimbursed, and there is a fee based on the relationship of either actual costs to previously established target costs or performance to previously established performance targets.]

d. The contractor agrees to a specific fee and gets a percentage of any shortfall. [This answer is correct. This arrangement generally identifies a target cost, agreed to by both the owner and the contractor, as a ceiling. At the completion of the project, the contractor receives a percentage of the savings, if any.]

4. Why might a contractor prefer to use customized contracts? **(Page 9)**

a. They are extremely cost-effective to write. [This answer is incorrect. One of the disadvantages of a customized contract is that they are more costly.]

b. They are more likely to favor the contractor. [This answer is incorrect. Customized contracts have specific disadvantages, one of which is that they generally favor the drafting party. Therefore, while a contractor might favor such a contract if it is the one that drafted it, the contractor might be less inclined to use a customized contract if the project owner drafted it.]

c. They will more accurately reflect the specific project. [This answer is correct. Customized or nonstandard contracts provide flexibility to both parties, and there are multiple advantages to using them. Such contracts (1) are more precisely designed to reflect the conditions of the project, (2) may better reflect or define the responsibilities and obligations or both parties, and (3) contain terms and conditions that are more specific to the agreement.]

d. They are generally well drafted since they are written new each time. [This answer is incorrect. One of the disadvantages that is commonly associated with customized contracts is that they have the potential to be poorly drafted.]

5. What type of bond helps protect the owner of a construction project from losses due to defective workmanship? **(Page 11)**

a. Bid bond. [This answer is incorrect. This type of bond protects the owner from loss if the contractor awarded the project does not sign the contract and furnish the required performance and payment bonds within a specified time.]

b. Maintenance bond. [This answer is correct. A maintenance bond normally guarantees against defective workmanship or materials for a specified period of time. In many cases, the cost of a 12-month maintenance bond is included with the purchase of a performance bond.]

c. Payment bond. [This answer is incorrect. This type of bond guarantees payment of all bills received by the contractor for labors and materials for the work.]

d. Performance bond. [This answer is incorrect. This type of bond protects the owner from loss resulting from the contractor's failure to complete the work in accordance with plans and specifications.]

CONTRACT BONDS

As previously discussed, a surety bond is a guarantee that a contract or other obligation will be completed. The different types of bonds were discussed in the previous section. By issuing a bond, a surety agrees to complete a project if the contractor is unable to do so. Therefore, when underwriting a surety bond application, the surety is looking for indications that the contractor may be unable to complete the contract for any reason including:

a. Financial difficulties.

b. Contractor incompetence, loss of key personnel, or other factors.

In short, the surety evaluates the odds that it will be forced to step in and complete the project. The surety makes this evaluation by assessing the contractor's ability to meet current and future financial obligations. Additionally, the surety will consider whether the contractor is of good character and has the appropriate knowledge and experience to successfully complete a construction project under the specified conditions of the contract. The surety also looks into the contractor's relationships with suppliers, subcontractors, and lending institutions. Successful completion of past projects provides the surety with a stronger level of assurance of the contractor's abilities.

Many projects require contractors to obtain bonding before work commences. Therefore, continued availability of surety bonds is of critical importance to most contractors. Many sureties have improved their understanding of financial information and have developed sophisticated methods of analyzing the financial strengths and weaknesses of contractors. To obtain surety bonds, the contractor needs to demonstrate that it is well managed, financially sound, and that its owners and key personnel know the industry. A strong financial position and a proper presentation of the financial statements and other financial information is crucial.

The Surety Information Office (SIO) is a good source of information about contract surety bonds and the agency provides much of its information free of charge. The agency's homepage is **www.sio.org**. The "Contractors & Subcontractors" link includes information regarding the basics of surety bonds, how to obtain surety bonds, how to establish and maintain a surety relationship, qualifying a surety company, and more. The U.S. Small Business Administration (SBA) also provides helpful information about surety bonds, including information specific for contractors, at its website at **www.sba.gov/surety-bonds**.

To obtain (or increase) surety bond coverage, the contractor must recognize the surety underwriter's concerns and address those concerns in a straight-forward manner. This process involves:

a. Maintaining contact with bonding agents and sureties.

b. Meeting the surety's information needs.

Maintaining Contact with Bonding Agents and Sureties

Typically, a contractor obtains a contract bond by working with a bonding agent, who often represents several surety companies. Bonding agents serve as middlemen between the contractors and the surety companies. As intermediaries, they are in the best position to advise the contractor about the availability of surety bonds. They are also aware of the form and content of information required by the sureties. Maintaining close contact with the bonding agent ensures that the contractor will be able to prepare information that is responsive to the underwriter's needs.

Another important reason for maintaining a close relationship with the bonding agent is to increase the agent's confidence in the business ability and construction knowledge of both the contractor and the CPA. If the bonding agent has confidence in the skills of the contractor, the agent is more likely to accept explanations during periods when the financial results are not as good as usual. In addition, by maintaining regular contact with the bonding agent, the contractor can communicate the status of various jobs, and thus avoid unpleasant surprises at the end of the year.

Many CPAs try to meet periodically with the bonding agents of their contractor clients. These meetings help the practitioner understand the surety's requirements for financial information. Although the CPA's primary objective in

meeting with a bonding agent is to help his or her contractor client, such meetings may also periodically result in the practitioner receiving business referrals. Bonding agents and surety companies are very concerned with the quality of the financial information they receive. As a result, they put a great deal of reliance on the skills of the contractor's independent accountant. A practitioner who is able to demonstrate in-depth knowledge of the construction industry, as well as the ability to deliver complete and timely financial statements to the bonding agent, is likely to obtain referrals for additional business through the bonding agent.

Providing Information Needed by the Surety

Sureties generally insist on receiving a great deal of information from their contractor clients—both financial and non-financial. The contractor should ensure that this information is properly presented and includes all information that the surety needs. Different agents and sureties give greater weight to different factors in deciding which contractors get bonded and which do not. Knowledge of these factors may mean the difference between getting a bond or not.

Contractors seeking bonding for the first time, changing sureties, or seeking to increase their bond amounts will generally provide more information than other contractors. In most instances, when the surety and contractor have a continuing relationship, the surety will maintain a file on the contractor containing historical financial information and other background material. In each succeeding year, it may be necessary to provide only the information necessary to update the surety's file. For example, the description of the business, debt agreements, and financial information previously provided need not be resubmitted, unless there has been a change.

Information requested by sureties typically falls into three categories:

a. Basic financial statements and supplementary schedules.

b. Non-financial statement information.

c. Information on the owners or principals of the contractor.

Basic Financial Statements and Supplementary Schedules. Sureties use the financial statements and the supplementary schedules to assess the financial stability of a contractor and to evaluate the contractor's earnings trend. Sureties typically want financial statements that have the following qualities:

a. *Conform to GAAP.* Sureties generally insist on receiving financial statements prepared in accordance with generally accepted accounting principles (GAAP) rather than a special purpose framework [until recently, known as an *other comprehensive basis of accounting* (or OCBOA)].

b. *Comparative.* Sureties usually require comparative statements, often covering a three to five year period.

c. *Audited.* Sureties generally insist on receiving audited annual financial statements. As noted above, reviewed statements may be acceptable for interim filings.

If the contractor intends to submit statements that do not conform to these guidelines, the contractor needs to consult with the bonding agent or surety to verify that those financial statements will be acceptable. In some cases, a surety will accept financial statements that do not meet its usual standards; however, it may reduce the size of the bond it is willing to underwrite. Therefore, if the contractor is unable to submit financial statements that conform to the surety's standards, the contractor needs to confirm that the type and size of bond the surety is willing to provide meets the contractor's needs. In times of an economic downturn, sureties may reduce capacity and therefore be more selective. Thus, it will be more important during those periods that the contractor meets the surety's standards. In addition, more than one surety may be used to spread the risk of large projects or large contractors.

In most cases, the basic financial statements do not provide as much detail as the surety needs to completely assess a contractor's financial position. As a result, the surety will usually request that the financial statements also include a variety of supplementary schedules. To the extent information is included in the financial statements or notes to financial statements, it need not be repeated in a supplementary schedule.

Although requirements vary between sureties, the following schedules are generally requested by all sureties:

a. Contract earnings showing income from contracts completed and contracts in progress for the periods included in the statement of income.

b. Completed contracts showing revenues and costs for the periods included in the statement of income.

c. Contracts in progress as of the most recent balance sheet date.

d. Backlog information on uncompleted contracts at the end of the current year. Such information may be presented as a rollforward of the prior year's backlog to the current year's amount or simply be compared to the backlog at the end of the prior year. Additionally, information on signed contracts should be segregated from information on letters of intent, if both types of backlog information are presented.

In addition, the surety may require the contractor to provide additional information including:

a. A detailed list of unallocated indirect costs for the periods included in the statement of income.

b. A detailed list of general and administrative expenses for the periods included in the statement of income.

c. A detailed list (including an aging) of receivables and retainages as of the most recent balance sheet date for both completed jobs and jobs still in process.

d. A detailed list of payables as of the most recent balance sheet date.

e. A list of inventory, including disclosure of:

(1) Inventory on job sites and other inventory.

(2) Basis for valuation.

f. Significant overbilling and underbilling with appropriate explanations.

g. Noncurrent assets, including narrative discussions of collectibility and terms.

h. Schedule of completed contracts showing revenue, costs, gross profit, and gross profit percentage for the previous three to five years.

i. A gross profit gain/fade analysis (an example is included at Exhibit 1-3).

j. Schedule of fixed assets and accumulated depreciation as of the most recent balance sheet date.

Interim Information. Particularly when new bonds are being written or when credit tightens, sureties often request interim (monthly or quarterly) information. Depending on the amount of the bond, the financial strength of the contractor, the period of time since the last audit, and other considerations, the surety may either request:

a. Audited financial statements and other financial information at an interim date. In these cases, the information discussed above about basic financial statements and supplemental schedules should be provided for the interim date and the earlier year-end dates requested by the surety (normally the prior two or three years).

b. Reviewed interim financial statements, in addition to the latest year-end audited information (which will normally be for the prior two or three fiscal years).

Nonfinancial Statement Information. In addition to the information previously discussed, sureties typically request a variety of other nonfinancial information. Although the type and extent of the information requested will

vary depending on such factors as the surety's underwriting standards, the length of the relationship with the contractor, and the size of the contract bond, information provided to the surety often includes the following:

a. Description of the company.

   (1) History.

   (2) Description of related or affiliated companies.

   (3) Description of key projects completed including job descriptions, contract amounts, and dates completed.

   (4) Organizational chart, if meaningful.

b. Business plan including cash flow projections, forecasts of fixed asset purchases and financing needs, and a discussion of how the contractor plans to accomplish the goals of the plan.

c. Succession plan, including resumes of key individuals.

d. Most recent financial budgets.

e. Appraisal of fixed assets and other noncurrent assets.

   (1) If not available, contractors may wish to discuss the need for an appraisal with the surety.

   (2) Some contractors provide current value basis balance sheets and/or statements of income as supplementary schedules.

f. Most recent income tax return of the entity requesting the bond.

g. Articles of Incorporation.

h. Copies of significant agreements, including:

   (1) Leases.

   (2) Stock buy-sell agreements.

   (3) Employment contracts.

   (4) Deferred compensation or other pension plan documents.

   (5) Non-compete agreements.

i. Claims experience, including claims made and amounts collected over a reasonable period of time (such as three years).

j. Description of lawsuits in progress.

k. Insurance coverage, including life insurance on owner(s) and key personnel and copies of surety agreements on any recent projects.

l. Names and addresses of references, such as:

   (1) Bank(s) and bank officer(s).

   (2) Attorney(s).

(3) Insurance agent(s).

(4) Consultant(s).

(5) Engineer(s) and architect(s).

(6) Supplier(s).

(7) Subcontractor(s).

Information about the Owners or Key Employees. Like many closely held businesses, the activities of the owners and key executives are critical to the ongoing success of most construction companies. As a result, sureties generally request information that will help them understand the depth of construction industry experience of the owners and key employees. In certain situations, sureties may also be concerned with the financial stability of the owners, and may request information relating to the owners' personal finances. (A surety company official indicated that in many cases, owners must give personal indemnity for the construction company to obtain surety credit.) Information that sureties may request relating to owners and principals includes:

a. Resumes summarizing the construction industry experience of the owners and key employees. (Include information on key projects completed if not included with those listed in the company description.)

b. Personal financial statements and income tax returns of the owners.

How Accountants Can Help Contractors Secure Bonding

A surety's decision to underwrite a bond is based in large part on a review of a contractor's financial statements. Accordingly, both the contractor's controller and the independent accountant can play important roles in helping the contractor make accounting policy and financial statement presentation decisions that put the contractor's financial position in the best light. This is not to suggest that the practitioner or internal accountant would engage in falsifying accounting records to make a troubled contractor look better. Rather, the role of practitioners and internal accountants ought to be one where they:

a. Assist the contractor in developing systems to produce timely and accurate records.

b. Analyze the financial statements to alert the contractor to transactions or accounting treatments that may not be viewed favorably by the surety.

c. Advise the contractor about the accounting impact of proposed transactions.

While it is obviously important that the surety be presented financial information that is accurate, it is also important that such information be consistent with other financial documents. For example, the financial statement data should be consistent with the data on the contractor's tax returns, bank loans, lines of credit applications, equipment loan applications, etc. Inconsistent data often delays the surety bond application process and may lead to rejection of the application. The practitioner, with the assistance of the contractor's financial officer, ought to ensure that relevant accounting records and reports have been carefully reviewed and compared so that accurate and consistent financial information is presented to the surety.

Developing Systems to Produce Timely and Accurate Records. To a large extent, the process of granting surety bonds is a matter of judgment. Naturally, the financial strength of the contractor has a great deal to do with the decision, but in many cases the underwriter's decision is based, in part, on a *gut feeling* about the ability of the contractor to complete the project. Anything the contractor can do to improve that sense of confidence improves the odds that the underwriter will grant the surety bond. One of the ways to enhance the surety's impression of the contractor's competence is to develop systems that can promptly produce reports and analyses needed by the surety. Therefore, hiring a competent bookkeeper and/or industry accountant and purchasing (and regularly upgrading) a financial reporting system that provides the information that sureties request are necessary investments.

A contractor's independent accountant has an important role in assuring that the surety receives needed financial information in a timely manner. In addition to advising the contractor on ways to improve the internal accounting system, the CPA is also responsible for ensuring that the annual audit is completed promptly. Many contractors rely on the CPA to ensure that the company's financial statements are presented in accordance with GAAP.

Audited financial statements need to be available no later than 90 days after the balance sheet date. The surety may perceive late reporting as an indication of sloppy record keeping, disagreements between the contractor and the independent accountant, or even financial problems. If the financial statements will not be available within 90 days, consider meeting with the surety to explain why.

Analyzing Financial Statements. Analyzing financial statements involves looking at each balance sheet and income statement account from the surety's standpoint. The objective is to identify areas in advance that may catch the surety's attention. The surety is primarily concerned with analyzing the contractor's solvency. As a result, the surety typically identifies assets that he or she does not consider recoverable and subtracts or discounts them from the balance sheet. Some of the financial statement items that often cause concern include:

a. *Receivables from Owners or Affiliates.* Advances by the contractor to its owner(s) and/or affiliated businesses are looked at with disfavor by many sureties. Such advances may indicate that an owner is having financial problems or is using the contractor's resources to fund outside investments. Many sureties assume that these amounts are uncollectible and reduce a contractor's working capital and net worth by the amount of such receivables for purposes of determining the bond amount. Accordingly, such advances should be avoided if possible.

b. *Cash Advances to Employees.* Significant cash advances to employees may also be looked at with disfavor by sureties. Such advances may lead the surety to doubt the contractor's business judgment or be used as evidence that the employees are not paid enough. In some cases, a surety may assume that the advances are not collectible and reduce a contractor's working capital and net worth by the amount of such receivables for purposes of determining the bond amount. Accordingly, such transactions should be avoided if possible.

c. *Short-term Borrowings.* Short-term bank borrowings should, where possible, be collateralized by personal guaranties, cash equivalents, securities, or other assets not subject to the surety lien. Normally contracts in progress, including contract receivables, are subject to the surety lien; however, lien laws vary from state to state. When assets subject to the surety lien are pledged to another lender, an acknowledgement by the bank (or other creditor) of the surety's prior lien on the pledged assets should relieve any concerns the surety may have regarding such liens. Also, the use of long-term assets as collateral for short-term debt will often be perceived by sureties as a financial weakness. If such a transaction has taken place or is planned, a meeting with the surety may mitigate any concerns.

d. *Past Due Receivables.* Sureties are often concerned about the collectibility of receivables from third parties that are over 90 days old. Generally, a surety will assume that such a receivable is uncollectible, and automatically deduct it from working capital without evaluating the actual collectibility of the balance. Accordingly, the best strategy is to aggressively collect all old receivable balances before the end of the fiscal year.

e. *Inventories.* Sureties generally assume inventories that do not relate to specific projects will not be fully convertible into cash and will write off some portion—often 50%—of the account balance. Although contractors should avoid large inventory accumulations, if the balance sheet includes significant nonproject related inventory, meeting with the bonding agent or the surety to explain how the inventory will be used may help mitigate the surety's concerns.

f. *Financial Ratios.* A contractor with deficient financial ratios, particularly working capital and net worth, will generally be unable to obtain or expand surety credit. Accordingly, contractors should strive to maintain healthy financial ratios that indicate their operation is being managed successfully.

g. *Unapproved Change Orders and Claims.* Unapproved change orders or claims are often obstacles to obtaining a bond. If such items are encountered, timely communication between the surety and the contractor may help relieve the surety's concerns.

h. *Significant Overbilling.* Some sureties believe that contractors should avoid significant overbillings of contracts in relation to costs incurred. The surety underwriter is concerned that a contractor may have overbilled a project to obtain cash to finish a previous job that is substantially billed, but is not complete. Such overbilling often means that the contractor is in financial trouble and may be unable to finish the current project. Sureties do not necessarily regard overbillings as a negative, but contractors should be prepared to explain any large overbillings, especially if the contractor's cash balance is less than the overbillings (indicating the overbillings were used to fund other cash needs).

i. *Use of Completed-contract Method.* Some contractors use the completed-contract method on their financial statements because it is acceptable for their tax returns. However, sureties view the use of the completed-contract method with suspicion because it suggests that the contractor is unable to reliably estimate job progress. Unless the contractor meets either of the two conditions of FASB ASC 605-35-25-90 that allow use of the completed-contract method, contractors should use the percentage-of-completion method in any financial statements submitted to sureties. Even so, most sureties and other third-party users of the contractor's financial statements generally require the use of the percentage-of-completion method. Thus, using the completed-contract method for financial reporting is almost always inappropriate.

j. *Changes in the Reporting Entity, Accounting Principles, or Independent Accountants.* Changes in reporting entity or accounting principle are often looked at with skepticism by sureties. One of the ways that sureties analyze financial statements is by developing historical statistics that allow them to identify and follow trends in the contractor's financial information. Therefore, they view any change in reporting entity or accounting principle that affects the comparability of the financial statements with suspicion. In addition, the surety may be concerned that the changes were motivated by a desire to improve earnings by adopting more liberal accounting policies. When a contractor changes independent accountants, the surety is concerned that the change was the result of a dispute, and may indicate a problem with the financial statements. When a contractor is considering any of these changes, the surety should be notified of the change and the reasons for it before the change occurs.

k. *S Corporations.* This form of entity is considered by many sureties as a higher risk than C corporations. The surety often assumes that the owners will draw enough cash out of the corporation to pay the personal income tax liability relating to the company's income. Often the surety will adjust the contractor's income statement by imputing a tax provision based on the maximum corporate tax rate, which is often greater than the actual income tax expense incurred by the shareholders. S corporation contractors will need to provide additional information to their sureties that will allow the surety to determine a more realistic tax provision.

The items described above are often considered by sureties in making bonding decisions. This does not mean all sureties will place equal significance on all of the items listed. Generally, the stronger a contractor is financially, the less significant any individual item will be in a surety's approval process. However, even financially strong contractors should make it a practice to know their sureties and keep them informed.

CPAs can render a valuable service to their construction clients by alerting them to accounts in their balance sheets that might adversely affect an application for a surety bond. This is discussed further below.

Advising on the Effect of Proposed Transactions. The contractor's CPA should usually review any potential transactions to make sure that, if possible, they are accounted for in a way that will have minimal impact on the bonding process. Some areas that can be reviewed include:

a. *Outside Investments.* Sureties are often wary of contractors whose owners have invested in outside enterprises. The sureties are concerned that the investments will cause the owner to divert his or her attention from the contractor's operations. Also, if an outside investment runs into trouble, the owner may try to take money out of the entity to strengthen the other investment. Accordingly, if the owner is considering an investment, especially one where he or she will have a partnership interest (and thus have

unlimited liability), the surety should be contacted in advance to assess the effect the proposed investment will have on the contractor's bonding capacity.

b. *Equipment Acquisitions.* Debt and asset purchases can often have a significant effect on a contractor's ability to obtain bonds because from a bonding standpoint, it may be preferable to lease assets rather than purchase them. Accountants can help contractor clients by assessing the effect of equipment acquisitions on the surety's analysis. For example, paying cash for new equipment could reduce working capital to a level that the surety regards as inadequate. On the other hand, if the contractor borrows money to buy equipment, it could impair the debt-to-equity ratio. The contractor and the CPA should be aware of what the surety considers an adequate financial position. If a proposed equipment purchase is likely to be viewed unfavorably by the surety, the contractor should explore alternatives, such as renting the equipment under the terms of an operating lease.

c. *Year-end Financial Statement Analysis.* Before the end of the contractor's fiscal year, the contractor and the CPA should analyze the interim financial statements and the general ledger to identify any areas that might be of concern to the surety. This exercise can result in two courses of action:

(1) *"Cleaning Up" the Balance Sheet.* If identified in time, a situation that could be potentially troubling to a surety can often be remedied. For example, if the year-end analysis identifies officer receivables, the contractor may be able to collect these amounts before the end of the year to prevent the surety from deducting officer receivables from working capital. The year-end analysis might also reveal that the contractor has a large loan maturing in the next fiscal year. If steps are not taken before the end of the year to roll the loan over into another long-term note, it will be classified as a current liability and could affect the contractor's bonding capacity.

(2) *Alerting the Surety about Possible Problems.* In some cases the year-end financial statement analysis will reveal items that cannot be as easily remedied as the items previously described. Some examples include contracts in a loss position or with significant collection problems. In those situations, the best course of action is to meet with the bonding agent and the surety to alert them of the potential problem. Discussing known problems in advance and describing in detail how the contractor intends to resolve them, demonstrates to the surety the contractor's willingness to avoid surprises. It also demonstrates that management was aware of problems before the books were closed at the end of the year.

Options Available to Sureties When Contractors Do Not Fulfill Their Obligations under the Contract

Construction is a risky business and a significant number of contractors and subcontractors fail to perform their contract obligations because of business-related issues, such as severe cash flow problems that lead to bankruptcy. Practitioners and industry accountants can provide an important service to their contractor client by working with the surety, who is required to fulfill its guarantee of project completion provided in the performance bond. The surety normally fulfills its guarantee to the owner using one of the following options:

- *Finance Option.* The surety provides financing for the contractor to complete the project.
- *Takeover Option.* The surety takes over the project and completes it by selecting a replacement contractor.
- *Tender Option.* The surety selects a replacement contractor, but does not take over the project. The surety then pays the owner the difference between the bonded contract balance and the new contract.
- *Settlement Option.* The surety does not complete the contract or select a replacement contractor, but instead negotiates a cash settlement with the owner.

To help the practitioner understand the surety's decision-making process, the following paragraphs discuss the advantages and disadvantages *to the surety* for each of these options.

Advantages and Disadvantages of the Finance Option. The advantages of the financing option to the surety include:

- *Cost Benefit.* Financing the completion of the project rather than employing a new contractor is usually more cost effective for the surety. Replacement contractors often build in large contingencies for unknowns such as corrective work or increased warranty expense. In addition, the replacement contractor would incur added costs to become familiar with the project and mobilize workers and tools, while the bonded contractor's work force and tools are normally still on site. Finally, expenses increase from delays while the surety selects a replacement contractor.

- *Contractor Remains in Business.* If the contractor goes out of business, the surety looses a customer. The surety may strengthen its ability to recover potential losses from this financing by obtaining collateral for advances from either the contractor or other guarantors.

- *Completion by Original Contractor.* The owner may prefer that the original contractor complete the contract.

The disadvantages to the surety of contractor financing include the following:

- *Risk of Additional Loss.* The surety may increase its losses by financing a failing contractor.

- *Other Professional Costs.* The surety may need to hire outside professionals with expertise in financial, legal, and engineering matters to draft the financing agreement, oversee the completion of the project, and ensure that the funds provided by the surety are used for completing the project.

- *Tax Ramifications.* The IRS may hold the surety liable for unpaid withholding taxes if the surety provides direct payroll financing.

Advantages and Disadvantages of the Takeover Option. This option provides the surety the ability to control its losses, depending on the type and terms of the contract with the replacement contractor. The surety may also require the replacement contractor to obtain a performance bond for protection against further loss.

The disadvantages of the takeover option to the surety include:

- *Commitment to the Owner.* If the surety cannot find an acceptable replacement contractor, the surety will retain risk.

- *Cost.* The cost for a replacement contractor to complete a project is usually more than the original contractor because of the time and effort required for the replacement contractor to become familiar with the project and to bring in the necessary equipment and workers. Also, legal costs may be higher due to the negotiation and preparation of new contracts and related documents.

- *Collection of Contract Funds.* The surety will have to bill and collect contract funds from the owner as they are earned.

Advantages and Disadvantages of the Tender Option. This option provides the surety the following advantages:

- *Time and Cost.* The tender option normally requires less time and is less costly than the financing or takeover options for the surety because consulting costs may be eliminated or significantly reduced, project monitoring will not be necessary, and legal fees are usually lower.

- *Owner Management of Project.* The owner continues overseeing the project and eliminates the surety's involvement.

The primary disadvantage of the tender option is the potential resistance by the owner to complete new bonds and contracts. This is often true of federal, state, or local governments. In addition, governmental policies may require the takeover option.

Advantages and Disadvantages of the Settlement Option. This option provides the surety the following advantages:

- *No Risk of Additional Loss.* The surety buys back its bond through a settlement with the owner and the loss is determined with the settlement, which releases the surety from any additional exposure.
- *Reduced Legal Fees.* The primary legal service required is the preparation of a release and assignment agreement.

The disadvantage to the surety of the settlement option is the cost of the settlement. The surety may need to incur professional costs to determine a reasonable settlement offer, and the negotiated settlement with the owner may be significant.

Other Surety Considerations When Contractors Are Unable to Fulfill Contract Obligations

Surety Analysis. When the contractor fails to meet its obligation, the surety must assess the project status and the contractor's current needs to complete the project. The surety should gather financial and other information to choose the appropriate option (discussed previously). Often, the information must be gathered quickly to avoid subcontractors walking off the job and failing to meet contractual deadlines that may cause additional damages. Practitioners and/or industry accountants are often requested to provide current financial and operational data to the surety, including one or more of the following:

- Status of creditors (for example, perfected or unperfected).
- Status of income taxes, including current returns, audits, or other examinations.
- Accounts receivable and accounts payable by project.
- Estimated costs to complete the project.
- Estimated cash payments through the project completion date for overhead, including debt principal payments, that are not included in the estimated costs to complete the project.
- Details of any contingent liabilities.
- Details of any claims made against the owner.
- The contractor's updated business plan.
- A proposed repayment plan if the surety incurs a loss related to the contractor.
- Current personal financial statements of the owners or officers of the contractor.

Contract Considerations. As the surety reviews the contract documents, many issues are considered, including the type of project; the quality of work; contractual deadlines; estimated costs to complete the project using the existing contractor versus a replacement contractor; projected cash surplus or deficit per job; the current relationship with the project owner, subcontractors, and suppliers; and the probability of incurring liquidated damages, back charges, and other similar costs.

Business Considerations. When evaluating operational information, the surety's primary considerations are the integrity of management and the quality of the contractor's operations. The surety will also evaluate the current financial data discussed in the "Surety Analysis" paragraph above.

Providing Services When Contractors Do Not Fulfill Contract Obligations

Services Available to Contractors. Practitioners and industry accountants may provide services to struggling contractors such as cash flow planning; cash flow projections to pay back surety workout funds; backlog

profitability; or a revised business plan with cash flow projections, explanation and analysis of current circumstances, and a discussion of how the contractor plans to accomplish the goals of the plan. (Performing nonattest services for an attest client could impair the practitioner's independence in regard to attest services).

Providing Services to Sureties for Nonclient Contractors. Practitioners may provide services to sureties for nonclient contractors. Potential services include analyzing the contractor's cash needs, reviewing estimates and costs to complete, providing a financial team to manage an orderly shutdown of the business, and offering disbursement control (depending on state licensing requirements) on projects that the contractor will complete to ensure payment of contracts costs (i.e. labor, materials, and overhead). The practitioner can also provide the surety assistance in analyzing the options discussed previously (finance, takeover, tender, and settlement).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. What service do bonding agents provide to contractors?

    a. They provide knowledge to contractors about construction issues.

    b. They provide business referrals.

    c. They provide substantial financial information.

    d. They are middlemen between contractors and surety companies.

7. A surety would be more likely to award a bond to which of the following contractors based on the financial information provided?

    a. Blake Construction uses the completed-contract method on its tax return and its financial statements.

    b. Milton & Sons Contracting rewards its employees with cash advances at the conclusion of jobs.

    c. Gonzales Construction Services has receivables from third parties that are 20 days old.

    d. Smith General Contracting paid an advance to Dawson Smith, its owner.

8. What is an advantage of a surety using the finance option?

    a. It is more cost effective than other options.

    b. The contractor will declare bankruptcy.

    c. A new contractor is selected to complete the job.

    d. The surety will be subject to less risk.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. What service do bonding agents provide to contractors? **(Page 18)**

    a. They provide knowledge to contractors about construction issues. [This answer is incorrect. One reason contractors should maintain a close relationship with bonding agents is to increase the agent's confidence in the business ability and construction knowledge of both the contractor and the CPA. If the bonding agent has confidence in the skills of the contractor, the agent is more likely to accept explanations during periods when financial results are not as good as usual. However, the contractor should already have the construction knowledge; the bonding agent would not provide it.]

    b. They provide business referrals. [This answer is incorrect. Many CPAs try to meet periodically with the bonding agents of their contractor clients. These meetings help the practitioner understand the surety's requirements for financial information. Although the CPA's primary objective in meeting with the bonding agent is to help his or her contractor client, such meetings may also periodically result in the practitioner receiving business referrals from the bonding agent. Therefore, while referrals may be provided, they are more likely to be provided to the CPA than the contractor. Also, this is not the primary service bonding agents provide.]

    c. They provide substantial financial information. [This answer is incorrect. Sureties generally insist on *receiving* a great deal of financial information from their contractor clients—both financial and nonfinancial. They do not provide that information.]

    d. They are middlemen between contractors and surety companies. [This answer is correct. Typically, a contractor obtains a contract bond by working with a bonding agent, who often represents several surety companies. Bonding agents serve as middlemen between the contractors and the surety companies. As intermediaries, they are in the best position to advise the contractor about the availability of surety bonds.]

7. A surety would be more likely to award a bond to which of the following contractors based on the financial information provided? **(Page 23)**

    a. Blake Construction uses the completed-contract method on its tax return and its financial statements. [This answer is incorrect. Some contractors, like Blake Construction, use the completed-contract method on their financial statements because it is acceptable on their tax returns. However, sureties view the use of the completed-contract method with suspicion because it suggests that the contractor is unable to reliably estimate job progress. Also, many sureties and other third-party users of the contractor's financial statements generally require the use of the percentage-of-completion method. Therefore, since Blake uses the completed-contract method, the surety will not find this favorable and would be more likely to award a bond to one of the other contractors in this list.]

    b. Milton & Sons Contracting rewards its employees with cash advances at the conclusion of jobs. [This answer is incorrect. Significant cash advances to employees may be looked at with disfavor by sureties. Such advances may lead the surety to doubt the contractor's business judgment or be used as evidence that the employees are not paid enough. In some cases, a surety may assume that the advances are not collectible and reduce a contractor's working capital and net worth by the amount of such receivables for purposes of determining the bond amount. Therefore, because of these cash advances, Milton & Sons Contracting is less likely to receive a bond from the surety than one of the others.]

    c. Gonzales Construction Services has receivables from third parties that are 20 days old. [This answer is correct. Sureties are often concerned about the collectability of receivables from third parties that are over *90 days old.* Generally, a surety will assume that such a receivable is uncollectible, and automatically deduct it from working capital without evaluating the actual collectability of the balance. However, receivables of only 20 days old are not yet uncollectible;

therefore, assuming there are no other red flags in its financial statements, the surety is more likely to award a bond to Gonzales Construction Services than any of the other contractors described here.]

d. Smith General Contracting paid an advance to Dawson Smith, its owner. [This answer is incorrect. Advances by the contractor to its owner(s) and/or affiliated businesses are looked at with disfavor by many sureties. Such advances may indicate that an owner is having financial problems or is using the contractor's resources to fund outside investments. Many sureties assume that these amounts are uncollectible and reduce a contractor's working capital and net worth by the amount of such receivables for purposes of determining the bond amount. Therefore, if choosing between these four contractors, a surety would be less likely to pick Smith General Contracting under these circumstances.]

8. What is an advantage of a surety using the finance option? **(Page 26)**

a. It is more cost effective than other options. [This answer is correct. One of the advantages a surety gets from using the finance option is better cost benefit. Financing the completion of the project rather than employing a new contractor is usually more cost effective for the surety. Replacement contractors often build in large contingencies for unknowns such as corrective work or increased warranty expense. In addition, the replacement contractor would incur added costs to become familiar with the project and mobilize workers and tools, while the bonded contractor's work force and tools are normally still on site. Finally, expenses increase from delays while the surety selects a replacement contractor.]

b. The contractor will declare bankruptcy. [This answer is incorrect. One advantage of using the finance option is that the contractor will remain in business. If the contractor goes out of business, the surety losses a customer. The surety may strengthen its ability to recover potential losses from this financing by obtaining collateral for advances from either the contractor or other guarantors.]

c. A new contractor is selected to complete the job. [This answer is incorrect. While this happens when certain options are used, one advantage of using the finance option is that the original contractor will be able to complete the job. This may be preferred by the owner.]

d. The surety will be subject to less risk. [This answer is incorrect. One of the disadvantages of using the finance option is that the surety may *increase* its losses by financing a failed contractor.]

Lesson 2: Audit Programs and Procedures, and Concluding the Audit

INTRODUCTION

This lesson explains audit procedures (especially those unique to construction contractors), wrap-up procedures performed at the completion of the audit, and reporting considerations unique to construction contractor audits.

This lesson covers the following topics:

a. *Detailed Audit Plans—Organization and Structure.* An explanation of the arrangement and relationships of the audit programs and their general format.

b. *Contract Billing and Cost-related Accounts.* A detailed explanation of the audit objectives and procedures for the transaction classes and account balances related to contract revenues and expenses.

c. *Job Site Visits.* An explanation of the objectives of site visits and recommendations on how to decide the number of sites and the particular ones to visit.

d. *Audit Wrap-up Procedures.* An explanation of those procedures undertaken at the completion of the audit with particular emphasis on matters unique to construction contracting.

e. *Client Communications.* Explanation of required client communications in connection with an audit of financial statements.

f. *Audit Workpapers and Related Documentation.* An explanation of the purposes and requirements of workpapers necessary to comply with professional standards in a contractor engagement.

g. *Audit Reports.* An explanation of audit reporting considerations unique to construction contracting.

h. *Audits of Group Financial Statements.* An explanation of when the requirements related to audits of group financial statements (group audits) would be likely to apply in the audit of the financial statements of a construction contractor.

i. *Supplementary Information.* An explanation of the audit approach and procedures and reporting considerations when the auditor is engaged to report on schedules, such as those for bonding agencies, that contractors often include as additional information with audited financial statements.

j. *Use of Internal Audit.* An explanation of aspects of using an internal audit function particularly applicable to construction contracting.

This lesson uses certain audit information from *PPC's Guide to Audits of Nonpublic Companies* and tailors it specifically to address the unique problems, circumstances, and audit approaches common to construction contractors. CPE courses do not include practice aids, but checklists, letters, and audit programs tailored to fit contractor engagements can be found in *PPC's Guide to Construction Contractors*. Guidance found in *PPC's Guide to Construction Contractors* and in *PPC's Guide to Audits of Nonpublic Companies* complements and amplifies the information covered within the scope of this course.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the appropriate organization and structure for a detailed audit plan for the audit of a construction contractor.
- Assess issues related to contract billings and cost-related accounts that might be discovered during the audit of a construction contractor and how the auditor should approach job site visits.

- Identify appropriate audit wrap-up procedures for a construction contractor audit engagement.
- Identify communications that may need to be made when auditing a construction contractor.
- Determine the best methods for dealing with audit workpapers and related documentation, drafting the financial statements and auditor's report, group financial statement audits, supplementary information, and internal auditors.

THE ORGANIZATION AND STRUCTURE OF DETAILED AUDIT PLANS

AU-C 300, *Planning an Audit*, at AU-C 300.09, indicates that the auditor should develop an audit plan that includes a description of (a) the nature and extent of planned risk assessment procedures, (b) the nature, timing, and extent of planned further procedures at the relevant assertion level, and (c) other planned procedures that are required to be carried out so that the engagement complies with GAAS. The audit plan is more detailed than the audit strategy and includes a detailed description of audit procedures to be performed by engagement team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

As part of developing the overall audit strategy, the auditor will ordinarily have identified material job sites or locations (or components), account balances, and audit areas where there may be higher risks of material misstatement. Once the audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The audit plan is commonly referred to as the audit program.

Determining the Audit Approach

The purpose of the risk assessment is to determine the nature, timing, and extent of further audit procedures to be performed. The auditor identifies risks (including risks of material misstatement due to fraud), considers management's response to those risks through operating decisions and controls, and assesses the risk of material misstatement at the relevant assertion level. Based on that risk assessment, the auditor determines what audit procedures need to be performed. For simplicity in the discussions throughout this lesson the overall decision of which further audit procedures will be performed is referred to as the selection of an audit "approach." The approach selected by the auditor to respond to the risk assessment should be documented, and it is a decision about whether to—

- perform only limited procedures and not develop a separate audit program,
- perform basic procedures from the core audit programs,
- perform basic procedures plus certain extended procedures from the core audit programs, or
- perform procedures from the specified risk audit programs.

Prepared audit programs, such as those included in *PPC's Guide to Construction Contractors*, can be a starting point for developing an audit program. Auditors often tailor the majority of the PPC audit programs for individual financial statement audit areas to respond to their client's specific risks and circumstances.

Limited Procedures Approach. The auditor first considers whether the preliminary analytical procedures and other risk assessment procedures performed during initial planning and the final analytical procedures performed in the overall review stage of the audit provide enough assurance that no further audit procedures are considered necessary. In other words, no separate specific audit program is needed because the procedures for performing preliminary analytics, other risk assessment procedures, and final analytics are included in the general programs. That approach is referred to as the Limited Procedures Approach and will generally be appropriate only for audit areas (or assertions) that are not significant and have a low combined risk of material misstatement. For audit areas that are not significant but have a risk of material misstatement other than low or require audit attention for other reasons such as client or third-party user expectations, ordinarily an audit program is needed. In addition, for significant audit areas, the auditor is required to perform some substantive procedures for each relevant assertion; therefore, an audit program is always needed for those areas.

Choosing between Core Audit Programs and Specified Risk Audit Programs. The next decision to be made by the auditor is whether to use the core audit programs or the specified risk audit programs for a particular audit area. Prepared audit programs, such as those in *PPC's Guide to Construction Contractors*, provide a starting point for the auditor to use in developing an audit response and determining the nature, timing, and extent of further audit procedures to be performed to respond to the risk assessment. Such audit programs can be easily tailored to respond to the individual risk assessment. The individual audit programs document audit procedures and the assertions relevant to each procedure and provide linkage to the assessed risk of material misstatement. The assessment of the risk of material misstatement by assertion assists the auditor when deciding on an appropriate audit response by providing linkage between the risks and related audit program procedures.

When deciding which approach is appropriate, it is important for the auditor to perform a careful review of the procedures in each program to ensure that the approach and the further audit procedures selected will appropriately respond to the assessed risk for his or her client. The key to audit effectiveness and efficiency is to choose an audit approach that adequately responds to the identified risks without requiring excessive time commitments.

Basic and Extended Approaches (Core). The PPC core audit programs, which are included in *PPC's Guide to Construction Contractors*, include both general audit programs and audit programs for specific financial statement audit areas. To assist auditors in tailoring their audit procedures to appropriately respond to the risk assessment, the core audit programs for individual audit areas include the following sections:

- *Basic Procedures*, which include primarily substantive analytical procedures and certain tests of details, most of which are required by GAAS (such as confirmation of receivables, inventory observation, and tests to address the risk of improper revenue recognition).

- *Extended Procedures (Procedures for Additional Assurance)*, which include procedures from which the auditor can choose one or more steps as necessary to supplement the basic procedures in response to the auditor's risk assessment at the relevant assertion level.

- *Other Audit Procedures*, which include procedures that may be warranted due to the specific circumstances of the engagement. (Other audit procedures are considered Extended Procedures when completing the "Risk Assessment Summary Form" and the "Contract Risk Assessment Summary Form.")

Auditors using the core audit programs decide whether to apply basic or basic plus extended procedures based on the risk assessment at the relevant assertion level. However, the analysis is not a simple determination based on whether that risk is high, moderate, or low. Usually, a low or moderate risk of material misstatement in a significant audit area means that a Basic Procedures approach is appropriate for those assertions. However, the auditor also has to consider the expected cause and direction of potential misstatements, the relationships among audit areas, and whether the risks are fraud risks or other significant risks, as well as client or third-party user expectations.

As previously stated, the Basic Procedures section of the core audit programs contains certain tests of details, many of which are required by the auditing standards (such as confirmation of receivables, inventory observation, and tests to address the risk of improper revenue recognition). If applicable, the auditor performs those procedures. The performance of those procedures may also be a response to a higher assessed level of risk for the related assertions. In other words, those procedures may provide additional assurance even though they are included in the Basic Procedures section rather than in the Extended Procedures section.

The Extended Procedures section of the core audit programs, which includes procedures for additional assurance, is a source list of possible audit procedures. It is not an alternative audit program. It is arranged by topic and includes a column indicating the assertions that are primarily and secondarily addressed by the procedure. The particular tests selected are tailored to the nature, cause, and direction of potential misstatements at the relevant assertion level. The selection of extended additional assurance procedures needed to address a particular risk is a matter of auditor judgment. Particularly in performing audit procedures for construction contracts, if the auditor has a higher level of assessed risk and wants to perform extended procedures, he or she may want to consider extending the level of detail testing performed in the Basic Procedures section of the audit program.

Specified Risk Approach. The specified risk set of audit programs is based on a set of underlying risk assumptions at the assertion level for most audit areas. The programs include substantive procedures for general ledger

account groupings common to many small, nonpublic contractors. These programs are designed to increase audit efficiency by linking the financial statement assertions, risk assumptions, and procedures to identify those procedures that are common to many small, nonpublic contractor audit engagements.

At the front of each specified risk audit program is a description of the underlying risk assumptions for that audit area. Before selecting the specified risk approach and using the related programs, auditors ought to perform a careful review of the underlying risk assumptions and the procedures in each program to ensure that the further audit procedures selected appropriately respond to the assessed risk for a particular client. The description of underlying risk assumptions is not intended to be part of the audit documentation. The risk assessment for a particular client and the assessed risks on individual construction contracts should be documented.

The procedures provided in the specified risk audit programs are intended to apply to small nonpublic general contractors or engagements that have the following general characteristics:

- The auditor does not intend to rely on the operating effectiveness of controls to reduce the control risk assessment. Substantive procedures alone are effective in responding to the risk assessment.
- Accounting personnel are generally competent to process data and make decisions necessary to perform their assigned duties.
- No fraud risks are identified except the risks of improper revenue recognition and management override of controls. The risk of management override of controls is addressed in the general audit program.
- There are no known significant deficiencies or material weaknesses in the control environment that would require modification of the programs.
- Audit procedures are either performed entirely at year end or are applied to transactions through an interim date and completed as part of year-end procedures (that is, audit conclusions are not extended from an interim date to the balance sheet date).

If the general characteristics in the previous paragraph do not apply to the particular engagement, auditors need to consider whether it is appropriate to use the specified risk approach or whether the basic or extended procedures approach using the core audit programs ought to be used. If the risk assessment for a particular audit area or assertion differs from the assumed underlying risk assumptions, the auditor ought to consider the need to modify the audit program for that audit area or assertion to adequately respond to the risk assessment. If additional procedures are needed, they can be selected from the core audit programs. In some cases, it may be possible to adequately respond to a particular risk assessment by altering the extent of procedures in the specified risk audit program rather than selecting additional procedures.

Documenting the Response. The approach the auditor has selected should be documented. The auditor may also want to include comments that might be appropriate concerning the audit program, including the linkage between risks and responses. Comments might include:

- Information that clarifies how the audit programs/procedures have been tailored to respond to the risk assessment.
- Information about the nature, timing, or extent of further audit procedures in response to identified risks.
- Descriptions of the procedures that will be performed to specifically respond to fraud risks or other significant risks.
- Whether certain tests of details (included in the basic audit plan) will be performed to respond to an identified risk.
- A cross-reference to where tests of controls are performed and documented in the workpapers.

Determining the Audit Approach for Contracts. After a contract risk score has been assigned to each significant contract, the auditor makes an initial decision on the audit approach that is appropriate for each contract. The initial

decision is whether the preliminary analytical procedures and the final analytical procedures to be performed in the overall review stage of the audit provide enough assurance that no additional audit procedures are considered necessary. This will generally be the case for contracts that are not significant and that have a low contract risk score. This audit approach falls within the Limited Procedures Approach discussed previously.

For significant contracts that have a moderate or high contract risk score, the auditor decides whether the Basic Procedures Approach or the Extended Procedures Approach is appropriate for each contract.

The Basic Procedures section of the audit program provides substantive analytical procedures (including inquiry and scanning) and some limited tests of details. The auditor decides whether this approach is sufficient based on the contract risk score. A moderate contract risk score normally necessitates this audit approach, while a contract risk score of high normally necessitates use of the Extended Procedures section of the audit program.

The auditor may also want to perform tests of details tailored to the nature, cause, and direction of contract risks. The risks associated with each contract are used as a basis for determining the appropriate procedures to be performed.

The procedures that are considered necessary for each high-risk contract should be documented. For example, the risks associated with Contract 1 that were not mitigated by other factors may only relate to direct payroll costs, and applicable comments can be made to document this fact. If more than one contract is assigned a contract risk score of high, this documentation will be important to clearly distinguish the procedures that will be performed for each contract.

Finally, two or more auditors may need to sign off on program steps if more than one individual performs extensive contract audit procedures. For example, Auditor A and Auditor B, both members of the same engagement team, may be responsible for testing three contracts each. Auditor A is assigned Contracts 1, 2, and 3; Auditor B is assigned Contracts 7, 8, and 9. If the same extensive audit procedure is required for Contracts 1 and 7, each auditor signs off that step to indicate performance of that step.

Organization of Audit Programs

Audit programs are usually organized using either a cycle approach or a financial statement (balance sheet) category approach. For a construction contractor, neither a strict balance sheet nor a total cycle approach is appropriate. For many of a contractor's account balances, the traditional balance sheet approach is efficient and effective. However, contract-related transaction classes and balances are different. A mixed approach is needed that treats the contract-related area as a separate cycle or grouping of accounts and recognizes the distinct characteristics of a construction contractor and the highly integrated nature of the accounts. A mixture of tests of controls and substantive procedures is used for contract-related accounts, which needs a hybrid audit program organization.

Types of Substantive Procedures and Audit Strategies

Limited, Basic, and Extended Approaches. Some procedures are more effective than others, and some are more time-consuming than others. The key to audit efficiency and effectiveness is to choose an audit approach that adequately responds to the assessed risks without requiring excessive time commitments. In the core audit programs, substantive procedures are grouped into the following categories based on the degree of detail involved:

- Limited procedures (preliminary analytical procedures, other risk assessment procedures, and final analytical procedures).
- Basic procedures.
- Extended procedures (procedures for additional assurance) and other audit procedures.

Exhibit 2-1 shows how the traditional substantive audit procedures fit into these audit approaches. Note that some procedures may fit more than one approach depending on how they are applied. For example, analytical

procedures, which may be used to test any financial statement assertion, might be applied in any type of audit approach. On the other hand, reperformance, which is used primarily to test valuation or allocation but may be used to test existence, occurrence, or completeness, is generally used only as a procedure for additional assurance. The following paragraphs discuss the types of procedures used in each audit approach.

Exhibit 2-1

Relationship of Substantive Audit Procedures to Audit Approach

	Related Assertions[a]		Audit Approach[b]		
Procedure	**Primary**	**Secondary**	**Limited Procedures**	**Basic Procedures**	**Extended Procedures**
Inquiry	All assertions[c]		✓	✓	✓
Analytical procedures	All assertions		✓	✓	✓
Observation[d]	All assertions			✓	✓
Inspection of tangible assets	E/O	A/CL, V, R/O		✓	✓
Confirmation[e]	E/O, R/O	C, A/CL, V, CO		✓	✓
Inspection of documents	All assertions			✓	✓
Reperformance and recalculation	A/CL, V, CO	E/O, C			✓

Notes:

[a] E/O—existence or occurrence; C—completeness; R/O—rights or obligations; A/CL—accuracy or classification; V—valuation or allocation; CO—cutoff.

[b] Some procedures fit more than one category depending on how they are applied.

[c] Inquiry may need to be supported by more evidence. However, it is usually more efficient to corroborate responses to inquiries than to find answers independently through an undirected examination of detailed evidence.

[d] According to AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, unless it is impracticable, the auditor should make or observe physical counts. This course suggests that immateriality of inventory balances is the only reason not to observe or make physical counts of inventory. If inventory is not observed due to immateriality, it is a best practice for auditors to document that conclusion.

[e] AU-C 330.20 and AU-C 505.03, *External Confirmations*, indicate that the auditor is required to use external confirmation procedures for accounts receivable unless certain specified conditions are met. Thus, there is a presumption that the auditor will request confirmation of accounts receivable during the audit unless certain conditions exist. If accounts receivable are not confirmed, the auditor is required to document how he or she overcame that presumption.

* * *

Limited Procedures (Preliminary Analytical, Other Risk Assessment Procedures, and Final Analytical Procedures). Limited procedures consist of performing preliminary analytics, other risk assessment procedures, and final analytics only. These procedures are included in the general audit programs and need to be performed on every engagement. Preliminary analytical procedures are normally simple analytical procedures, such as comparison of current and prior-year balances on the working trial balance or lead schedule. Limited procedures may also include inquiries of client personnel or other procedures to determine explanations for differences, as well as the risk assessment procedures applied to obtain an understanding of the client's business and fraud risks, management's response to those risks, and their effect on the audit. In the overall review stage of the audit, similar analytical procedures are applied to the audited financial statement amounts. The auditor's planned audit approach for each audit area or assertion and each significant contract should be documented. The Limited Procedures Approach is normally sufficient for areas in which audit risk is low, such as asset accounts with immaterial balances. The Limited Procedures Approach may also be appropriate for individual contracts that are assigned a low contract risk score. However, AU-C 330.18 states that auditors should design and perform substantive procedures for all *relevant* assertions related to each *material* class of transactions, account balance, and disclosure. As a result, the limited procedures approach is not appropriate for material or otherwise significant audit areas.

Basic Procedures. The basic procedures section of the audit programs includes primarily substantive analytical procedures and certain tests of details, most of which are required by GAAS. Analytical procedures include more than just comparisons of recorded amounts to financial and nonfinancial information. Similarly, the basic procedures include such tasks as the following:

- Scanning accounting records to identify unusual relationships or the absence of expected relationships.
- Inquiring of the client about relevant audit matters.
- Observing certain assets or client practices.
- Performing certain inspections of client documentation or other limited detail tests.

The basic procedures are generally sufficient when the risk of material misstatement has been assessed as low or moderate. Often, these procedures are supplemented in higher risk areas by extended procedures (procedures for additional assurance). These procedures also apply to individual contracts that have been assigned a contract risk score of low or moderate. That is, analytical procedures are often performed on those contracts, supplemented by procedures for additional assurance based on the identified risk of each contract. Basic procedures by themselves are not ordinarily appropriate to respond to a fraud risk or other significant risk. However, the following are examples of areas where basic procedures may be appropriate to respond to high risks:

- *Observation of Inventory.* Observing inventory, which is a basic procedure in the audit program for inventory, may be an appropriate response to high risks related to the existence of inventory.
- *Confirmation of Receivables.* Confirming receivables, which is a basic procedure in the audit program for accounts receivable, may be an appropriate response to high risks related to the existence of receivables.
- *Search for Unrecorded Liabilities.* A search for unrecorded liabilities, which is a basic procedure in the audit program for accounts payable and other liabilities, may be an appropriate response to high risks related to the completeness of liabilities.

In those cases, the auditor needs to carefully consider the extent and timing of the basic procedures when responding to the higher risk.

Analytical procedures have been described as a natural extension of the process of understanding the client's business. Substantive analytical procedures are a focused way of translating this understanding into reasonable assurance that a particular account balance is not materially misstated. Exhibit 2-2 provides factors that affect the expected effectiveness of an analytical procedure.

Exhibit 2-2

Factors Affecting the Expected Effectiveness of an Analytical Procedure

- *Nature of the Account.* (Income statement accounts are generally more favorable to the use of analytical procedures as substantive tests than are balance sheet accounts. Also, substantive analytical procedures generally are more effective for accounts that have a large volume of transactions that are predictable over time.)

- *Nature of the Assertion Being Tested.* (Analytical procedures can be more effective than tests of details for testing the completeness assertion.)

- *Likely Cause of Potential Misstatement.* (Analytical procedures tend to be more effective when the risk of misstatement is assessed as being primarily from error rather than from fraud.)

- *Degree of Relationship among the Data to Which the Analytical Procedure Is Applied*. (Analytical procedures are generally more effective when there is a close relationship between the account and the data used to predict the balance. For example, labor costs on a job should be closely associated with the number of workers assigned to that job.)

- *The Stability of the Client Environment.* (Analytical procedures are generally more effective in a stable environment.)

- *Existence of Offsetting Factors*. (Analytical procedures are generally more effective when offsetting factors that affect the amount being tested are taken into consideration. For example, an extrapolation of historical results is more effective when current changes in normal seasonal patterns are taken into consideration, such as an unusually mild winter.)

- *The Source and Reliability of Data Used in the Test.* (Examples of reliable data include internal financial information from comparable prior periods, budgets, extrapolations from interim or annual data, or data developed under a reliable system with adequate controls; internal nonfinancial or operating data from sources independent of those responsible for the amount being audited; and external industry statistics or comparable company data.)

- *The Level of Aggregation of Information Used to Develop the Expectation.* (For instance, a more effective test generally results from the use of monthly rather than annual data, or data by department or project manager rather than company-wide data.)

* * *

Extended Procedures (Procedures for Additional Assurance). By selecting the Extended Procedures approach, the auditor is stating that he or she will perform the basic procedures plus selected extended procedures (procedures for additional assurance) or other audit procedures. Extended procedures consist primarily of the following types of substantive procedures:

- *Tests of Details.* These are procedures, such as vouching, tracing, or confirmation, that are applied to individual transactions or balances.

- *Analytical Procedures.* These analytical procedures are similar to those discussed earlier related to limited procedures. However, they are performed at a higher level of precision. For example, they are typically performed at a very detailed (disaggregated) level.

These procedures generally provide a higher degree of audit assurance, so one or more extended procedures are normally selected to supplement the basic procedures when responding to a higher-risk area or assertion.

Specified Risk Approach. The specified risk programs have been developed from the basic and extended procedures in the core audit programs. (All procedures in the specified risk programs are also in the core audit

programs.) Generally, the audit procedures in the specified risk programs are more focused on substantive tests of details versus substantive analytics. The programs have been developed based on a predefined set of risk assumptions and include procedures that may be typical in a small, nonpublic construction contractor engagement.

Other Audit Program Considerations

Can the Auditor Use a Combination of Core Audit Programs and Specified Risk Audit Programs? The answer is "Yes." There may be circumstances where the auditor decides to use a combination of core audit programs and specified risk audit programs for different audit areas. For example, assume the auditor has performed the risk assessment, performed a thorough review of the assumptions and procedures in the specified risk audit programs, and decided that the specified risk approach appropriately responds to the risk assessment for the client in all audit areas except Accounts Receivable (A/R). In that case, the auditor could use the specified risk programs for all of the audit areas except A/R. For A/R, the auditor would develop the audit program for receivables from the core audit programs and indicate on the risk assessment summary form that either a basic or extended procedures approach was selected for A/R.

PPC's *SMART Practice Aids*. Another set of audit programs for situations in which the circumstances of the engagement matches predefined characteristics is included in PPC's *SMART Practice Aids* by selecting the "SMART Start" functionality. This functionality provides the option of beginning the audit with a set of practice aids and audit programs that are pretailored for a small nonpublic general contractor who performs limited subcontracting work.

Initial Audit Programs. Initial audit programs, such as those included in *PPC's Guide to Construction Contractors*, should include additional procedures necessary in an initial audit engagement. All of the procedures in initial audit programs would typically be extensions of the procedures in the core audit programs and the specified risk audit programs and generally are performed in conjunction with those procedures. The initial audit programs should include both general audit programs and audit programs for individual financial statement audit areas. The initial audit programs for individual audit areas should include procedures relating to review of a predecessor auditor's workpapers and certain other procedures. Tailoring of the initial audit programs is generally related to whether information from a review of the predecessor auditor's workpapers will or will not be used as evidence for opening balances.

Documentation Requirements

AU-C 330.30 requires the auditor to document the following related to preparing the detailed audit plan:

- Overall responses to the assessed risks of material misstatement at the financial statement level.
- Nature, timing, and extent of further audit procedures performed.
- Linkage of the procedures performed with the assessed risks at the relevant assertion level.
- Results of the audit procedures performed, including conclusions that are not otherwise clear.

As previously noted, AU-C 300.09 states that the audit plan should include the following:

- A description of the nature and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement.
- A description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level for each material class of transactions, account balance, and disclosure.

- A description of other audit procedures planned to be carried out for the engagement to comply with generally accepted auditing standards (for example, seeking direct communication with the entity's lawyers).

Planning continues during the course of the audit and risk assessment procedures may cause a change in planned specific further audit procedures. AU-C 300.10 notes that the auditor should document changes to the original audit plan.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. If preliminary analytical procedures, initial risk assessment procedures, and final analytical procedures provide the auditor with enough assurance that no other procedures are needed, what approach has been used on that audit area?

    a. The basic approach.

    b. The extended approach.

    c. The limited approach.

    d. Other auditing procedures.

10. When would the use of analytical procedures be the most effective?

    a. Balance sheet accounts are being tested.

    b. An account is small and has irregular transactions.

    c. Misstatement is likely to be caused by fraud.

    d. The client's environment is stable.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. If preliminary analytical procedures, initial risk assessment procedures, and final analytical procedures provide the auditor with enough assurance that no other procedures are needed, what approach has been used on that audit area? **(Page 34)**

    a. The basic approach. [This answer is incorrect. When an audit area needs its own audit program, one of those selected can be basic procedures, which includes primarily substantive analytical procedures and certain tests of details, most of which are required by GAAS. However, this is not the approach outlined above.]

    b. The extended approach. [This answer is incorrect. When extended procedures are used on an audit area, the auditor is creating a separate program and choosing procedures necessary to supplement those used in a different approach. Such extended procedures are not part of the approach described above.]

    c. The limited approach. [This answer is correct. When determining an audit approach, the auditor first considers whether the preliminary analytical procedures and other risk assessment procedures performed during initial planning and the final analytical procedures performed in the overall review stage of the audit provide enough assurance that no further audit procedures are necessary. In other words, no separate specific audit program is needed because the procedures for performing preliminary analytics, other risk assessment procedures, and final analytics are included in the general programs. This approach is referred to as the Limited Procedures Approach.]

    d. Other auditing procedures. [This answer is incorrect. Such procedures include those that may be warranted due to the specific circumstances of the engagement; however, these would be performed in addition to the approach discussed above, which means there is a better answer to this question.]

10. When would the use of analytical procedures be the most effective? **(Page 40)**

    a. Balance sheet accounts are being tested. [This answer is incorrect. One factor that affects the expected effectiveness of an analytical procedure is the nature of the account. Income statements are generally more favorable to the use of analytical procedures than are balance sheet accounts.]

    b. An account is small and has irregular transactions. [This answer is incorrect. Substantive analytical procedures generally are more effective for accounts that have a large volume of transactions that are predictable over time.]

    c. Misstatement is likely to be caused by fraud. [This answer is incorrect. The likely cause of misstatement can affect the effectiveness of analytical procedures. They are more effective when the risk of misstatement is assessed as being primarily from error rather than fraud.]

    d. The client's environment is stable. [This answer is correct. There are many factors that can affect the effectiveness of analytical procedures. A few of those include the existence of offsetting factors, the source and reliability of the data used, and the stability of the client environment. In regards to the last one, analytical procedures are generally more effective in a stable environment than they would be in an unstable one.]

AUDIT PROCEDURES FOR CONTRACT BILLINGS AND COST-RELATED ACCOUNTS

This section describes the audit procedures that may be performed for those general ledger accounts unique to companies with construction or manufacturing contracts subject to FASB ASC 605-35. However, as previously discussed, the selection of the specific procedures to be performed for each contract will depend on the approach chosen by the auditor. This section is organized in the following major subsections:

a. Planning and preparation.

b. Contract prices and billings to date.

c. Contract costs.

d. Revenue recognition.

e. Workpapers.

The audit focus in the audit of a construction contractor is individual contracts, and the audit procedures are designed to obtain an understanding of the accounting for contracts and to substantiate the recorded contract-related amounts. The following discussion of audit procedures refers frequently to *individually significant contracts*. The identification of individually significant contracts involves consideration of both audit risk and materiality. The auditor focuses on individual contracts that are significant in amount, but cannot ignore audit risk considerations. The auditor keeps in mind the types of contracts that prior experience and analytical procedures, such as the profit fade/gain analysis, indicate have a high risk of material misstatement. The analysis of individual contract risk is also considered.

Planning and Preparation

Because GAAP requires contractors to accumulate costs on a contract-by-contract basis, an important objective in the audit of a construction contractor is to obtain reasonable assurance that contract costs are correctly identified, allocated, and recorded for each contract being worked during the accounting period. Thus, a significant aspect of planning and preparing for the examination of contract-related accounts is to understand the financial reporting system. Other aspects of planning and preparation are concerned with the related matters of obtaining knowledge of the contract terms and contract activity for the accounting period. Performing the audit procedures related to planning and preparation before year end helps maximize audit efficiency.

Financial Reporting System Considerations. Gaining an understanding of a contractor's financial reporting system often is more time-consuming than gaining the same understanding in many other types of industries due to the complexity of accounting in the construction industry. Additionally, the financial reporting systems from one contractor to another can vary considerably in complexity and degree of sophistication. Also, the characteristics of the financial reporting system often do not match the complexity and sophistication of the contractor's operations. For convenience of discussion, the range of sophistication in contractors' financial reporting systems can be classified as follows:

a. *Sophisticated.* All contract costs, both direct and indirect, are allocated to individual contract records.

b. *Moderately Sophisticated.* All direct costs, except construction-period interest costs, are allocated to individual contract records, but indirect costs are not allocated by contract.

c. *Unsophisticated.* Only direct material, direct labor, and subcontractor costs are allocated to individual contract records.

Also, many contractors maintain their accounting records on the cash basis, and individual contract records include only those invoices that have been processed and paid.

The categories of financial reporting systems described above represent extremes, but an auditor will find that for many contractor clients the financial reporting systems are relatively unsophisticated and all costs required by GAAP to be allocated to individual contracts will not be included in the individual contract records when the audit begins. Thus, an important initial step in planning and preparing for the examination of contract-related accounts is to consider the contractor's financial reporting system and attempt to identify costs the contractor's system would obviously omit from individual contract records.

In many cases, a brief review of accounting records and discussions with management and accounting personnel will identify important categories of omitted contract costs. For convenience of discussion, two broad categories of omitted costs can be identified as follows:

a. *Invoice-related Costs.* This category includes those costs for which a vendor's or subcontractor's invoice has been received, but the charge to the contract was not recorded concurrently. In a cash basis system, this category would include those invoices received but not yet processed and disbursed.

b. *Journal Entry Costs.* This category includes those costs that must be allocated to contracts by a journal entry, such as depreciation costs and overhead.

The auditor usually will take a different approach to the correction of each category.

The client's personnel normally have a good understanding of the invoices that ought to be charged to contracts. Also, the work involved in identifying costs in this category is detailed clerical processing. It will be necessary to comb the disbursements journal and the open order and invoice files for items that ought to have been charged to contracts. The auditor needs to evaluate whether the client's personnel can do a competent job of accumulating the information and preparing the bookkeeping entries necessary to correct this category of omitted costs. This evaluation can be based on prior experience and current inquiry and observation of the client's personnel.

The second category of omitted costs—contract costs allocated by journal entry—requires a greater understanding of accounting principles and includes some relatively complex evaluations, such as the apparent adequacy of the overhead burden rate. Thus, this second category may require the auditor's assistance.

Preliminary Review of Contract Terms and Activity during the Period. The auditor's efficiency can be improved if the client will prepare (a) a schedule of contract activity for all contracts completed during the period and all contracts still in progress and (b) a schedule that summarizes the significant terms for each contract. Preferably, these schedules are prepared at an interim date and updated at year end. The auditor uses these schedules to obtain an understanding of the contractor's operations and to aid in planning the audit procedures.

The auditor identifies contracts that are likely to have significant billings, costs, profit fade at year end, or new contracts with a significant bid spread. The auditor also considers contracts with other risk factors such as complex projects, projects outside the contractor's geographic area or expertise, projects behind schedule, projects with significant penalties for late completion, projects with owners or subcontractors in a weak financial position, and projects with unusual or significant underbillings. The auditor also becomes familiar with the basic terms of each contract by reading the signed contract, scanning the contract files and customer correspondence, and discussing the status of the contract with client personnel. The auditor identifies contract features of accounting or auditing significance, such as the type of contract, contract price, escalation clauses, cancellation clauses, change order provisions, terms of payment, bonding requirements, equipment rental provisions, penalties, or other unusual features.

As previously discussed, the auditor's efficiency is improved if the client's personnel prepare the schedule of contract activity. In some cases, the client may have a computerized system to generate a list of all billings and costs for the period, which can be copied and used as a schedule of contract activity. In other cases, clerical personnel may need to prepare the schedule from billing and cost records. Whether the schedule is computer generated or prepared manually, the auditor ordinarily needs to test the clerical accuracy of the schedule and reconcile it with the general ledger. As part of this reconciliation process at year end, the auditor considers whether any obvious billing or cost omissions noted in the earlier consideration of the financial reporting system have been corrected. Usually, the reconciliation will not be a simple comparison of amounts in the general ledger to amounts

on the schedule. For example, the general ledger may be maintained on a completed-contract basis or cash basis rather than the percentage-of-completion basis used in preparing financial statements.

Contract Prices and Billings to Date

The auditor ordinarily takes a primarily substantive approach to contract prices and billings because it is efficient and effective to confirm these matters with customers at year end. Also, the confirmation request can be used to obtain information on other matters relating to the contract.

Generally, the auditor selects individually significant contracts in progress at year end from the schedule of contract activity and sends confirmation requests on those contracts. (Electronic confirmations may be considered reliable audit evidence when properly controlled. *PPC's Guide to Audits of Nonpublic Companies* provides information about using electronic confirmations.) The procedures in this area need to be coordinated with those for accounts receivable. If there are individually significant accounts receivable outstanding, identified from an accounts receivable aging, that are not selected for confirmation as a result of selecting individually significant contracts, those balances also need to be confirmed. For this purpose, an individually significant amount would be contract materiality or an amount not less than 1/2 of contract materiality. The auditor also considers whether any accounts receivable are individually significant because of their nature, such as those with related parties, those that are outstanding longer than normal, or a contract with unusual features.

The confirmation letter requests confirmation of the following contract-related information:

a. Description of contract.

b. Contract price.

c. Total change orders and last change order number.

d. Total billings on the contract from inception to year end, including amounts collected.

e. Accounts receivable outstanding at year end.

f. Amount of retainage at year end.

g. Annual interest rate on retainage, if applicable.

h. Estimated percentage of completion.

i. Space to record any contract disputes.

Besides substantiating the existence and amount of accounts receivable, the confirmation is also designed to provide the customer's independent and knowledgeable opinion on percentage of completion, billings to date, and whether there are any disputes.

Returned confirmations ordinarily ought to be retained in the workpapers, even when a schedule of confirmation results is prepared for the workpapers. An AICPA Technical Question and Answer (Q&A 8340.16) reminds practitioners that confirmations are generally used for accounts with higher risk of material misstatement and that they provide significant evidence to support the assertions being tested. As a result, auditors generally retain returned confirmations.

Contract Costs

The most efficient and effective audit approach for testing the allocation of costs to contracts varies by category of cost and by the assessed level of risk for each contract. This section discusses substantive procedures at the contract level for each of the following categories of contract costs:

a. Direct costs other than labor.

b. Direct labor costs.

c. Indirect costs except construction period interest.

d. Construction period interest.

e. Precontract costs.

Generally, the starting point in testing contract costs is the selection of individually significant contracts. For the contracts selected, the auditor will ask the client to prepare an individual cost summary that shows the direct material, subcontractor costs, direct labor and other direct costs, and the indirect costs charged to the contract. The summary needs to include enough detail on the costs charged to the contract to permit the auditor to vouch the costs to supporting documents; for example, invoice number, voucher number, check number, journal entry code and number, etc. The auditor may test the clerical accuracy of each cost summary and trace the total costs charged to the schedule of contract activity. After selecting individually significant contracts, the auditor may select individually significant cost items within those contracts.

Direct Costs Other Than Labor. When applying the Basic Approach to a contract, the primary audit procedures include comparing the direct costs other than labor to job cost records, discussing the status of the contract with a member of management, comparing the costs to budgeted costs, and other relevant substantive analytical procedures. If extended procedures will be applied to test direct costs other than labor, the auditor may choose one or more of the procedures discussed in the following paragraphs.

For each contract selected, the auditor may select for testing any direct costs charged to the individual summary, other than direct labor, that are individually significant. Generally, an individually significant cost would be one with an amount greater than contract materiality or an amount not less than 1/2 contract materiality. This is not an audit sampling application because the auditor is testing all items above a cutoff point. Normally, the auditor will want to obtain a reasonable coverage of the selected contracts and types of items. The exact number of items is judgmental, but the auditor needs to avoid using an arbitrary number (such as five or ten) rather than judgmentally evaluating the coverage.

For the cost items selected as individually significant, the auditor may vouch the items to supporting documentation, such as purchase orders, vendor invoices, receiving reports, and equipment rental contracts. The auditor may also consider the propriety of allocation of the costs to the contract considering the auditor's knowledge of factors such as the following: description of the contract; location of the site; start date; blueprints, drawings or other contract plans; discussions with client personnel; and observations made at job site visits. (Job site visits are discussed later in this lesson.) Other costs charged to both the contracts selected and the remaining contracts may be tested analytically, using predictive tests and scanning.

For materials that have been transferred to the job from central stores or supply inventory, the auditor may vouch the amount to accounting records rather than to a recent invoice for similar items. Transfer prices from central stores or supply inventory ought to be at the carrying amount, which should be the lower of cost or market.

Individually significant subcontractor costs may be confirmed directly with the subcontractor. These confirmations ought to be coordinated with audit procedures in the accounts payable area. The confirmation letter ought to request confirmation of the following information:

a. Contract price (or the major terms of a cost-plus-type contract).

b. Total change orders and last change order number.

c. Total billings by the subcontractor from inception to year end, including amounts paid, unpaid, and held in retainage.

d. Annual interest rate on retainage, if applicable.

e. Percentage of completion of the subcontractor's work.

f. Space for the subcontractor to describe any claims or disputes.

g. Space for the subcontractor to supply total unbilled charges for work performed through year end.

Besides substantiating contract amounts, the confirmation is also designed to provide the subcontractor's independent and knowledgeable opinion on percentage of completion and the existence of disputes or claims. Thus, the auditor has information from both the customer and the subcontractor to use in considering the reasonableness of the client's estimates and the client's estimating ability. Besides confirming significant subcontractor amounts, the auditor also considers whether there are any subcontractors with significant activity during the year that have not been selected on that basis and sends confirmation requests to those subcontractors.

In testing individually significant contracts, the auditor may encounter some contracts for which most or all of the charges are for a large number of relatively small items. These items when totaled for the category are individually significant even though the individual charges are relatively small. Normally, these are for recurring costs, such as monthly equipment rentals and utility bills, where the amounts are relatively similar. An efficient approach for substantiating this type of cost is to vouch one or a few of the individual charges and then analytically project the total charge for that category.

After testing individually significant direct costs other than labor, the auditor considers whether any additional testing of this cost category is necessary. The factors the auditor considers in making this judgment include prior experience with the client; assessed risk of material misstatement for this category of cost; nature and cause of misstatements, if any, detected in testing individually significant charges; and evidence derived from other related procedures. Normally, the other related procedures will be analytical tests, such as scanning for reasonableness and propriety the remaining direct costs charged to contracts selected and the job cost records for the contracts on the schedule of contract activity that were not selected.

Detecting Omitted Contract Costs. An important consideration in deciding whether additional testing is necessary is the auditor's assessment of the risk of contract costs not being allocated to individual contracts, that is, *omitted* contract costs. If evidence from other procedures performed to this point does not allow the auditor to assess this risk as relatively low, then additional testing would be advisable. Testing costs charged to the contract cannot detect *omitted* contract costs. To detect omitted costs, the direction of testing has to be from the initial gathering point for costs in the accounting records, such as the disbursements journal. The auditor's assurance about the lack of material misstatement caused by omitted costs has to come from the auditor's control risk assessment and other substantive procedures.

The auditor's assessment of the risk of material omitted contract costs comes primarily from two areas: the work done in planning and preparing to identify categories of cost the client's system would omit, and the work done testing significant charges to individually significant contracts. If the auditor concludes that the risk of material omitted contract costs is more than relatively low, additional testing may be necessary. If so, it is important for the auditor to select items for additional testing from the initial accounting gathering point, such as from the disbursements journal, rather than from selected contracts. The audit approach in this case normally would use audit sampling. By selecting the sample items from the initial additional gathering point in the accounting records, the auditor obtains assurance on both the accuracy and completeness of contract costs.

Direct Labor Costs. When applying the Basic Approach to direct labor costs charged to a contract, the primary audit procedures include comparing the labor costs to job cost records, discussing the status of the contract with a member of management, comparing the costs to budgeted costs, and other relevant substantive analytical procedures. If extended procedures will be applied to test direct labor costs, the auditor may choose one or more of the procedures discussed in the following paragraphs.

The extended audit procedures for direct labor costs differ from those for other direct costs because no single employee's labor charge will be individually significant. Normally, the contract summaries will show a total monthly, semimonthly, or weekly allocation of labor to the individual contract records. The source of these charges is usually individual time records of laborers and identifiable salaries of exempt employees who worked on the contract during the period.

Generally, the most efficient and effective extended audit procedures for direct labor costs depend on the relative size of the contractor's work force. For contractors with a relatively small work force, the auditor often relies primarily on analytical testing of labor charges. For larger contractors, the auditor also performs tests of details of payroll transactions. The auditor has to consider how labor-intensive the contractor's operations are and evaluate the most efficient and effective audit approach in the circumstances. The exact number of employees that is necessary

before a contractor is regarded as *large* is a matter of professional judgment. Some auditors regard any contractor with more than 50 employees as large. However, the auditor needs to exercise judgment and consider the nature of the contractor's operations, the size and composition of the labor force, and the effectiveness of the predictive analytical tests of direct labor costs in the circumstances.

An effective overall substantive analytical procedure can often be performed for testing direct labor charged to individually significant contracts. For each of the contracts selected for testing, the auditor would perform the following analysis:

a. Divide total labor costs by the average hourly, daily, or other rate as appropriate.

b. Convert the total hours from the prior computation into average-work-days (total hours divided by average hours in a work day).

c. Consider whether the average-work-days charged to the job appear reasonable based on the commencement date of the contract, the number of employees working on the contract, and the working conditions during the period (weather, nature of work, etc.).

d. Investigate and evaluate significant differences.

AU-C 520, *Analytical Procedures*, explains the use of analytical procedures as substantive procedures to obtain sufficient appropriate audit evidence. The expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements depends on, among other things, (a) the nature of the assertion, (b) the plausibility and predictability of the relationship, (c) the availability and reliability of the data used to develop the expectation, and (d) the precision of the expectation. The analytical procedure described above is usually highly efficient and can be very effective. Generally, effectiveness is enhanced if the contractor has a relatively stable and regular work force, similar contracts, and a regular or standardized pay schedule. However, substantive procedures cannot consist entirely of analytical procedures. For example, AU-C 240.32 specifically requires some detail testing of journal entries to address the risk of management override of internal controls. In addition, certain other tests of details ordinarily should be applied.

When substantive analytical procedures are performed, AU-C 520.08 states that the auditor should document:

- the expectation and the factors considered in its development (unless readily determinable from the work performed),
- the results of comparing recorded amounts to the expectation, and
- any additional procedures performed to address significant unexplained differences and the results of those procedures (for example, the amount of any misstatement quantified as a result of the analytical procedures performed).

In addition to the analytical procedure described in the preceding paragraphs, the auditor usually scans the direct labor charges on contracts not selected for individual testing to evaluate the reasonableness of the amounts.

If the contractor has a relatively large labor force, the auditor may conclude that, in addition to the analytical testing, detailed tests of payroll transactions using audit sampling are necessary. In that case, the auditor will select, using a representative selection method, a sample of payroll transactions from pay periods throughout the year. The sample unit will be an individual employee's pay for a particular pay period; individual payroll checks often make a convenient physical sample unit.

For each sample unit selected for testing, the auditor would perform the following procedures:

a. Recompute gross pay for laborers (hours on time record × authorized pay rate) and for salaried employees, trace gross pay to authorized salary schedule.

b. Determine that the job or jobs worked on during the pay period represented by the gross pay have been properly charged with the direct labor cost.

c. Review the employee's personnel file for the following:

(1) hourly rate or authorized salary,

(2) withholding authorizations,

(3) authorizations for other payroll reductions, and

(4) proof of authorization to work in the U.S. (DHS Form I-9).

If job site visits are performed, these detailed payroll procedures ought to be coordinated with those visits to observe the existence of employees included in the detailed testing.

Indirect Costs Except Construction Period Interest. This aspect of testing contract costs needs to be carefully timed to avoid inefficiency. Tests of the allocation of indirect costs need to be performed toward the completion of the audit after adjustments from other audit areas such as unrecorded liabilities and depreciation have been posted. Exhibit 2-3 provides a simple example to help explain how to test the allocation of indirect costs.

Exhibit 2-3

Test of Indirect Cost Allocation

Indirect cost accounts on the adjusted trial balance total $1,200,000. $300,000 of those costs are estimated to be of a pure general and administrative nature, and $100,000 are directly identifiable with Contract A. The entity believes that direct labor is the best allocation base, and direct labor totaled $500,000 during the year.

The burden rate would be calculated as follows:

Indirect cost per adjusted trial balance	$ 1,200,000
Less: General and administrative portion	(300,000)
Less: Identifiable indirect costs of Contract A	(100,000)
Indirect cost to allocate to contracts	800,000
Divided by direct labor	500,000
Burden rate	160%

If Contract A incurred $75,000 of direct labor costs during the year, indirect overhead costs allocated to Contract A would be calculated as follows:

Direct labor cost	$ 75,000
Multiplied by calculated burden rate	× 160%
Allocated indirect overhead costs	$ 120,000
Identifiable indirect costs of Contract A	100,000
Total indirect overhead costs	$ 220,000

* * *

FASB ASC 605-35-25-37 describes the general principles for indirect costs identifiable with or allocable to contracts as follows:

> Indirect costs allocable to contracts include the costs of indirect labor, contract supervision, tools and equipment, supplies, quality control and inspection, insurance, repairs and maintenance, depreciation and amortization, and, in some circumstances, support costs, such as central preparation and processing of payrolls.

The methods of allocating indirect costs should be systematic and rational. FASB ASC 605-35-25-37 indicates that those methods include the following:

> . . . allocations based on direct labor costs, direct labor hours, or a combination of direct labor and material costs.

Frequently, the client has not allocated any indirect costs to individual contract records and the auditor might need to provide substantial bookkeeping assistance in this area. The initial step of allocating indirect costs is usually to total the general ledger expense accounts that contain indirect costs. Thus, the auditor needs to consider what contract-related costs have not been posted directly to individual contract records. Usually, the auditor can identify the accounts and have the client's personnel prepare a schedule. The auditor can then trace accounts on the schedule to balances on the general ledger trial balance. Next, the auditor can inquire about any costs included in this summary that are directly identifiable with *specific* contracts. For example, a significant portion of the costs of the engineering department may be associated with one complex job. Also, the auditor can inquire about costs included in the summary that are really general and administrative expenses. For example, a significant portion of payroll taxes may be attributable to general office personnel.

At this point, the auditor has established the total amount or pool of indirect costs that represents overhead costs to be allocated to individual contract records for contracts completed during the period and those still in progress at year end. The next step is to determine an allocation base.

In determining an allocation base, the auditor considers the base used in prior periods and the base used for tax purposes. Consistency with prior periods and income tax reporting is an important consideration. A base of direct labor hours or costs is common. However, there are many possible bases, such as cubic feet of concrete poured, cubic yards of dirt moved, and square feet of paving. The pool of overhead costs is divided by the base to establish a burden rate for allocation of overhead. The client's personnel can post indirect costs to individual contract records using the burden rate.

The auditor tests the client's execution of the allocation by reviewing the indirect costs charged to the individually significant contracts previously selected for testing other contract costs. The auditor considers whether the amount has been calculated correctly, including the allocation of any indirect costs determined to be directly identifiable with the contract, and appears reasonable based on the auditor's knowledge of the contract. The reasonableness of the allocation is extremely important because the overhead rate will also be used to allocate indirect costs for the estimates of costs to complete on contracts in progress.

Construction Period Interest. Normally, the client will not have posted any construction period interest to individual contract records. The auditor considers whether interest expense incurred during the period should be capitalized as a cost of individual contracts. The typical financing arrangements of a construction contractor often result in an immaterial effect on contract costs and capitalization is not necessary.

GAAP requires capitalization of interest on *discrete projects*, and an asset being constructed under a long-term contract would be a *qualifying asset* for capitalization. This is true even though title to items charged to the job passes to the customer as construction progresses. In accordance with GAAP, the amount of interest to be capitalized should be determined on an individual contract basis. However, a contractor's normal approach to financing can result in an insignificant amount of interest cost that would be capitalized. Normally, a contractor obtains short-term loans for 30 to 60 days to provide working capital for individual contracts. The contractor also usually obtains large enough advances from the customer to cover payments to vendors or pays vendors only after collecting on billings from customers. Thus, the costs incurred on an individual contract are usually offset by advance payments and related payables, and the net balance is so small that the potential interest cost to be capitalized is insignificant. Also, when the percentage-of-completion method is used, the gross profit recognized as the contract progresses also offsets the effect of expensing interest currently.

Precontract Costs. Except as described in the next paragraph, some costs incurred by a contractor may be deferred in anticipation of future contracts. These costs include engineering or architectural costs incurred to obtain information to negotiate a contract, costs incurred for equipment or supplies to be used on anticipated contracts, and learning or start-up costs incurred in anticipation of follow-on or future related contracts. FASB ASC 605-35-25-41 provides criteria for evaluating the propriety of deferral of those costs. In general, costs incurred in

anticipation of contracts should not be deferred unless their future recovery is probable. Qualifying costs should be deferred outside the contract cost or inventory classification. If the anticipated contract is obtained, the deferred costs should then be charged to the contract; otherwise, they should be charged to expense. Costs related to anticipated contracts that were expensed when incurred because recovery was not considered probable should not be reinstated if the contract is subsequently received. Learning or start-up costs in anticipation of follow-on or future contracts related to existing contracts should be charged to the existing contracts.

FASB ASC 605-35-25-41 requires precontract costs that qualify as start-up activities to be expensed as incurred. Start-up activities are defined at FASB ASC 720-15-20 as "those one-time activities related to any of the following: opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with an entirely new class of customers . . . or beneficiary, initiating a new process in an existing facility, or commencing some new operation."

If the client has capitalized significant costs on contracts that have not started by year end and those costs do not qualify as start-up costs as defined in the previous paragraph, the auditor needs to consider whether those costs meet the recoverability criterion discussed above. If the costs qualify as start-up costs, the auditor needs to verify that the costs were properly expensed and reported.

Revenue Recognition

AU-C 240 includes a rebuttable presumption that improper revenue recognition is a fraud risk that may result in material misstatement of the financial statements. If that presumption is overcome by the auditor, the reasons need to be documented. AU-C 240.29 states that auditors should incorporate an element of unpredictability in the selection of audit procedures from year to year as an overall response to fraud.

In addition to incorporating an element of unpredictability, the auditor considers factors that affect audit efficiency and effectiveness, especially in the revenue recognition area. He or she ought to avoid overauditing contract costs because they are objective and susceptible to traditional audit procedures and underauditing those other components of revenue recognition that are highly subjective and judgmental. Another important efficiency consideration is timing.

The testing of revenue recognition ought to be performed late in the audit after the following adjustments have been posted:

a. Obvious cost omissions identified during planning and preparation.

b. Billing adjustments identified during confirmation work.

c. Cost adjustments identified in tests of direct costs other than labor, direct labor, indirect costs, and construction period interest.

d. Adjustments to contract costs identified during the search for unrecorded liabilities as part of payables work.

e. Any other adjustments of contract billings or costs coming to the auditor's attention.

If tests of revenue recognition are begun before all adjustments are posted to the schedule of contract activity, the auditor will need to reconsider and reperform some of those tests.

The remaining revenue recognition discussion is organized by the following topics:

a. Total estimated costs on jobs in progress.

b. Total contract price on jobs in progress.

c. Total estimated gross profit on jobs in progress.

d. Loss contracts.

e. Calculation—completed-contract method.

f. Calculation—percentage-of-completion method.

The last two topics are alternatives based on the client's method of revenue recognition on long-term contracts.

Total Estimated Costs on Jobs in Progress. For those contracts on the schedule of contract activity that are still in progress at year end and that were selected as individually significant, the auditor reviews the total estimated cost with client personnel. The auditor inquires of appropriate client personnel whether there have been any changes in the total contract costs expected to be incurred by contract completion. These inquiries may take place during the job site visit, if performed. The auditor also inquires about whether changes in the estimate are necessary because of matters such as the following:

a. Failure to accurately estimate the cost of change orders.

b. Failure to allocate adequate overhead costs to the job.

c. Misstatements identified in tests of contract costs incurred that would also affect estimates of total cost.

d. Additional costs (including liquidated damages) necessary to complete the job due to adverse experiences on the job, such as weather delays, strikes, disputes, unanticipated engineering problems, subcontractor defaults, etc.

e. Additional costs due to changes in the economy or industry, relating to inflation, wage contract increases, etc.

f. Other adverse factors identified as a result of applying other audit procedures.

The auditor reviews the charges to the individual contract records for jobs that are still in progress during the subsequent period to see whether any changes or trends indicate a need to revise the original estimates. If material adjustments are identified, the auditor expands the testing of total estimated costs.

As part of reviewing total estimated cost with client personnel on contracts selected as individually significant, the auditor identifies when the estimate of costs to complete was last updated and inspects that update. The estimate should be reviewed with the client personnel who are knowledgeable about the status of the project, for example, the project manager (or others who report to the project manager) rather than the regional manager. The auditor considers whether the update of costs to complete is sufficiently detailed and timely to produce a reliable estimate for accounting purposes. All costs, including indirect costs, ought to be included. If claims or change orders impact the costs of the project, the auditor also considers the extent to which contractors update their estimated costs to complete, as well as monitor the actual costs versus the cost estimates and investigate any significant differences both during and at the completion of projects.

In inquiring of client personnel about estimates of costs to complete, the auditor considers the client's estimating ability by reviewing the profit fade/gain analysis for each contract. If more than one person is involved in preparing and approving construction bids, the auditor's analysis ought to be performed by each bid preparer to consider trends in overbidding or underbidding by individual. Another analysis would be to consider the accuracy of bids by type of project.

If the client has experienced estimating difficulties in particular areas, the auditor needs to make specific inquiries in those areas. For example, the client may have difficulty in estimating subcontractor costs, and the auditor may need to apply additional procedures to test whether subcontractor cost estimates are reasonable. Alternatively, the client may have estimating problems with particular types of contracts, such as government versus private contracts, and the auditor may need to apply additional procedures to the troublesome category of contracts.

Total Contract Price on Jobs in Progress. The total estimated contract price includes consideration of (a) the basic contract price, (b) options and additions, (c) change orders, and (d) claims. The auditor considers whether any

adjustments are necessary to the total estimated contract price as a result of matters identified in applying other audit procedures, such as disputes noted in confirmation work, disallowed costs on cost-plus type contracts, penalties for violation of contract terms, claims, unapproved change orders, and examination of contracts.

Total Estimated Gross Profit on Jobs in Progress. After considering any adjustments to total estimated cost or contract price, the auditor recomputes the gross profit on contracts selected for testing. To evaluate the gross profit on contracts, the auditor considers two procedures: (a) analyze the bid spreads on new contracts obtained during the year and investigate any contracts with significant bid spreads, and (b) analyze the gross profit percentage on contracts in progress versus the gross profit percentage on contracts completed in the current year (and possibly in prior years) and investigate any significant differences.

Loss Contracts. Based on the foregoing procedures for contracts selected for testing and scanning the other contracts on the summary of contract activity, the auditor identifies any contracts on which a loss is anticipated and, if necessary, proposes an adjustment to recognize the proper amount of loss. Auditors need to be aware that it is not unusual for the estimated loss on a contract in progress to increase, especially when the contractor lacks internal controls over the estimating process or has a history of profit fade. These loss accruals also need to be posted to the income tax workpapers because they are temporary differences.

Calculation—Completed-contract Method. All of the foregoing procedures apply to both the completed-contract and the percentage-of-completion methods. However, the procedures in this subsection are unique to the completed-contract method. The auditor identifies any contracts that are substantially complete and for which revenue recognition is appropriate. Generally, a contract is regarded as substantially complete if remaining costs to complete and potential risks are insignificant. The auditor specifically considers whether any contracts are intentionally being held open as incomplete to avoid income taxes. In making this consideration, the auditor notes whether the contractor has vacated the construction site, all retainages have been collected, there is an acceptance by the customer in the contract file, or there are any other indications of completion.

For each contract on the schedule of contract activity, the auditor computes the difference between contract costs incurred and billings. The result will be one of the following:

- *Costs in Excess of Billings on Uncompleted Contracts (Underbillings).* This is an asset account.
- *Billings in Excess of Costs on Uncompleted Contracts (Overbillings).* This is a liability account.

These accounts are unique to the completed-contract method. The aggregate amount in each of the two categories is determined and presented in the financial statements. The two categories cannot be netted.

Calculation—Percentage-of-completion Method. When contractors use the cost-to-cost method to arrive at the percentage-of-completion, the auditor considers the need to exclude from the computation costs that do not represent progress on the project. FASB ASC 605-35-25-53 states the following concerning costs included in the cost-to-cost ratio to measure percentage of completion:

> Costs as here used might exclude, especially during the early stages of a contract, all or a portion of the cost of such items as materials and subcontracts if it appears that such an exclusion would result in a more meaningful periodic allocation of income.

FASB ASC 605-35-25-75 provides additional interpretation of this point as follows:

> Some of the costs incurred, particularly in the early stages of the contract, should be disregarded in applying this method [cost-to-cost] because they do not relate to contract performance. These include the costs of items such as uninstalled materials not specifically produced or fabricated for the project or of subcontracts that have not been performed.

An example of material cost that should be excluded is materials not unique to the project that have been purchased or accumulated at job sites but that have not been physically installed.

The auditor inquires about uninstalled materials and unperformed subcontracts with client personnel and considers observations at job sites. If necessary, the auditor computes an adjustment. Often this type of adjustment is

made only in the auditor's percentage-of-completion workpapers; that is, only the amount used in the cost-to-cost computation is adjusted. However, some companies may wish to record the reclassification of such costs as inventory. For tax purposes, the percentage of completion is not normally reduced by the amount of uninstalled materials, so a temporary difference may result regardless of whether the reclassification is recorded.

After any necessary adjustments are made, the auditor computes a cost-to-cost percentage of completion for each contract in progress. Adjusted cost incurred to date is divided by total estimated cost at completion to estimate percentage of completion. The percentage of completion estimated using the cost-to-cost computation is compared to information on contract progress obtained from other audit procedures, such as confirmations from customers and subcontractors, job site visits, and inquiry of client personnel familiar with the project. If the other information is not substantially consistent with the computed percentage of completion, the auditor makes further inquiries. Differences may indicate unrecorded costs, recorded costs that do not represent progress on the project as discussed above, inaccurate total cost estimates, or other mistakes. The percentage is adjusted as necessary. Using this percentage, the auditor computes the gross profit to date on each contract.

Some contractors may want to use a method other than cost-to-cost to estimate percentage of completion. GAAP does not require use of the cost-to-cost method, but other methods should generally be avoided unless there is good reason to believe that a method other than cost-to-cost produces a more accurate and reliable measure of contract performance. The IRS requires use of cost-to-cost for tax purposes and it is generally simpler and less costly to use the same method for preparing financial statements.

Gross profit as computed previously or as based on another method of determining percentage-of-completion is added to the total cost incurred to date on each contract to arrive at a *total cost and profit* on each contract in progress. Unless the client reclassified uninstalled materials to inventory as discussed above, total cost incurred includes the cost of uninstalled materials. The auditor computes the difference between *total cost and profit* and billings on each contract. The result will be one of the following:

- *Costs and Estimated Earnings in Excess of Billings on Uncompleted Contracts (Underbillings).* This is an asset account.

- *Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts (Overbillings).* This is a liability account.

These accounts are unique to the percentage-of-completion method. Similar to the comparable accounts for the completed-contract method, the accounts are aggregates for each of the two categories and the accounts are not offset or presented as a net amount. An overbilling situation (that is, billings in excess of costs and estimated earnings) while a liability account, indicates that the contractor has bid its work in a manner such that the contract owner assists the contractor in financing the job. While it is normally advantageous for contractors to have overbillings, some types of contractors will rarely have that opportunity due to the contract terms. For example, subcontractors such as electrical and HVAC contractors are often only able to bill after services are rendered and materials are installed. Thus, they will rarely have significant billings in excess of costs and estimated earnings. An underbilling situation (that is, costs and estimated earnings in excess of billings on contracts in progress) although an asset on the balance sheet, may indicate poor billing or bidding practices, or might also indicate overly aggressive profitability forecasts. Based on the type of contractor, the auditor analyzes any significant overbillings or underbillings, obtains explanations for the cause, and determines the reasonableness of the amount.

Some contractors follow the policy of not recognizing any profit on a contract until enough work has been performed to make a more dependable estimate of total contract cost. Rules of thumb ranging from 5%–40% completion are common; that is, no profit is recognized until a contract is X% complete. This approach seems to be in conformity with GAAP and the built-in conservatism makes many auditors more comfortable. However, contractors who must use the percentage-of-completion method or the percentage-of-completion/capitalized cost method for tax purposes are required by the IRS to use the pure cost-to-cost method.

The approach to testing the estimated gross profit on contracts in progress as described in the preceding paragraphs seems to be consistent with AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. AU-C 540.08 requires the auditor to obtain an understanding of several

matters, including how management makes the accounting estimates and the data on which they are based. AU-C 540.13 indicates that, in responding to the assessed risks of material misstatement, the auditor should perform one or more of the following, depending on the nature of the accounting estimate:

a. Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.

b. Test how management made the accounting estimate and the data on which it is based. In doing so, evaluate whether—

   (i) the measurement method is appropriate in the circumstances,

   (ii) the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework, and

   (iii) the data on which the estimate is based are sufficiently reliable.

c. Test the operating effectiveness of the controls over how management made the accounting estimate and perform appropriate substantive procedures.

d. Develop a point estimate or range to evaluate management's estimate. For this purpose—

   (i) If the assumptions or methods used to make the estimate differ from management's, obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's estimate.

   (ii) If it is appropriate to use a range, narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

The approach for calculating percentage of completion, as described in the previous paragraphs, combines review and testing of the process used by management with an independent expectation of the estimate developed by the auditor. This approach gives due consideration to the contractor's historical experience in making prior estimates and requires the auditor to bring personal knowledge and experience to bear on evaluating the reasonableness of the estimate.

AU-C 240.32 also requires the auditor to review accounting estimates for biases that could result in material misstatement due to fraud. In addition, it requires auditors to perform a retrospective review of significant prior year accounting estimates to determine whether the underlying judgments and assumptions indicate possible bias. Estimates to complete, stage of completion, and related gross profit are critical estimates for contractors. A profit gain/fade analysis can be used to analyze the contractor's job estimating ability. The review may provide additional information about whether the current year's estimates could be biased. If the auditor identifies possible bias, AU-C 240.32 requires the auditor to evaluate whether the circumstances represent a risk of material misstatement due to fraud.

Workpapers

The audit steps discussed in this section use several workpapers that are unique to the audit of a construction contractor. The following schedules, preferably prepared by the client, are commonly used:

a. Schedule summarizing significant contract terms by contract.

b. Schedule summarizing contract activity during the period by contract.

c. Schedule for each individually significant contract listing the costs charged to individual contract records.

d. Schedule summarizing the profit fade/gain by contract.

Generally, these schedules should include contracts completed during the period and contracts still in progress. These schedules may take a variety of formats depending on the number and complexity of the client's contracts. Examples of these and other appropriate workpapers are included in *PPC's Guide to Construction Contractors*.

Calculation Workpaper. Another useful workpaper for a construction contractor audit is a calculation workpaper to organize and consolidate the information used in percentage-of-completion computations.

VISITING A CONTRACTOR'S JOB SITE

Job site visits in the audit of a construction contractor are not a generally accepted auditing procedure in the same sense as confirmation of receivables or observation of physical inventory in the audit of an ordinary commercial business. Job site visits may not be necessary on a particular engagement because confirmations with the customer (owner) and subcontractors can be used to substantiate existence of the project and corroborate the estimated percentage of completion. The AICPA Guide, at Paragraph 10.02, states that, in certain situations, job site visits are necessary for the auditor to understand the contractor's operations and to relate the internal accounting information to events that occur at the job sites. A job site visit may be particularly important when all, or part, of the accounting functions for the job are performed at a temporary job site office staffed by personnel with limited accounting training and experience.

The discussion of job site visits in this section addresses two main considerations:

a. Audit objectives and procedures for job site visits.

b. Determining the number and location of sites to visit.

Audit Objectives and Procedures for Job Site Visits

The AICPA Guide, at Paragraph 10.02, indicates that job site visits can assist the auditor in meeting the following objectives:

- Obtaining an understanding of the contractor's operations.
- Obtaining additional evidence of job existence.
- Corroborating management's information with field employees, including whether employees charged to the job are those physically working at the job site.
- Understanding components of internal control maintained on site, such as payroll disbursements, equipment and material controls, etc.
- Determining job status, including whether materials have been installed that were charged to the site.
- Identifying major equipment, company vehicles, or other fixed assets on site to substantiate existence, including noting VIN or equipment numbers and physically observing the assets.
- Determining whether there are problems or disputes related to the job.

The audit approach to a job site visit typically begins with a tour of the construction site with the project manager, contract supervisor, or other appropriate personnel. For convenience and to provide an accurate record of matters observed at the site, digital pictures can be taken during job site visits. Doing so can save a great deal of time and provide clear evidence to support the auditor's position on contentious points. The auditor ought to take pictures of the major parts of the project as well as the overall construction site. The auditor also ought to take pictures of major equipment at the site and any materials not incorporated in the construction. If there are significant amounts of unused materials, the auditor ought to obtain job site records of the receiving reports, the name of the vendor, and any other information that would help identify the cost of the material. Otherwise, it may be difficult to distinguish the unused material from the other material charged to the contract and used in construction. The auditor might also observe whether materials are stored in a secure location.

Besides photographing the major equipment on site, the auditor may record the serial number and description of each major item to the extent considered necessary. Based on observation and discussions with job site personnel, the auditor attempts to identify damaged or obsolete equipment. If equipment is rented, the name of the lessor also needs to be recorded. If equipment is used on the job but not at the site on the day of the auditor's visit, the auditor needs to discuss the description and status of the equipment with the contract supervisor.

Job site visits are related to the financial statement assertions in several account balances. The audit procedures performed on job site visits typically include determining the following:

a. Costs charged to contracts in progress appear reasonable and represent actual work being performed at a construction site.

b. Significant stockpiles of material observed at the construction site that have not been used in the construction process are identified for consideration when computing cost-to-cost percentage of completion.

c. Significant current year additions or retirements of equipment and defective or obsolete equipment are identified promptly and treated properly in the accounting records.

d. Disputes, claims, or other problems in the contract are identified promptly and treated properly in the accounting records or disclosed if necessary.

If considered necessary, the auditor may record the names of subcontractors working on the site and inquire of them as to the progress of the job. In addition, it may be beneficial to speak to the project owner or a representative of the owner about the job's progress. The auditor may also record the names of workers observed at the site for later comparison with payroll records. If there are many workers, the auditor may record the names of several rather than all of them. Also, the auditor needs to identify employees of the company separately from employees of a subcontractor.

The auditor inquires about the following matters with the project manager, contract supervisor, and other personnel:

a. The status of job completion. (If possible, the auditor at the same time inspects blueprints and similar documents used at the job site as points of reference.)

b. Whether the project is over or under budget as to material cost or usage and labor hours or costs.

c. Whether there are any claims, disputes, or other problems with the project, including mold, hazardous waste, or employee safety problems.

d. Whether there are known contingencies, such as workers' compensation claims.

e. Whether there are any significant unapproved change orders.

f. Whether there are any large billings for services rendered or materials purchased that have not been received but should be brought to the attention of the accounting department.

The auditor records information regarding the most recent receipts of material at the site for later comparison with accounts payable records to test cutoff. Generally, the auditor documents each job site visit by preparing a memorandum that records the information obtained and responses to inquiries by job site personnel.

Determining the Number and Location of Sites to Visit

Determining the number and location of sites to visit is a subjective judgment. Normally, there are too few sites to even consider using audit sampling, and the auditor's objectives do not include projection of results of procedures performed at the site. Job site visits are considered *extended procedures* as defined earlier in this lesson because they do not seem to be necessary for contracts classified as low risk contracts.

The auditor needs to consider several factors in establishing the scope of job site visits, including:

a. Prior experience with the contractor client.

b. The extent of accounting functions and internal controls performed on site.

c. The number, size, and significance of projects in process.

d. Unusual or troublesome features of contracts.

e. The risk assessment, including fraud risk, related to the specific contract and the contractor.

Performing job site visits and the number of job sites to visit is generally a function of audit risk; for example, large jobs and jobs with a low percentage of completion generally have higher risk than small jobs and jobs that are substantially complete.

If the contractor is a new client, the auditor may believe that several site visits are necessary to obtain the needed understanding of the contractor's operations to facilitate planning the audit. For existing clients, if prior site visits have disclosed problems that would have been difficult to detect by other audit procedures, such as substantial uninstalled materials or other discrepancies between the physical progress of the project and the cost-to-cost computation of percentage of completion, site visits might be considered necessary.

The number of important accounting functions performed on site and the resulting importance of controls operating on site influence the desirability of site visits. A small contractor with relatively small projects may have no accounting functions on site, and a medium-size contractor may have a few accounting functions performed at the job site but maintain centralized control. However, a large contractor may have significant accounting tasks performed and controls in effect only on job sites.

The number, size, and significance of projects also influence the desirability of job site visits. If the contractor has one or a few very large contracts with substantial costs incurred, visits to those sites would probably be appropriate.

Finally, the auditor considers visiting the sites of contracts with unusual or troublesome features, such as a contractor of residential housing with a single large commercial building project. The auditor also considers whether unusual contract terms or conditions make job site visits desirable. Unusual or troublesome contract terms or conditions may include contracts that are combined or segmented for accounting purposes, those with significant unpriced change orders or unsatisfied claims, and those subject to unusual risks such as postponement or cancellation provisions, or disputes between the parties.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. The financial reporting system used by West End Construction allocates costs for subcontractors and direct materials and labor to individual contract records. Other costs are not allocated by contract. What type of financial reporting system does West End Construction have?

    a. Extremely sophisticated.

    b. Sophisticated.

    c. Moderately sophisticated.

    d. Unsophisticated.

12. Which of the following pieces of information should auditors include in confirmation letters sent to their audit client's customers?

    a. Accounts receivable at the end of each quarter.

    b. Amounts collected so far on the contract.

    c. A reference number for the contract.

    d. A description of any contract disputes.

13. Which of the following statements most accurately describes an aspect of a construction contractor's revenue recognition?

    a. The presumption that improper revenue recognition can lead to material misstatement of the financial statements cannot be overcome.

    b. Significant contracts that will still be in progress at year end should be omitted from selection for the audit.

    c. Basic contract price, change orders, claims, and options and additions should all be factored into total estimated contract price.

    d. The estimated costs for loss contracts that are still in progress should be expected to decrease over time.

14. What objectives might an auditor meet by performing job site visits?

    a. Corroborating information field employees provided about management.

    b. Obtaining an understanding of the contractor's financial reporting system.

    c. Determining how many other job sits to visit during the audit.

    d. Determining whether specific materials were installed.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. The financial reporting system used by West End Construction allocates costs for subcontractors and direct materials and labor to individual contract records. Other costs are not allocated by contract. What type of financial reporting system does West End Construction have? **(Page 45)**

    a. Extremely sophisticated. [This answer is incorrect. This course divides the financial reporting systems of construction into three categories: (1) sophisticated, (2) moderately sophisticated, and (3) unsophisticated. Extremely sophisticated is not used. Users of this course should also keep in mind that, though this is the language used in the course, these categories represent extremes.]

    b. Sophisticated. [This answer is incorrect. For this type of financial reporting system, a contractor must allocate all contract costs, whether direct or indirect, to individual contract records. West End Construction does not allocate all of its costs in this way.]

    c. Moderately sophisticated. [This answer is incorrect. To be classified as moderately sophisticated, West End Contractors would have to allocate all direct costs, except construction-period costs, to individual contract records. However, it does not. Indirect costs are not allocated by contract with this type of financial reporting system.]

    d. Unsophisticated. [This answer is correct. Only direct material, direct labor, and subcontractor costs are allocated to individual contract records when an unsophisticated financial reporting system is used. As those are the costs West End Construction allocates, its financial reporting system would be classified as unsophisticated. Auditors will find that many of their contractor clients have financial reporting systems that are relatively unsophisticated and that all costs required by GAAP to be allocated to the individual contracts will not be included in the individual contract records when the audit begins. Thus, an important initial step in planning and preparing for the examination of contract-related accounts is to consider the contractor's financial reporting system and attempt to identify costs the contractor's system would obviously omit from individual contract records.]

12. Which of the following pieces of information should auditors include in confirmation letters sent to their audit client's customers? **(Page 47)**

    a. Accounts receivable at the end of each quarter. [This answer is incorrect. The confirmation letter to an audit client's customer would generally include accounts receivable outstanding as of year end, not as of each quarter.]

    b. Amounts collected so far on the contract. [This answer is correct. In the confirmation letter to an audit client's customer, the auditor should request confirmation of total billings on the contract from inception to year end, including amounts collected so far.]

    c. A reference number for the contract. [This answer is incorrect. The confirmation letter to an audit client's customer should include a description of the contract, not just a reference number. The contract price should also be included.]

    d. A description of any contract disputes. [This answer is incorrect. The confirmation letter should leave space so that the audit client's customer can record any contract disputes. Information about any disputes should not be filled in for them on the confirmation letter.]

13. Which of the following statements most accurately describes an aspect of a construction contractor's revenue recognition? **(Page 54)**

    a. The presumption that improper revenue recognition can lead to material misstatement of the financial statements cannot be overcome. [This answer is incorrect. AU-C 240 includes a rebuttable presumption that improper revenue recognition is a fraud risk that may result in material misstatement of the financial statements. If that presumption is overcome by the auditor, the reasons need to be documented.]

    b. Significant contracts that will still be in progress at year end should be omitted from selection for the audit. [This answer is incorrect. For those contracts on the schedule of contract activity that are still in progress at year end and that were selected as individually significant, the auditor reviews the total estimated cost with client personnel. The auditor inquires of appropriate client personnel whether there have been any changes in the total contract costs expected to be incurred by contract completion.]

    c. Basic contract price, change orders, claims, and options and additions should all be factored into total estimated contract price. [This answer is correct. The total estimated contract price includes consideration of (1) the basic contract price, (2) options and additions, (3) change orders, and (4) claims. The auditor considers whether any adjustments are necessary to the total estimated contract price as a result of matters identified in applying other audit procedures, such as disputes noted in confirmation work or disallowed costs on cost-plus type contracts.]

    d. The estimated costs for loss contracts that are still in progress should be expected to decrease over time. [This answer is incorrect. Auditors need to be aware that it is not unusual for the estimated loss on a contract in progress to *increase* (not decrease), especially when the contractor lacks internal controls over the estimating process or has a history of profit fade.]

14. What objectives might an auditor meet by performing job site visits? **(Page 58)**

    a. Corroborating information field employees provided about management. [This answer is incorrect. According to the AICPA Guide, job site visits allow auditors to corroborate management's information with field employees (not vice versa), including whether employees charged to the job are those physically at the job site.]

    b. Obtaining an understanding of the contractor's financial reporting system. [This answer is incorrect. According to the AICPA Guide, job site visits allow auditors to obtain an understanding of the contractor's operations. An understanding of the contractor's financial reporting system would be obtained using other audit procedures.]

    c. Determining how many other job sits to visit during the audit. [This answer is incorrect. Determining the number and location of sites to visit is a subjective judgment. Normally, there are too few sites to even consider using audit sampling, and the auditor's objectives do not include projection of results of procedures performed at the site. Therefore, one job site visit will not be the sole reason for attempting other such visits; more data would be needed for the auditor to make that decision.]

    d. Determining whether specific materials were installed. [This answer is correct. The AICPA Audit Guide, at Paragraph 10.02, indicates that job site visits can assist the auditor in meeting certain specific objectives. One of those objectives is determining the job status, including whether materials have been installed that were charged to the site. Another objective that can be met with these visits is identifying major equipment, company vehicles, or other fixed assets on site to substantiate existence, including noting VIN or equipment numbers and physically observing the assets.]

WRAPPING UP THE AUDIT

This section describes certain audit procedures performed at the conclusion of the audit to wrap-up the examination of individual contracts and to complete other audit areas. This discussion focuses on those matters that are unique or of particular importance to companies that have construction or manufacturing contracts subject to the accounting requirements of FASB ASC 605-35, *Construction-Type and Production-Type Contracts*.

This section is organized in the following major subsections:

a. Commitments and contingencies, including environmental remediation liabilities and guarantees.

b. Risks and uncertainties.

c. Subsequent events.

d. Related parties.

e. Going-concern considerations.

f. Written representations.

g. Analytical review.

h. Evaluation of overall materiality.

For each of these areas, the discussion is limited to significant matters pertinent to construction contractors. A more detailed discussion of each area and other routine aspects of concluding the audit is provided in *PPC's Guide to Audits of Nonpublic Companies*.

Commitments and Contingencies

Because of the nature of the construction contracting industry, disputes, litigation, and claims are relatively common. It is important for the auditor to obtain reasonable assurance that those matters have been identified, provided for, and disclosed. The general procedures that are normally performed in all audits that may disclose such matters are inquiry of management, reading of minutes and contracts, and obtaining legal representation letters from the contractor's attorneys.

The auditor needs to be aware that state statutes affecting construction contractors may have audit or disclosure implications. The AICPA Guide, at Paragraph 11.37, highlights the importance of state lien laws. While the existence of lien laws varies from state to state (and some states may not have them), such laws provide that funds received or receivable by a contractor constitute trust funds that may generally only be used to pay the specified contract-related costs. Thus, it is important that the auditor review with the contractor and the contractor's counsel, the applicable statute in each state in which the contractor operates to evaluate whether amounts that constitute trust funds under those statutes have been properly applied. The auditor may choose to include specific inquiries concerning compliance with lien laws in the letters of inquiry to the contractor's attorneys.

In wrapping up the examination of contract billings and cost-related accounts, the auditor considers whether information from confirmations with customers (owners) and subcontractors, review of contract terms, job site visits, or the results of other audit procedures have identified disputed claims, back charges, change orders, or other disputes or contingencies associated with contracts. These matters need to be appropriately provided for or disclosed in the financial statements.

Environmental Remediation Liabilities. Various federal, state, and local laws have been enacted to clean up existing hazardous waste sites and prevent further pollution. Practitioners should be familiar with FASB ASC 410-30, *Environmental Obligations*, which discusses accounting for environmental remediation liabilities.

To identify instances of noncompliance with environmental regulations that may have a material effect on the financial statements, in accordance with AU-C 250.14, auditors should (a) inquire of management and, when

appropriate, those charged with governance about whether the entity is in compliance with such laws and regulations, and (b) inspect correspondence, if any, with the appropriate licensing or regulatory authorities. If there is an increased risk that the contractor has environmental remediation liabilities, auditing procedures generally are the same as those applied for other contingent liabilities (that is, reading the minutes of director's or stockholders' meetings, making inquiries of the client's attorney, and making inquiries of the client). Due to the higher incidence of environmental issues that tends to occur in the construction industry, it is a good idea for auditors to also be aware of situations that may indicate a possible exposure to environmental liabilities. For example, at a job site visit, the auditor may note old steel drums unearthed during excavation for the project. It may be necessary for the client to obtain representation from a lawyer who specializes in environmental matters. An in-depth discussion of such situations is beyond the scope of this course, but more information is available in *PPC's Guide to Construction Contractors*. Substantive procedures performed to audit a recorded environmental remediation liability will consist of (a) reviewing and testing the process used by management to develop the estimate, or (b) developing an independent expectation of the estimate, which usually will require the use of an environmental specialist. A combination of the two approaches may be necessary in some cases.

Guarantees. It is not uncommon for construction contractors to guarantee the debt or other obligations of an equipment company, subcontractor, real estate venture, or a joint venture that it does not control. According to FASB ASC 460, *Guarantees*, a guarantor is required to recognize a liability for the fair value of a guarantee at inception because the guarantor's obligation to stand ready to perform under a guarantee is noncontingent.

Auditors need to be alert to the existence of guarantees and consider whether the guarantor's obligation to stand ready under the guarantee has been given appropriate recognition in the financial statements. Because the obligation to stand ready is recorded at fair value, the guidance in AU-C 540 applies.

Risks and Uncertainties

FASB ASC 275, *Risks and Uncertainties*, requires disclosures about risks and uncertainties that could significantly affect the amounts or situations reported in the financial statements. The disclosures are grouped into the following four areas:

- Nature of operations.
- Use of estimates in the preparation of financial statements.
- Certain significant estimates.
- Current vulnerability due to concentrations.

The first two areas do not require significant additional audit work because the disclosures are required in all financial statements and the information needed for the disclosures is readily available. However, for the other two areas, specific procedures may be necessary to determine that all required disclosures have been identified.

Certain Significant Estimates. One way of determining the existence of a significant estimate that requires disclosure is to answer the following questions:

- Was an estimate used in preparing the financial statements?
- Is there more than a remote possibility that the estimate will change by a material amount within one year from the date of the financial statements based on information known prior to issuance of the financial statements?

Initially, an auditor's objective is to determine whether all significant estimates have been identified. It is a best practice for the estimates used by construction contractors in applying the percentage-of-completion method to recognize revenues to always be *considered* for disclosure. It is also a good idea for a significant estimates disclosure to be made in most construction contractor financial statements if the contractor uses the percentage-of-completion method.

The next step is determining whether it is at least *reasonably possible* that an estimate will change in the near term. The term reasonably possible encompasses the entire range from *more than remote* to *less than likely*. It could be concluded that it is at least reasonably possible that almost any estimate could change. To conclude otherwise, an auditor would have to conclude that there is only a *remote* chance of an estimate changing.

It is good practice to document conclusions about estimates that could change, particularly if the decisions are difficult or contentious. This documentation can be informal and can be done, for example, on the relevant workpaper or in a separate memo. Even if the chances of an estimate changing are more than remote, the remaining criteria—*material amount*, *near term*, and *existing conditions*—may still eliminate the need for disclosure. However, AU-C 540.22 notes that the auditor is required to document the basis for conclusions pertaining to the reasonableness of accounting estimates and their disclosure where there are significant risks.

Current Vulnerability Due to Concentrations. The audit approach for concentrations is similar in many respects to the audit approach for significant estimates. That is, the auditor's first objective is to determine whether all concentrations have been identified. Once an auditor has identified concentrations, evaluation of disclosure can be documented on the relevant workpaper, by memo, or on a checklist like the one included in *PPC's Guide to Construction Contractors.* One significant difference between auditing disclosures of concentrations and auditing disclosures of significant estimates is that the threshold for disclosure is different. For concentrations, the threshold is *severe impact*, whereas for significant estimates, the threshold is *material*.

For many small construction contractors, it seems logical that the predominant concentrations disclosures will be about concentrations in revenue from particular products or services, and concentrations in the geographic area or markets in which the contractor operates. Concentrations in a few customers is often not required to be disclosed by contractors since many customers are often not repeat customers in the near term. As a result, loss of those specific customers would not necessarily severely impact the company over the next year. Also, alternate suppliers of materials, labor, and lenders are often readily available to small construction contractors, thus avoiding disclosure of those concentrations.

Subsequent Events

AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, identifies the types of subsequent events the auditor should evaluate and specifies the procedures that should be performed to determine the occurrence of such events. FASB ASC 855-10, *Subsequent Events*, includes accounting and disclosure standards on subsequent events.

Besides the normal subsequent events procedures performed in all audits, the auditor is particularly concerned with events in the subsequent period that affect estimated gross profit reported in the financial statements. Any significant contracts completed after the balance sheet date but before the audit report date ought to be reviewed for differences between the total estimated gross profit and the actual gross profit. Transactions or events that could materially affect estimated costs to complete significant contracts also ought to be reviewed, such as receipt of materials ordered for a specific project but not included in estimated costs to complete, or weather delays, strikes, or construction problems that could cause a loss on major projects.

Related Parties

AU-C 550, *Related Parties*, addresses the auditor's responsibilities relating to related party relationships and transactions in an audit of financial statements. Related party transactions are relatively common in the construction contracting industry. Contractors often participate in joint ventures or have a direct or indirect affiliation with another related business. The existence of these arrangements in the industry is generally attributable to legal liability concerns, taxation, labor and union considerations, competition, limited financial resources, and regulatory requirements.

The auditor considers the contractor's participation in joint ventures and evaluates whether investments in joint ventures are properly recorded and disclosed. The AICPA Guide, Chapter 3, contains recommendations and illustrations on contractor accounting and financial statement presentation for joint ventures based on the FASB

ASC guidance. Paragraph 11.03 of the AICPA Guide indicates that the auditor considers the following factors concerning joint ventures:

- The method(s) of reporting joint venture investments.
- The nature of capital contributions and the methods of recording them.
- The timeliness of the available financial statements of joint ventures in relation to the reporting investor's financial statements.
- The appropriateness of accounting for any joint venture losses in excess of a contractor's loans and investments.
- Whether joint venture-related disclosures in the financial statements are adequate.

The contractor's ownership interest may be in a corporate joint venture, a partnership, or undivided interests. Generally, the accounting and auditing considerations are the same regardless of the legal form of ownership. However, there are additional concerns when the contractor acts as a general partner in a limited partnership. In that case, the auditor assesses the actual and contingent obligations that arise from the contractor's role as a general partner. The auditor considers the financial condition of other partners (general and limited) and their ability to fund partnership contribution commitments, obligations, and losses.

If an auditor is engaged to audit one of a group of affiliated companies, the auditor may conclude that only an audit of the combined financial statements of the affiliated group would permit an unmodified opinion. The situation is discussed in the AICPA Guide, at Paragraph 11.10, which indicates that an examination of the records of only one entity of an economic unit may not provide satisfactory evidence of the substance, nature, business purpose, and transfer prices of significant transactions between the parties of the affiliated group. In such cases, the auditor may recommend combined or combining financial statements rather than separate financial statements.

VIEs. Another area of concern for auditors is the appropriate consolidation of entities commonly referred to as variable interest entities. Such entities are often created to carry out a specified purpose or activity. In a variable interest entity (VIE), control is achieved through variable interests rather than through voting interests. Accounting guidance for VIEs is found in FASB ASC 810-10, *Consolidation—Overall*. The guidance explains how to identify VIEs and how to assess a company's interests in a VIE to decide whether to consolidate that entity. It gives guidance on identifying a controlling financial interest established by means other than voting interest and requires consolidation of a VIE by an enterprise that holds such an interest.

FASB ASC 810-10 may have a significant impact on construction companies because contractors often have arrangements that could be subject to its guidance. For example, common arrangements in this industry include—

- Forming separate legal entities to own property to be developed.
- Establishing separate legal entities to acquire equipment that is then leased to the contractor.
- Forming joint ventures to develop a project.

Each of the above arrangements may meet the criteria in FASB ASC 810-10 to be a VIE, which requires the auditor to carefully consider the provisions of the arrangement.

Auditors will need to obtain information from owners, officers, directors, or others about the existence of related party transactions. Communication with other auditors regarding known related parties and related party transactions is required by auditing standards. Typically a letter would be used for such communications.

Related Party Transactions and Fraud. AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to consider the existence of fraud risk factors when identifying and assessing risks of material misstatement due to fraud. A common thread in many frauds is the use of related parties unknown to the auditor to facilitate

management intentionally misstating the financial statements. AU-C 240.A75, Appendix A, lists the following example risk factors that may involve transactions with related parties:

- Significant related party transactions not in the ordinary course of business or with related entities that are unaudited or audited by another firm.
- Significant, unusual, or highly complex transactions, especially those close to year end, that are difficult to assess for substance over form.
- Overly complex organizational structure involving unusual legal entities or lines of managerial authority.
- Difficulty in determining the organization or individual(s) that control the company.
- Significant bank accounts (or subsidiary or branch operations) in tax-haven jurisdictions for which there does not appear to be a clear business justification. (Any time a principal party to a transaction such as a seller, buyer, lender, or guarantor, is in a tax-haven jurisdiction, the auditor needs to consider the risk of undisclosed related party transactions.)

The auditor's consideration of these risk factors should be documented in the workpapers. Additional procedures to respond to risks relating to related party transactions and for significant related party transactions outside the normal course of business may also be needed.

Going Concern Considerations

A contractor's financial statements prepared in accordance with GAAP are based on the assumption that the contractor is a going concern unless and until the contractor's liquidation becomes imminent. FASB ASC 205-40, *Presentation of Financial Statements—Going Concern*, is effective for the annual period ending after December 31, 2016, and for annual periods and interim periods thereafter. It provides guidance for evaluating whether there is substantial doubt about an entity's ability to continue as a going concern and provides related disclosure requirements. FASB ASC 205-40 requires management to evaluate, at both interim and annual periods, whether conditions and events raise substantial doubt about an entity's ability to continue as a going concern within one year after the financial statements are available to be issued. Management's evaluation should be based on an assessment of the effect of known and reasonably knowable conditions and events at the date the financial statements are available to be issued. For example, a contractor's inability to complete contracts or obtain required performance bonds would be a serious indication of a going concern problem.

FASB ASC 205-40 differs in several respects from the current auditing standards at SAS No. 126 (AU-C 570A), *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. In addition to the explicit recognition that it is management's responsibility to make the initial evaluation, the primary technical differences between FASB ASC 205-40 and past practice guided by auditing standards are (a) lengthening the evaluation period from one year after the date of the financial statements to one year after the date the financial statements are available to be issued and (b) identification of *probable* as the threshold of uncertainty for determining the existence of substantial doubt. The term *probable* means the future event or events are likely to occur, which is consistent with how that term is used in FASB ASC 450, *Contingencies*.

In February 2017, the AICPA issued SAS No. 132 (AU-C 570), *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, which aligns auditing standards with the requirements of FASB ASC 205-40. SAS No. 132 becomes effective for audits of financial statements for periods ending on or after December 15, 2017, and will supersede SAS No. 126 (AU-C 570A). Theoretically, until SAS No. 132 (AU-C 570) becomes effective, the auditor should follow the existing requirements of SAS No. 126 (AU-C 570A) during the one year period between the effective dates of FASB ASC 205-40 and SAS No. 132. However, because most contractors will have adopted the requirements of FASB ASC 205-40 for the financial statements being audited, it seems likely that auditors will follow many (or most) of the provisions of SAS No. 132 prior to its effective date. Also, the significance of the differences between SAS Nos. 126 and 132 is reduced considerably by the interpretations to AU-C 570A issued by the AICPA in January 2015. Those interpretations clarify that because the auditor forms an opinion about whether financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework, the auditor should look to the requirements of the applicable framework. In other words, the

auditor would incorporate into his or her evaluation the requirements of FASB ASC 205-40 on the meaning of *substantial doubt,* the length of the look-forward period, and the required disclosures even when applying SAS No. 126 (AU-C 570A) rather than SAS No. 132 (AU-C 570).

Because AU-C 570 incorporates the requirement for management to evaluate whether aggregate conditions or events exist that raise substantial doubt, there are corresponding changes in the auditor's approach to going concern considerations. For example, under AU-C 570, the auditor determines during risk assessment procedures whether management has performed an evaluation, discusses with management the planned use of the going concern basis, and is required to remain alert throughout the audit for any evidence of conditions or events that raise substantial doubt. In contrast, under AU-C 570A, the auditor is not required to perform specific procedures to search for conditions or events that might affect going concern status, but is specifically required to assess whether customary auditing procedures applied during the audit for other purposes have identified conditions and events that, when considered in the aggregate, indicate that there could be substantial doubt. This course discusses general aspects of the auditor's consideration of going concern status, as well as certain matters that are unique to contractors under both AU-C 570 and AU-C 570A. Detailed guidance on the specific requirements and the auditor's responsibilities for going concern considerations under both the new and existing auditing standards is available in *PPC's Guide to Audits of Nonpublic Companies*.

Conditions and Events. Under both AU-C 570 and AU-C 570A, the auditor has to consider whether conditions or events have been identified that reflect on the use of the going concern basis of accounting. Examples of conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the contractor's ability to continue as a going concern for a reasonable period include the following:

a. Negative trends.

   (1) Recurring operating losses.

   (2) Working capital deficiencies.

   (3) Negative cash flows from operating activities.

   (4) Adverse key financial ratios.

   (5) Frequent loss jobs.

   (6) Declining level of backlog.

b. Other indications of possible financial difficulties.

   (1) Default on loan or similar agreements.

   (2) Arrearages in dividends.

   (3) Denial of usual trade credit from suppliers.

   (4) Restructuring of debt.

   (5) Need to seek new sources or methods of financing.

   (6) Need to dispose of substantial assets.

   (7) Projected negative effect of current backlog.

c. Internal matters.

   (1) Work stoppages or other labor difficulties.

   (2) Substantial dependence on the success of a particular project.

(3) Uneconomic long-term commitments.

(4) Need to significantly revise operations.

(5) New joint ventures with unfamiliar partners.

(6) Loss of key people.

d. External matters that have occurred.

(1) Legal proceedings, legislation, or similar matters with potential adverse effects that might jeopardize an entity's ability to operate.

(2) Change in existing surety bonding.

(3) Denial of surety bond.

(4) Losing a key franchise, license, or patent.

(5) Losing a principal customer or supplier.

(6) Uninsured or underinsured catastrophe (such as drought, earthquake, hurricane, tornado, or flood).

e. New endeavors for which the contractor might not have the required experience to successfully operate.

(1) Bidding on new types of construction.

(2) Entering new geographical areas.

(3) Significantly increasing the size of jobs.

If necessary, the auditor needs to obtain additional information about any conditions and events identified.

Relevant Audit Procedures. The following customary auditing procedures are examples of procedures that might provide evidence about such conditions and events:

a. Applying analytical procedures.

b. Reviewing for subsequent events.

c. Reviewing compliance with the terms of debt and loan agreements, with particular attention to debt maturing in the near term.

d. Reading the minutes of meetings of stockholders, board of directors, and other important committees.

e. Inquiring of an entity's legal counsel about litigation, claims, and assessments.

f. Confirming contract details with owners and subcontractors that may indicate significant performance problems on contracts in progress.

g. Confirming with related and third parties the details of arrangements to provide or maintain financial support.

h. Reviewing costs to complete contracts in progress that indicate either a loss contract situation or a cash flow problem where future cash receipts cannot cover future contract performance obligations.

i. Reviewing significant events and transactions, such as termination of major proposed transactions, disposal of a facility or significant equipment, or significant changes in joint venture relationships.

j. Reviewing, if available, forecasts of cash flow or profit.

k. Reviewing correspondence with banks concerning credit lines and similar commitments.

l. Considering whether there has been loss of a major customer, license, supplier, franchise, or market.

An important aspect of considering the ability of a contractor to continue as a going concern is careful attention to projected cash flow. Because contractors use practices such as front-end loading to accelerate cash collections, the future cash generated by uncompleted projects may not be sufficient to meet the contractor's future obligations if there is a downturn in the contractor's level of activity.

The AICPA Guide, at Paragraphs 11.15–.17, includes a discussion of the cash flow practices of contractors and the need to test uncompleted contracts to determine the effect of projected cash receipts and payments on the contractor's cash position and ability to meet current obligations. A contractor's cash flow practices may affect the ability to continue as a going concern. For example, a cash deficiency toward the end of contracts may be experienced if a contractor incurs substantial losses on contracts that have been front-end loaded. Such deficiencies may prevent the contractor from meeting current obligations, and the contractor may front-end load new contracts to generate funds to meet those obligations. The need to generate cash may cause the contractor to accept jobs that are only marginally profitable. Thus, in reviewing uncompleted contracts, the auditor assesses both the adequacy of provisions for anticipated losses on contracts in the current period and the effect of the projected cash flow from those contracts on the contractor's ability to meet current and future obligations.

Documentation. When conditions or events are identified that (considered in the aggregate) raise substantial doubt about the contractor's ability to continue as a going concern for a reasonable period of time, before consideration of management's plans, both AU-C 570 and AU-C 570A require such matters to be documented. In other words, even if management's plans overcome the conditions or events that raised substantial doubt, documentation is still required of matters such as the specific conditions or events, particularly significant elements of management's plans, audit procedures performed to evaluate those elements, and the auditor's conclusions concerning effects on the auditor's report and the adequacy of disclosure.

Auditors can use a generalized audit program step or checklist to document going concern considerations to ensure that the assessment will be made on every audit. *PPC's Guide to Construction Contractors* includes such a program. It also includes a checklist that summarizes the consideration of management's plans and other procedures necessary when such conditions and events are identified and enables auditors to meet the documentation requirements of SAS No. 126 or SAS No. 132.

Written Representations

AU-C 580, *Written Representations*, addresses the auditor's responsibility to obtain written representations from management and, when appropriate, those charged with governance, in an audit of financial statements. Besides the representations that AU-C 580 indicates should be obtained, the AICPA Guide, at Paragraph 10.65, suggests that representations concerning the following matters be obtained:

- Income recognition method used.
- Anticipated loss provisions on contracts.
- Unapproved change orders, extras, claims, and back charges, and contract postponements or cancellations.
- Backlog information, if presented in the financial statements.
- Contracts completed during the year and in progress at year end, if presented in the financial statements.
- Participations in joint ventures and other related party transactions.

It is a best practice to include management's representations on the status of each project in the representation letter. Generally, it is more convenient to prepare a separate list of each contract and its status that is referred to in

the letter. Auditors might consider maintaining in the workpapers a list of significant management representations relied on during the audit to ensure that none are missed when preparing the representation letter. (The list would not need to include every statement or answer to a question made by management.) The auditor may wish to document on the list the reason why any representations included on the list were not included in the representation letter, but such a *to do* list needs to be handled in accordance with firm policy at the end of the audit.

AU-C 580.20 indicates that written representations should encompass all periods covered in the auditor's report. For example, if the auditor's report covers the financial statements for the years ended 20X1 and 20X2, management's representation letter should also cover both years. AICPA Technical Question and Answer, Q&A 8900.11, *Management Representations Regarding Prior Periods Presented That were Audited by a Predecessor Auditor*, clarifies that a successor auditor need not obtain written representations from management on the financial statements of prior periods when the successor's report expresses an opinion on the current period financial statements and includes an other-matter paragraph regarding the predecessor auditor as required by AU-C 700.55.

Audit Adjustments. AU-C 580.14 requires an acknowledgment in the representation letter that management has considered whether the effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of the uncorrected misstatements should be included in or attached to the representation letter. Authoritative literature does not provide specific guidance for the auditor when there are no uncorrected misstatements. In that situation (that is, when either no misstatements are noted in the audit or all noted misstatements are corrected), it seems logical that no representation about uncorrected misstatements would be necessary in the management representation letter.

Materiality. AU-C 580.A22 indicates that management's representations may be limited to matters that are either individually or collectively material to the financial statements. That limitation is acceptable only for representations that directly relate to amounts included in the financial statements and only if the auditor and management reach an agreement about what is material for this purpose. For example, it would not be acceptable to limit representations about the completeness of available financial records, management's responsibility for fair presentation, or management's acknowledgment of its responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud. AU-C 580.A22 notes that materiality may be different for different representations, and it permits, but does not require, including an explicit discussion of materiality in the representation letter in either qualitative or quantitative terms. A discussion that includes both qualitative and quantitative terms is also acceptable. However, it is not a good idea to use a purely quantitative discussion of materiality because it is inappropriate to rely solely on quantitative considerations when determining materiality. As a practical matter, this course suggests that it is not necessary to include an explicit discussion of materiality in the management representation letter for most small construction contractor engagements.

Considering the Accumulated Results of Audit Procedures

Reevaluating Risk Assessments. The auditor's assessment of the risks of material misstatement at the relevant assertion level made during planning is based on available audit evidence and naturally may change as additional evidence is obtained. For example, in performing substantive procedures, the auditor may identify misstatements that are larger or more frequent than had been anticipated. AU-C 315.32 requires the auditor to revise the risk assessment and modify further planned audit procedures if new information is obtained or if the initial assessed risks of material misstatement at the assertion level change during the audit. Furthermore, AU-C 330.27 requires the auditor to reevaluate, before the conclusion of the audit, whether the assessment of risks of material misstatement at the relevant assertion level remains appropriate. The audit evidence may either confirm the auditor's risk assessments or result in the auditor performing additional audit procedures.

An auditor cannot assume that an identified error or instance of fraud is an isolated occurrence. Instead, the auditor needs to consider how the misstatement affects the assessed risks of material misstatement. (Additionally, misstatements may indicate a significant deficiency or material weakness in internal control.) In doing so, the auditor should consider all relevant audit evidence, even if it appears to contradict relevant assertions in the financial statements.

It is natural for a contractor to have some deviations in the way controls are applied. Deviations may be caused by such factors as changes in key personnel, seasonal fluctuations in business activity, and human error. As a result,

controls may not operate as effectively as the auditor had expected. If the auditor detects deviations when performing tests of controls, he should make inquiries to understand such matters and their potential consequences and should determine whether the tests provide an appropriate basis for reliance on the controls, whether additional tests of controls are needed, or whether the potential risks of misstatement need to be addressed by substantive procedures. The auditor should also evaluate whether misstatements identified when performing substantive procedures indicate that the related controls are not operating effectively. However, the absence of identified misstatements when performing substantive procedures does not provide audit evidence that the controls related to the relevant assertion being tested are effective.

At the end of the audit, the auditor should conclude whether sufficient appropriate audit evidence was obtained to reduce to an appropriately low level the risk of material misstatement in the financial statements and to support the opinion on the financial statements. This requires the auditor to evaluate whether the audit was performed at a level that provides the auditor with a high level of assurance that the financial statements, taken as a whole, are free of material misstatement. The sufficiency and appropriateness of audit evidence is a matter of the auditor's professional judgment.

AU-C 330.29 states that if the auditor has not obtained sufficient appropriate audit evidence with respect to a relevant assertion, the auditor should try to obtain additional evidence. If the auditor cannot obtain sufficient appropriate audit evidence, the auditor should either express a qualified opinion or disclaim an opinion.

Evaluating the Existence of Fraud. Assessing the risks of material misstatement due to fraud is an ongoing process that should occur throughout the audit. Fraud risks may be identified during the engagement acceptance/continuance process, during engagement planning, while obtaining an understanding of internal control, when assessing the risks of material misstatement of the financial statements due to error or fraud, when performing further audit procedures to respond to assessed risks, or when communicating with management or others. Examples of conditions the auditor may note that may change or support the assessment of fraud risks made during planning are included in Exhibit 2-4.

Exhibit 2-4

Conditions That May Change or Support the Auditor's Assessment of Fraud Risks

- Unrecorded transactions or transactions recorded improperly as to account, amount, period, or company policy.
- Balances or transactions that are unsupported or unauthorized.
- Adjustments made by the entity at the last minute that substantially affect financial results.
- Evidence of employees' unauthorized or unnecessary access to systems or records.
- Missing documents.
- Indications of altered documents.[a]
- Only photocopies or electronic versions of documents being provided to auditors when originals are expected to exist.
- Significant unexplained reconciling items.
- Vague, implausible, or inconsistent responses by the client to the auditor's inquiries.
- Significant amounts of inventory or other physical assets are missing.
- Denial by client personnel of auditor's access to records, job sites, facilities, certain employees, customers, vendors, or others.[b]

- Unusual discrepancies between confirmation replies and the entity's records.
- Failure to retain documents or electronic files consistent with the company's record retention policies or practices.
- Unexplained, unusual transfers of costs between projects.
- Unusual delays by client personnel in providing requested information.
- Unreasonable time pressures to resolve complex or contentious accounting issues.
- Attempts by management or the owner/manager to intimidate audit team members or control the conduct of the audit.
- Complaints or tips received by the auditor about fraud or potential fraud.
- Unwillingness to make financial statement disclosures more clear or complete.
- Management's proposal of adjustments, not previously identified or communicated to the auditor, that offset misstatements found by the auditor.
- Evidence of management bias in accounting estimates.

Notes:

[a] If the auditor suspects that documents have been altered, it may be necessary to engage a specialist to determine their authenticity.

[b] Denial of access to information may constitute a limitation on the scope of the audit sufficient to preclude an unmodified opinion on the financial statements.

* * *

Required Procedures. AU-C 240.34 requires auditors to evaluate, at or near the completion of fieldwork, whether the accumulated results of auditing procedures (including analytical procedures performed as substantive tests or in the overall review stage of the audit), affect the assessment made earlier in the audit regarding the risks of material misstatement due to fraud or indicate a previously unidentified risk of material misstatement due to fraud. In addition, the auditing guidance requires analytical procedures relating to revenue to be performed through the end of the reporting period. If the full year's revenue information is available during audit planning, the procedures can be performed during preliminary analytical procedures. Otherwise, the procedures performed during planning should be updated during the final analytical review stage of the audit.

Based on the evaluation, the auditor determines whether additional or different audit procedures are necessary. In addition, the auditor should perform a qualitative evaluation of misstatements identified in the financial statements and determine whether the misstatements may indicate possible fraud. Also, communication among the engagement team about information or conditions that indicate potential risks of material misstatement due to fraud should continue throughout the audit.

Evaluating Significant Unusual Transactions. Additional substantive procedures that may be needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence in the circumstances. Because of the judgmental nature of the auditor's risk assessments and the inherent limitations of internal control, particularly the risk of management override, some substantive procedures have to be performed in every audit.

AU-C 240.32 requires the auditor to evaluate the business rationale for significant unusual transactions to address the risk of management override of controls by considering whether the business rationale (or lack thereof)

suggests that transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. In evaluating the business rationale for significant unusual transactions, the auditor may consider whether:

- The transaction is overly complex in relation to its stated purpose.
- Management is overly concerned that the transaction receives a particular accounting treatment.
- Previously unidentified related parties are involved in the transaction.
- The parties to the transaction lack substance.
- The transaction and the manner of accounting have been reviewed and approved at an appropriate level, such as by those charged with governance.

Considering the Application of Significant Accounting Principles for Bias. AU-C 240.29 states that the auditor should evaluate whether the application of significant accounting principles indicates a bias on the part of management. In particular, the auditor should consider accounting related to subjective measurements and complex transactions. Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure is one way in which fraudulent financial reporting can be accomplished.

Documentation Requirements. AU-C 230.08 requires auditors to document significant audit findings or issues, the conclusions reached about such findings or issues, and significant professional judgments made in reaching those conclusions. Judging the significance of a finding or issue generally requires an objective analysis of the facts and circumstances. Examples of significant audit findings or issues and a discussion of the requirements of AU-C 230 are provided later in this lesson.

Analytical Review

AU-C 520.06 requires the use of analytical procedures in the final review stage of all audits. The purpose of analytical procedures at this stage is to assist the auditor in assessing the validity of the conclusions reached, including the opinion on the financial statements. In other words, the auditor uses analytical procedures at this stage to assess whether the financial statements make sense based on the knowledge and understanding obtained during the audit. Are the relationships depicted in the financial statements reasonable, based on the auditor's knowledge of the contractor client, its operations and industry, and other information obtained in performing the audit?

AU-C 520.A25 states that this overall review would generally include consideration of:

a. the adequacy of evidence gathered in response to unusual or unexpected balances identified in planning the audit or in the course of the audit, and

b. unusual or unexpected balances or relationships that were not previously identified.

In other words, the auditor considers whether the information gathered during the audit provides a sufficient understanding of unusual or unexpected financial statement relationships. This assessment includes consideration of those matters identified during preliminary analytical procedures, as well as matters that become apparent for the first time during the final review stage. When the auditor does not have a sufficient understanding of the cause of an unusual or unexpected relationship, the auditor may need to revise the risk of material misstatement and apply additional audit procedures.

Preliminary analytical procedures are risk assessment procedures performed to obtain an understanding of the entity and its environment for the purpose of assessing the risks of material misstatement and determining what further audit procedures should be performed in response to the risk assessment. Final review analytical procedures are used to consider the adequacy of the procedures performed. Although the objective of applying the procedures may differ, the analytical procedures actually applied may be very similar or identical. At the planning stage, analytical procedures will be applied to unaudited amounts. In the final review stage, the procedures will be

applied to amounts after audit adjustment. Thus, in the final review, a simple comparison to prior period amounts at the financial statement level is normally effective.

AU-C 240 requires the auditor to perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. Those procedures should be performed through the end of the reporting period. If the full year's revenue information is available during audit planning, the required procedures can be performed during preliminary analytical procedures and updated during the final analytical review stage of the audit.

Evaluation of Overall Materiality

The combined effect of uncorrected misstatements on various financial statement components (amounts, subtotals, or totals) should be compared to the amount that the auditor considers material to the financial statements taken as a whole. The auditor's judgments about materiality in audit planning may be different than materiality used in evaluating audit findings because it is not possible to anticipate everything that could ultimately influence judgments about materiality when evaluating audit findings at completion of the audit. For example, while performing the audit, the auditor may become aware of quantitative or qualitative factors that were not initially considered but could be important to users of the financial statements. Those factors should be considered in making materiality judgments about audit findings. If the auditor concludes that a lower materiality level than initially determined is appropriate, the auditor reconsiders performance materiality and appropriateness of the nature, timing, and extent of further audit procedures. If the nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that could be material when aggregated with identified misstatements, the auditor should also consider whether the overall audit strategy and audit plan need to be revised.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. Archie General Contracting guarantees the debt of a subcontractor that it does not control. What is the correct accounting for this type of situation?

    a. Recognizing a liability for the guarantee amount at its inception.

    b. Developing an independent expectation of the estimated amount.

    c. Determining whether the amount would have a severe impact.

    d. Consolidating the subcontractor in the general contractor's financial statements.

16. The following auditors are all performing annual audits for a construction contractor client. Which one has correctly performed one of the typical wrap-up procedures for this type of engagement?

    a. Stephen makes sure that all environmental remediation liabilities that will have a severe impact on the financial statements have been disclosed.

    b. Erin obtains written representations from her client's management and those charged with its governance.

    c. David does not perform many procedures to account for related parties as they are very uncommon in the construction industry.

    d. Julie focuses her procedures related to subsequent events on those that affect gross profit that her contractor client reports in the financial statements.

17. When evaluating a significant unusual transaction, which of the following is a warning sign of possible fraudulent financial reporting or misappropriation of assets?

    a. The transaction is simple and serves its stated purpose.

    b. The transaction receives the typical accounting treatment for its type.

    c. Parties involved in the transaction lack substance.

    d. Appropriate levels of oversight have reviewed and approved the transaction.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. Archie General Contracting guarantees the debt of a subcontractor that it does not control. What is the correct accounting for this type of situation? **(Page 65)**

    a. Recognizing a liability for the guarantee amount at its inception. [This answer is correct. According to FASB ASC 460, *Guarantees,* a guarantor, like Archie General Contracting, is required to recognize a liability for the fair value of a guarantee at inception because the guarantor's obligation to stand ready to perform under a guarantee is noncontingent.]

    b. Developing an independent expectation of the estimated amount. [This answer is incorrect. When a contractor is subject to an environmental remediation liability, one action that may need to be taken is to develop an independent expectation of the estimate, which usually will require the use of an environmental specialist. However, Archie General Contracting is not subject to an environmental remediation liability in this scenario; therefore, this accounting is not necessary.]

    c. Determining whether the amount would have a severe impact. [This answer is incorrect. One significant difference between auditing disclosures of concentrations and auditing disclosures of significant estimates is that the threshold for disclosure is different. For concentrations, the threshold is *severe impact,* whereas for significant estimates, the threshold is *material*. However, in the scenario above, Archie General Contracting did not face a significant estimate or a concentration. The accounting treatment for a guarantee would not differ based on the amount or its impact.]

    d. Consolidating the subcontractor in the general contractor's financial statements. [This answer is incorrect. Contractors need to appropriately consolidate variable interest entities; however, the situation with the guarantee described in this scenario does not make the subcontractor a variable interest entity with relation to Archie General Contracting.]

16. The following auditors are all performing annual audits for a construction contractor client. Which one has correctly performed one of the typical wrap-up procedures for this type of engagement? **(Page 71)**

    a. Stephen makes sure that all environmental remediation liabilities that will have a severe impact on the financial statements have been disclosed. [This answer is incorrect. To be in compliance with AU-C 250, the auditor needs to identify instances of noncompliance with environmental regulations that may have a *material* effect on the financial statements. In this scenario, Stephen may not have identified enough such situations.]

    b. Erin obtains written representations from her client's management and those charged with its governance. [This answer is correct. AU-C, *Written Representations*, addresses the auditor's responsibility to obtain written representations from management and, when appropriate, those charged with governance, in an audit of the financial statements. Therefore, it is possible that Erin will need representation from both entities, as described in this answer choice.]

    c. David does not perform many procedures to account for related parties as they are very uncommon in the construction industry. [This answer is incorrect. Related party transactions are relatively common in the construction contracting industry. Contractors often participate in joint ventures or have a direct or indirect affiliation with another related business. Therefore, David needs to make sure he fulfills his responsibilities in this regard as discussed in AU-C 550, *Related Parties.*]

    d. Julie focuses her procedures related to subsequent events on those that affect gross profit that her contractor client reports in the financial statements. [This answer is incorrect. Though the auditor is particularly concerned with events in the subsequent period that affect estimated gross profit reported in the financial statements, procedures related to this type of subsequent event are not the only ones that should be performed. Auditors also need to perform the normal subsequent events procedures that they

do for all audits. If Julie focuses all her procedures on this one type of subsequent event, she could miss something that affects the financial statements.]

17. When evaluating a significant unusual transaction, which of the following is a warning sign of possible fraudulent financial reporting or misappropriation of assets? **(Page 74)**

    a. The transaction is simple and serves its stated purpose. [This answer is incorrect. A warning sign would be if the transaction is overly complex in relation to its stated purpose.]

    b. The transaction receives the typical accounting treatment for its type. [This answer is incorrect. If management is overly concerned that a significant unusual transaction receives a particular accounting treatment, it could be a red flag for fraud or misappropriation.]

    c. Parties involved in the transaction lack substance. [This answer is correct. AU-C 240.32 requires the auditor to evaluate the business rationale for significant unusual transactions to address the risk of management override of controls by considering whether the business rationale (or lack thereof) suggests that transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets. One of the things the auditor should consider is whether the parties to the transaction lack substance. If they do, the auditor should check more closely for fraud or misappropriation.]

    d. Appropriate levels of oversight have reviewed and approved the transaction. [This answer is incorrect. One thing an auditor should consider is whether the transaction and the manner of accounting have been reviewed and approved at an appropriate level, such as by those charged with governance.]

CLIENT COMMUNICATIONS IN A CONSTRUCTION CONTRACTOR'S FINANCIAL STATEMENT AUDIT

This section describes client communications in conjunction with an audit of financial statements including:

a. Communicating internal control related matters.

b. Communication with those charged with governance.

c. Communication of violations of laws and regulations and fraud.

Communicating Internal Control Related Matters

AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, establishes requirements for auditors to communicate certain control deficiencies that they have identified during the audit. Control deficiencies that are, in the auditor's judgment, *significant deficiencies* or *material weaknesses* should be communicated in writing to management and those charged with governance.

Definitions. AU-C 265, as amended by AU-C 940, contains the following definitions:

- *Deficiency in Internal Control.* "A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing, or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively."

- *Significant Deficiency.* A significant deficiency is "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance."

- *Material Weakness.* A material weakness is "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable as defined as follows:

  - *Reasonably Possible.* The chance of the future event or events occurring is more than remote but less than likely.

  - *Probable.* The future event or events are likely to occur."

Examples of Deficiencies. Exhibit 2-5 lists examples from AU-C 265.A37 of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

Identifying Control Deficiencies. The responsibility imposed by AU-C 265 is a reporting, not a detection, responsibility. An auditor is not required to perform procedures to identify deficiencies in internal control, but may become aware of control deficiencies while performing audit procedures such as obtaining an understanding of internal control, performing risk assessment procedures, or performing tests of the operating effectiveness of controls (that is, tests of controls).

Exhibit 2-5

Examples of Circumstances That May Be Control Deficiencies, Significant Deficiencies, or Material Weaknesses

Deficiencies in the Design of Controls

- Inadequate design of internal controls over the preparation of financial statements.
- Inadequate design of internal control over a significant account or process.
- Inadequate documentation of the components of internal control.
- Insufficient control consciousness within the organization, e.g., the tone at the top and the control environment.
- Absent or inadequate segregation of duties within a significant account or process.
- Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).
- Inadequate design of IT general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
- Employees or management lack the qualifications and training to fulfill their assigned functions. For example, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording transactions or preparing the financial statements.
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of internal control over time.
- The absence of an internal process to report deficiencies in internal control to management on a timely basis.
- An indication that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance or other evidence that certain aspects of the control environment are ineffective.
- Failure of management to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified or other evidence that the entity's risk assessment process is ineffective.
- Absence of controls over a significant identified risk or other evidence of an ineffective response to significant risks that have been identified.
- Absence of a risk assessment process when such a process would ordinarily be expected to have been established.

Failures in the Operation of Controls

- Failure in the operation of effectively designed controls over a significant account or process (for example, the failure of a control requiring dual authorization for significant disbursements).
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy (for example, the failure to obtain timely and accurate information from job sites).

- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. (This circumstance may need careful consideration when it is evaluated as a significant deficiency or material weakness.)
- Failure to reconcile significant accounts.
- Undue bias or lack of objectivity by those responsible for accounting decisions (for example, expenses are consistently understated at the direction of management).
- Misrepresentation by client personnel to the auditor (an indicator of fraud).
- Management override of controls.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.
- An observed deviation rate that exceeds the number of deviations expected by the auditor in a test of the operating effectiveness of a control. For example, if the auditor designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

* * *

Evaluating Identified Deficiencies. If the auditor has identified one or more deficiencies in internal control, AU-C 265.09 requires that the auditor evaluate each deficiency to determine, on the basis of the audit work performed, whether, individually, or in combination with other deficiencies, it constitutes a significant deficiency or material weakness. Auditors should evaluate control deficiencies individually and in combination with other deficiencies affecting the same significant class(es) of transactions, account balance(s), or disclosure(s), relevant assertion(s), or component(s) of internal control. This is because multiple control deficiencies that affect the same financial statement class(es) of transactions, account balance(s) or disclosure(s), relevant assertion(s) or component(s) of internal control increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness even though they are individually insignificant.

AU-C 265.A5 provides guidance on evaluating the severity of an identified deficiency, stating that it depends on whether a misstatement has actually occurred and on:

- The magnitude of the potential misstatement resulting from the deficiency or deficiencies and
- Whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct a misstatement of an account balance or disclosure.

Factors Affecting Magnitude of a Potential Misstatement. If an actual misstatement has occurred, it may be easier for the auditor to evaluate the severity of a control deficiency because the amount of the misstatement is known. In that instance, however, it is still necessary to evaluate whether the control deficiency could have resulted in additional misstatements. In many cases, the auditor will be evaluating only a potential misstatement. Determining the magnitude of a potential misstatement may be difficult. When evaluating the magnitude of the potential misstatement, according to AU-C 265.A6 the auditor might consider several factors, including:

- The financial statement amounts or transaction totals exposed to the deficiency.
- The volume of activity (in the current period or expected in future periods) in the account or class of transactions exposed to the deficiency.

Generally, the most an account balance or transaction total could be overstated is the recorded amount. Potential understatement, however, is not limited to the recorded amount.

Auditors should focus on the fact that the magnitude of a potential misstatement discussed in AU-C 265 affects only whether a deficiency is communicated to management and those charged with governance. Unlike judgments about the materiality of a misstatement or omission, which can affect whether a client's financial statements are fairly presented (and, thus, the auditor's opinion on those statements), the auditor's judgment about the magnitude of a potential misstatement affects only whether the auditor is required to communicate the identified deficiency to the client. Therefore, when in doubt about the severity of a control deficiency, it is a best practice for the auditor to communicate it to the client.

Factors Affecting Whether There Is a Reasonable Possibility of a Misstatement. *Reasonable possibility* was defined above. When evaluating whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure, AU-C 265.A8 notes that the auditor might consider certain risk factors such as:

- The nature of the classes of transactions, account balances, disclosures, and assertions involved (for example, suspense accounts or transactions with related parties may present more risk).
- The cause and frequency of exceptions detected as a result of the deficiency(ies).
- Susceptibility of the related assets or liabilities to loss or fraud.
- The complexity, subjectivity, and extent of judgment needed to determine the amount involved.
- The relationship and interaction of the control with other controls.
- Interaction of the control deficiency with other control deficiencies.
- Possible future consequences resulting from the deficiency.
- The importance of controls to the financial reporting process—for example, general monitoring controls (such as oversight of management) or controls over:
  - The prevention and detection of fraud
  - The selection and application of significant accounting policies
  - Significant transactions with related parties
  - Significant transactions outside the entity's normal course of business
  - The year-end financial reporting process (such as controls over nonrecurring journal entries)

Indicators of Material Weaknesses. AU-C 265.A11 states that indicators of a material weakness include the following:

- Identification of fraud, whether or not material, on the part of senior management.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.
- Identification by the auditor of a material misstatement of the financial statements under audit in circumstances indicating that the misstatement would not have been detected by the entity's internal control.
- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

While AU-C 265 identifies the factors described in the preceding paragraph only as *indicators of material weaknesses*, it seems likely that auditors generally would consider such deficiencies material weaknesses.

Combination of Identified Deficiencies. As previously discussed, in addition to evaluating the severity of individual control deficiencies identified during the audit, AU-C 265.09 requires that the auditor evaluate whether deficiencies are considered to be material weaknesses or significant deficiencies when combined with other deficiencies affecting the same class of transactions, account balance or disclosure, relevant assertion, or component of internal control.

To illustrate, assume an auditor considers several control deficiencies in and of themselves insignificant and, thus, only control deficiencies. If those control deficiencies were related, however (for example, they all related to the same account balance), the requirement in AU-C 265 to combine control deficiencies might cause the auditor to consider them a significant deficiency or material weakness.

Control Deficiency Evaluation Worksheet. To determine which control deficiencies to report, the auditor first *identifies* control deficiencies, and then *evaluates* them to determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses. Auditors can begin by listing all identified control deficiencies and the significant class(es) of transactions, account(s), or disclosure(s), relevant assertion(s), or internal control component(s) to which they relate. PPC's process for evaluating the severity of identified control deficiencies is included in the practice aids in *PPC's Guide to Construction Contractors*.

When developing information about a control deficiency for communication to management and those charged with governance, the auditor should document all of the important elements of the control deficiency, as well as with whom the control deficiency was discussed and whether it will be communicated to management and those charged with governance.

Can the Auditor Draft the Financial Statements? AICPA staff have indicated that some auditors may be misunderstanding important concepts underlying AU-C 265. Among these misunderstandings is the belief that the auditor's drafting of the financial statements automatically results in a material weakness. Asking the auditor to draft the financial statements does not cause a control deficiency. However, it may be the result of a control deficiency.

A system of internal control over financial reporting does not stop at the general ledger. It includes controls over financial statement preparation, including note disclosures. A control deficiency exists when the client does not have controls over preparation of the financial statements that would prevent, or detect and correct, a misstatement in the financial statements.

It is important for the client to know that even if the auditor drafts the financial statements and the related notes, the client remains responsible for them. The auditor should clearly communicate to management and those charged with governance that the financial statements are the responsibility of management. Further, management and those charged with governance need to be made aware of the possible consequences of not correcting control deficiencies.

It is important to distinguish between the auditor's responsibilities under the AICPA *Code of Professional Conduct* (the Code) and AU-C 265. The Code requires independence in the performance of an audit. According to ET 1.295 of the Code, before auditors perform nonattest services, they should determine that the general requirements of ET 1.295, *Nonattest Services*, have been met.

The determination of auditor independence is separate from the evaluation of whether there is a control deficiency. Even though the auditor can prepare financial statements and maintain independence under the Code, there could be a control deficiency. Determining whether a control deficiency exists and whether it is a significant deficiency or a material weakness is subjective and often may be a difficult judgment call. Auditors need to evaluate the facts and circumstances specific to each situation.

Communication Requirements. AU-C 265.11 states that the auditor should communicate significant deficiencies and material weaknesses identified during the audit in writing to *those charged with governance*. In addition, AU-C 265.12 states that the auditor should communicate the following *to management*:

- In writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances.

- In writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.

AU-C 265.A20 observes that significant deficiencies and material weaknesses reported in prior years that still exist need to be reported again. Therefore, it is a best practice for there to be an indication that the same comments were made in prior communications. For convenience, such comments may be presented separately from new comments under a heading such as "Significant Deficiencies Communicated in Prior Years." Prior-year comments typically are presented after new comments. The communication may merely refer to the previously-issued communication and its date.

Reporting When There Are No Significant Deficiencies. AU-C 265.16 precludes auditors from issuing a written communication stating that no significant deficiencies were identified during the audit because of the potential for such a communication to be misunderstood or misused. Therefore, in an audit engagement where no significant deficiencies or material weaknesses were identified, no written communication would be provided.

If there are no significant deficiencies, less serious control deficiencies may still exist. AU-C 265.12(b) states that the auditor should communicate, in writing or orally, other deficiencies in internal control that (a) have not been communicated to management by other parties and (b) in the auditor's professional judgment, are of sufficient importance to merit management's attention.

Reporting When There Are No Material Weaknesses. Those charged with governance or management may request the auditor to provide a written communication indicating they identified no material weaknesses during the audit. Such a written communication does not provide any assurance about the effectiveness of an entity's internal control over financial reporting; however, AU-C 265 does not preclude the auditor from issuing such a communication. However, it seems like it would be inappropriate for an auditor to issue, at an interim date, a communication stating that no material weaknesses were identified as of the interim communication date. Such a communication could be misinterpreted by management and those charged with governance that there are no identified material weaknesses when material weaknesses could be identified before completing the engagement. (As previously discussed, however, AU-C 265 does preclude the auditor from issuing a written communication stating that no *significant deficiencies* were identified.)

If the auditor agrees to issue a written communication indicating no material weaknesses were identified during the audit, AU-C 265.15 states that the written communication should include the matters required by AU-C 265.14(a), (c), and (d).

Additional Guidance on Communicating Internal Control Matters

Comprehensive guidance and tools to help auditors effectively comply with the requirements of AU-C 265 are available in *PPC's Guide to Internal Control Communications*. The *Guide* includes hundreds of examples of comments about significant deficiencies and material weaknesses categorized by significant class(es) of transactions, account balance(s), or disclosure(s) and internal control component(s). The *Guide* can be ordered by calling customer service at (800) 431-9025 or by visiting the website at **https://thomsonreuters.com/products/brands/checkpoint/ppc/**.

Communication with Those Charged with Governance

AU-C 260, *The Auditor's Communication With Those Charged With Governance*, addresses the auditor's responsibility for communicating with the individuals responsible for an entity's governance. The communication requirements of AU-C 260 apply to all entities regardless of their governance structure or size. However, specific considerations are provided for situations where all of those charged with governance are also involved in managing the entity. AU-C 260 does not establish requirements for communication with management or owners unless they are also charged with a governance role.

AU-C 260.06 defines *those charged with governance* as the persons or organizations "with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process."

For a construction contractor, the legal form of the entity will usually determine the individuals with whom the auditor is to communicate. If the contractor is not incorporated, the auditor needs to reach agreement with the owners or partners as to the individuals with whom to communicate. If the contractor is organized as a corporation, the board of directors should generally be the governing body with whom the auditor will communicate. If the board has established an audit committee or similar group, the communications may generally be with that subgroup.

Matters to Be Communicated. The auditor should clearly communicate matters that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. AU-C 260.10–.14 discusses the requirements that auditors should follow to achieve the objectives of (a) clearly communicating the auditor's responsibilities regarding the audit as well as an overview of the planned scope and timing of the engagement, and (b) providing timely observations that are significant and relevant to the responsibility of overseeing the financial reporting process. The following paragraphs explain these requirements classified and presented in the following categories:

a. *Auditor Responsibility.* The auditor's responsibilities under generally accepted auditing standards.

b. *Planned Scope and Timing of the Audit.* An overview of the planned scope and timing of the audit.

c. *Significant Findings from the Audit.* The auditor's views about findings or issues that the auditor considers to be significant and relevant to those charged with governance regarding their oversight of the financial reporting process.

d. *Uncorrected Misstatements.* Information regarding uncorrected misstatements should also be communicated.

The Auditor's Responsibilities under GAAS. AU-C 260.10 provides that the auditor should communicate the following matters:

a. The auditor is responsible for forming and expressing an opinion about whether the financial statements are presented fairly in conformity with GAAP.

b. The audit does not relieve management or those charged with governance of their responsibilities.

The auditor may communicate these matters through the engagement letter or similar means as long as that communication is provided to those charged with governance.

Planned Scope and Timing of the Audit. AU-C 260.11 requires the auditor to communicate an overview of the planned scope and timing of the audit. However, the communication ought not be so detailed as to compromise the effectiveness of the audit. For example, the auditor might describe the use of the concept of materiality in planning and performing the audit, but not specific testing thresholds or amounts.

Significant Audit Findings. AU-C 260.12 requires the auditor to communicate significant audit findings or issues, including the following:

a. Qualitative aspects of the entity's significant accounting practices, including the appropriateness of the entity's significant accounting policies, management's process for identifying and making significant estimates, and the neutrality, consistency, and clarity of disclosures. If the auditor considers a significant accounting practice to be inappropriate, the auditor should explain why and request changes.

b. Significant difficulties encountered during the audit, such as significant delays in receiving required information, unavailability of expected information, an unnecessarily brief time to complete the audit, or unexpected effort to obtain sufficient, appropriate audit evidence.

c. Disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the contractor's financial statements or the auditor's report.

d. Other findings or issues that the auditor judges to be significant and relevant to those charged with governance regarding their oversight of the financial reporting process.

Uncorrected Misstatements. AU-C 260.13 requires the auditor to communicate uncorrected misstatements (other than those considered to be trivial), including the effect they might have on the auditor's opinion, to those charged with governance. The auditor should discuss material uncorrected misstatements individually and request that they be corrected. (If there are a large number of individually immaterial uncorrected misstatements, the auditor may summarize them and communicate the number and overall monetary effect on the financial statements.) The auditor should discuss the implications of not correcting known and likely misstatements. The auditor needs to also communicate the effect of prior period uncorrected misstatements on classes of transactions, account balances or disclosures, and on the financial statements taken as a whole.

AU-C 260.14 indicates that, unless all those charged with governance are involved in managing the entity, the auditor also should communicate the following:

a. Material corrected misstatements brought to the attention of management as a result of audit procedures.

b. Written representations requested from management.

c. The auditor's views about significant accounting or auditing matters that were the subject of consultation between management and other accountants.

d. Significant issues discussed, or subject to correspondence, with management.

AU-C 260.16 requires the significant audit findings to be communicated in writing when the auditor believes that oral communication would not be adequate. When the communication is in writing, according to AU-C 260.17, the auditor should indicate in writing, that it is intended solely for the information and use of those charged with governance and, if appropriate, management, and is not intended to be and should not be used by anyone other than these specified parties. AU-C 260.18 states the communication should be on a sufficiently timely basis to permit appropriate action. The auditor should evaluate whether the two-way communication process with those charged with governance is adequate according to AU-C 260.19, and, if it is not, consider the effects of the risks of material misstatements and the sufficiency and appropriateness of the audit evidence supporting the auditor's opinion. AU-C 260 does not change the communication requirements of other AU-Cs.

Documentation of Communications. AU-C 260.20 requires the auditor to document matters that have been communicated orally. This documentation may include a copy of minutes prepared by the entity. When matters have been communicated in writing, the auditor should retain a copy of the communication. The engagement letter may be used to communicate planning matters, including the auditor's responsibilities under GAAS and the planned scope and timing of the audit, as long as the letter is provided to those charged with governance. Alternatively, a separate letter can be used to communicate those matters with those charged with governance during the planning phase of the audit.

Violations of Laws and Regulations and Fraud

The auditor has certain detection and communication responsibilities under AU-C 240 related to misstatements caused by fraud and under AU-C 250 related to violations of laws and regulations. An in-depth discussion of all such responsibilities is beyond the scope of this course; however, more information is available in *PPC's Guide to Construction Contractors.* The following discussion addresses the auditor's additional responsibilities when evidence indicates that a violation of laws or regulations or fraud may have occurred.

When the auditor is confronted with information indicating potential noncompliance with laws and regulations (such as noncompliance cited in regulatory examination reports or the payment of fines and penalties) or a circumstance that indicates the possibility of fraud (such as a discrepancy between the accounting records and other audit evidence, including transactions with no supporting documentation, no apparent authorization, or that have not been recorded), the auditor should consider how and why that might have occurred and investigate further. If the investigation indicates there may have been fraud or a violation of laws or regulations, the auditor should do the following:

a. Obtain an understanding of the matter and sufficient other information to evaluate the possible effects on the financial statements and auditor's report (including the need for adjustments and for disclosure of a

violation of laws or regulations and any related contingencies, or the need for a report modification if necessary financial statement adjustments or disclosures are not made or because of a scope limitation).

b. Consider the implications for other aspects of the audit, for example, risk assessment and reliance on management's representations.

c. Discuss the matter and the need for any further investigation with an appropriate level of management at least one level above those involved.

d. If appropriate, consult with the client's legal counsel (or suggest that the client consult with legal counsel) on any questions of law and on the course of action the client should take.

e. Document a description of the identified or suspected fraud or violation of laws and regulations and the results of any conversations with management, those charged with governance, and others, if applicable.

In the rare event that management is not willing to follow sound legal advice about fraud or a violation of laws or regulations, the auditor should consider seeking the recommendation of legal counsel about possible courses of action, including possible withdrawal from the engagement. The auditor would, of course, carefully document all communications related to the matter and its disposition.

The auditor ordinarily is not responsible for disclosing fraud or violations of laws or regulations to parties other than senior management and those charged with governance. However, state laws may require communication of certain fraud or violations of laws or regulations. Some states provide criminal penalties for those who fail to report a felony to the proper authorities. Others require auditors to maintain confidentiality. It is a best practice for auditors to seek legal counsel in those situations.

Communications about Violations of Laws and Regulations or Possible Fraud. AU-C 250.21 requires the auditor to ensure that the audit committee or those charged with governance (such as the owner/manager or board of directors) is adequately informed about any violations of laws and regulations, unless clearly inconsequential, that come to the auditor's attention. If the auditor determines there is evidence fraud may exist (even if the matter is inconsequential), AU-C 240.39 requires the auditor to report it to the appropriate level of management. If the fraud or potential fraud involves senior management or causes the financial statements to be materially misstated, it should be reported directly to those charged with governance. AU-C 240.A69 indicates that auditors *may consider it appropriate* to communicate with those charged with governance about misappropriations committed by lower-level employees that do not result in a material misstatement. Auditors also normally reach an understanding with those charged with governance regarding communication about misappropriations committed by lower level employees. In the absence of such an agreement, it is a best practice for the auditor to report all instances of fraud to both the appropriate level of management and to those charged with governance. It is better for this communication to be made in writing; if not, it should at least be documented in the workpapers.

In some cases, the auditor may have a duty to disclose violations of laws and regulations or fraud to parties outside of the company. Examples of those situations include:

- To comply with legal or regulatory requirements.
- To a successor auditor making inquiries in accordance with AU-C 210, *Terms of Engagement*.
- When responding to a subpoena.
- To a government funding agency or other specified agency when complying with requirements for audits of recipients of governmental financial assistance.

Before disclosing instances of fraud to parties outside the company, it is a good idea for the auditor to consult with legal counsel due to the nature of the auditor's ethical and legal obligations.

If identified fraud risks have internal control implications, the auditor should determine whether they represent deficiencies related to the contractor's internal control that should be reported to management and others in accordance with AU-C 265. The absence of or deficiencies in processes and controls designed to mitigate or otherwise prevent, deter, and detect fraud may also be matters that require communication. The beginning of this section provides a further discussion of communicating significant deficiencies and material weaknesses to management and those charged with governance. Auditors also may wish to communicate identified fraud risks that are not otherwise required to be communicated to those charged with governance as discussed above.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

18. Which of the following contractors has a weakness in the design of its internal controls?

    a. Contractor A has an internal process for reporting deficiencies in internal control to management.

    b. Contractor B's controls do not safeguard assets from misappropriation.

    c. Contractor C uses competent employees for internal control functions.

    d. Contractor D does not have documentation of its internal control policies and procedures.

19. Existence of which of the following could indicate a material weakness in internal control?

    a. Identification of immaterial fraud on the part of senior management.

    b. Specific oversight of financial reporting by those charged with governance.

    c. Having one control that interacts with other controls.

    d. Restatement of financial statements for a change in accounting principle.

20. When might an auditor need to disclose violations of laws or regulations or fraud to someone outside of the client?

    a. The predecessor auditor makes inquiries.

    b. An attorney makes a request for information.

    c. When required by law or under a regulation.

    d. When the client receives donations from third parties.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

18. Which of the following contractors has a weakness in the design of its internal controls? **(Page 81)**

    a. Contractor A has an internal process for reporting deficiencies in internal control to management. [This answer is incorrect. A deficiency in the design of internal control would be *the absence* of an internal process to report deficiencies in internal control to management on a timely basis. Since Contractor A has this type of system in place, its internal control is functioning as designed in this area.]

    b. Contractor B's controls do not safeguard assets from misappropriation. [This answer is incorrect. While the failure of controls designed to safeguard assets from loss, damage, or misappropriation is a deficiency, it is considered a failure in the operation of Contractor B's internal control, not the design of its controls.]

    c. Contractor C uses competent employees for internal control functions. [This answer is incorrect. When employees or management lack the qualifications and training to fulfill their assigned functions, it is a deficiency or weakness in the design of an entity's internal control. Since Contractor C uses employees who are competent to perform their assigned tasks, the Contractor does not have this deficiency.]

    d. Contractor D does not have documentation of its internal control policies and procedures. [This answer is correct. One example of a deficiency in the design of internal controls is inadequate documentation of the components of internal control. Since Contractor D does not have such documentation, it has a design deficiency/weakness.]

19. Existence of which of the following could indicate a material weakness in internal control? **(Page 83)**

    a. Identification of immaterial fraud on the part of senior management. [This answer is correct. AU-C 265.A11 lists specific indicators of material weakness. One such indicator is the identification of fraud, whether or not material, on the part of senior management.]

    b. Specific oversight of financial reporting by those charged with governance. [This answer is incorrect. One of the indicators of a material weakness listed in AU-C 265.A11 is ineffective oversight of the entity's financial reporting and internal control by those charged with governance. If those charged with governance are doing specific oversight of these issues, it is less likely there will be material weakness.]

    c. Having one control that interacts with other controls. [This answer is incorrect. When determining whether there is a reasonable possibility of a misstatement, one of the considerations an auditor makes, per AU-C 265.A8, is the interaction of a control deficiency with other controls. However, just having a control that interacts with other controls is not an indicator of a material weakness.]

    d. Restatement of financial statements for a change in accounting principle. [This answer is incorrect. According to AU-C 265.A11, one indication of a material weakness is when previously issued financial statements are restated to reflect the correction of a material misstatement due to error or fraud. Restatement for other reasons is not listed in AU-C 265.A11.]

20. When might an auditor need to disclose violations of laws or regulations or fraud to someone outside of the client? **(Page 88)**

    a. The predecessor auditor makes inquiries. [This answer is incorrect. If a *successor* auditor is making inquiries in accordance with AU-C 210, *Terms of Engagement,* the auditor might have to make such a disclosure, but not to a predecessor auditor.]

    b. An attorney makes a request for information. [This answer is incorrect. The auditor does not have to respond to an attorney in this situation, but a response would have to be made if the auditor receives a subpoena.]

c. When required by law or under a regulation. [This answer is correct. In some cases, the auditor may have a duty to disclose violations of laws or regulations or fraud to parties outside the company. One example of such a situation is when it is necessary for the auditor to comply with legal or regulatory requirements.]

d. When the client receives donations from third parties. [This answer is incorrect. Donations from third parties do not always require such disclosures; however, this type of disclosure may be required to a government funding agency or other specified agency when complying with the requirements for audits of recipients of governmental financial assistance.]

THE AUDIT WORKPAPERS AND RELATED DOCUMENTATION

AU-C 230, *Audit Documentation*, addresses the auditor's responsibility to prepare audit documentation for an audit of financial statements. It requires the auditor to prepare and retain workpapers; addresses the form, content, and extent of audit documentation; and specifies requirements for revisions made to documentation after the date of the auditor's report. AU-C 230 primarily contains general documentation requirements. Other AU-C sections include additional documentation requirements that specify the application of AU-C 230 in the particular circumstances of those other AU-C sections. Exhibit A of AU-C 230 (AU-C 230.A30) lists other AU-C sections that contain specific documentation requirements and guidance.

The main purpose of workpapers, as identified in AU-C 230.02, is to provide the principal evidence for the auditor's report that includes:

- The representation that the audit was performed in accordance with generally accepted auditing standards.
- The opinion expressed (or disclaimed) on the financial statements.

In addition to this primary purpose, audit documentation can be used for a variety of other purposes. These additional purposes are discussed below.

Support for Auditor's Report

Auditors should prepare audit documentation with an appropriate amount of detail that provides a clear understanding of the work performed, the evidence obtained along with its source, and the conclusions reached. One critical need to use workpapers to support the audit report arises if the quality of the audit is questioned, for example, in litigation or regulatory proceedings where an auditor has to defend the quality of the audit or in internal and external quality control reviews. Audit documentation is an essential aspect of audit quality. An auditor's support for audit report representations, however, may not be strictly limited to what is in the workpapers. The workpapers are the principal record of the work done and conclusions reached, but an auditor, in defending the quality of the audit, might supplement the audit documentation by other means. According to AU-C 230.A7, on their own, the auditor's oral explanations do not constitute adequate support for the work performed or conclusions reached, but may be used to explain or clarify information contained in the audit documentation. An auditor does not document every consideration made during the course of the audit, but auditors should ensure that the audit documentation meets the overall requirement of providing a clear understanding of what was done, the evidence gathered, and conclusions that were reached based on the procedures and evidence obtained. As noted above, the possible use of oral explanations is not a substitute for sufficient, appropriate audit documentation that supports the auditor's report.

Auditors need to be aware that certain states and regulatory agencies may have more stringent requirements for audit documentation. For example, California has adopted rules applicable to both public and nonpublic company audits containing a rebuttable presumption that an audit procedure not documented was not performed. The burden of proof lies with the auditor. The presumption can be overcome by a preponderance of the evidence, which ordinarily needs to be more than just an oral explanation.

Other Purposes of Workpapers

While audit workpapers need to achieve the primary purpose noted above, audit documentation that is thoroughly prepared with a sufficient amount of detail can be useful for a number of purposes. In fact, firms that adopt documentation policies that encourage well-designed and prepared workpapers will often achieve a higher degree of audit effectiveness and efficiency in their engagements of both the current and future years. Some additional purposes of audit documentation include (AU-C 230.03):

- Aids in the planning and performance of the engagement.
- Provides guidance for newer team members.

- Retains a record of matters of continuing significance to future audits.
- Assists in the conduct of quality control reviews and inspections pursuant to SQCS No. 8 (QC 10).
- Reinforces and demonstrates accountability.
- Aids in engagement supervision and review.
- Assists in external review (such as regulatory compliance and peer review).

Basic Requirements for Content

The basic requirements for workpaper content in authoritative pronouncements allow some discretion in deciding on the specific workpapers to prepare. However, AU-C 230 provides criteria auditors can use in making documentation decisions. AU-C 230.08 establishes the fundamental requirement that workpapers should enable *an experienced auditor, having no previous connection with the audit* to understand—

a. The nature, timing, and extent of auditing procedures that were performed to comply with GAAS and applicable legal or regulatory requirements.

b. The results of the audit procedures performed and the evidence obtained.

c. The significant judgments made and conclusions reached on significant findings or issues.

The use of the term *experienced auditor with no previous connection to the audit* reinforces a documentation concept practiced by many auditors that indicates workpapers need to *stand by themselves*. That is, much like a well-written book, the documentation needs little or no oral explanation as to what was done, who performed the work, and the reasons for the conclusions that were reached. AU-C 230.06 defines an *experienced auditor* as an individual with practical audit experience and a reasonable understanding of audit processes; GAAS and applicable legal and regulatory requirements; the client's business environment; and auditing and financial reporting issues relevant to the client's industry.

As previously discussed, there are few stringent requirements as to what needs to be contained in the workpapers. There is no requirement for an auditor to document every item considered during the course of the audit. To do so would be impractical, if not impossible. Accordingly, the form, content, and extent of the workpapers will be dependent on factors that are unique to the engagement. In determining the documentation appropriate for a particular engagement, auditors consider:

a. The size and complexity of the entity.

b. The audit methodology and tools used.

c. The identified risks of material misstatement.

d. The nature of the auditing procedures performed.

e. The amount of judgment involved in carrying out the procedure and evaluating the results.

f. The significance of the audit evidence obtained.

g. The nature and extent of exceptions.

h. The need to document or support a conclusion not readily apparent from the documentation of the work performed or evidence gathered.

AU-C 230.09–.15 provide certain specific audit documentation requirements as follows:

a. Audit documentation should include copies of the client's records and abstracts or copies of significant contracts or agreements examined.

b. Documentation of procedures performed should identify the items tested.

c. When documenting the audit procedures performed, auditors should record who performed the work, the date of completion, who reviewed specific documentation, and the date and extent of the review.

d. Auditors are required to document information related to significant audit findings or issues.

e. In the rare instances where an auditor deems it necessary to depart from a presumptively mandatory requirement, documentation must be made of the justification for the departure and how alternative procedures performed were sufficient to achieve the objectives of the requirement.

f. Auditors are required to document certain items if revisions to the workpapers are necessary after the date of the auditor's report.

g. The report release date should be recorded in the audit documentation.

Documenting Specific Items Tested and Other Procedures

Audit documentation of the procedures performed should include identifying characteristics of the specific items that were tested. This requirement includes tests of the operating effectiveness of controls, substantive tests of details involving inspection of documents or confirmation, and inquiry and observation procedures. For inspection of documents and confirmation procedures, it seems logical that items tested can be identified by listing the items; by including a detail schedule in the workpapers, such as an aged trial balance, on which the items are identified; or by documenting in the workpapers the source and selection criteria. For example:

- For tests of significant items, documentation may describe the auditor's scope and the source of the items (for example, all payments greater than $5,000 from the December cash disbursements records).

- For haphazard or random samples, documentation may identify the items by their dates and specific invoice numbers, check numbers, employee numbers, etc.

- For systematic samples, documentation may indicate the source, starting point, and sampling interval (for example, a selection of checks from the cash disbursements journal for the period 1/1/X2 to 12/31/X2, starting with check number 2150 and selecting every 100th check thereafter).

For inquiry and observation procedures, the identifying characteristics may be recorded as follows:

- For inquiries, document the dates of the inquiries, the names and job functions of client personnel queried, and the inquiry that was made.

- For observations, document the matter observed, the individuals involved and their responsibilities, and where and when the observation took place.

If an analytical procedure is used as a substantive procedure for a relevant financial statement assertion, AU-C 520.08 requires the auditor to document (a) the expectation and the factors considered in its development (unless readily determinable from the work performed), (b) the results of the comparison between the expectation and recorded amounts, and (c) any additional procedures performed to address significant unexplained differences and the results of those procedures. Although not required by AU-Cs, documentation might also include information about the auditor's approach to evaluating the significance of the difference between the recorded amount and the expectation.

Documenting the Identification of Preparer and Reviewer

According to AU-C 230.09, auditors should record who performed the audit procedures and when such work was completed. In most situations, this is a simple process; normally the individual who performs the procedure initials and dates the specific workpaper, checklist, or program step that specifies the work performed. However, if a program step is supported by workpapers, there is no need to date both the program step and the supporting

workpapers. Doing so creates the possibility of discrepancies in the dating. Therefore, when completing audit program steps that are supported by workpapers, some auditors may choose to sign, but not date, such program steps since the supporting workpapers indicate the date the procedures were performed. In such cases, it is preferable to cross-reference the program steps to the supporting workpapers.

AU-C 230.09 also requires documentation of who reviewed *specific* audit documentation and the *date* of the review. AU-C 230.09 does not indicate the manner or form of recording the evidence of these *who and when* components of the review. However, reviewers are *not* required to evidence their review on each working paper. Often, for detailed reviewers, a practical and efficient way of indicating who reviewed the audit work and when is for the reviewer to initial and date the specific workpapers reviewed. However, auditors may adopt other documentation methods to evidence this review as long as it is clear who reviewed specified elements of the work and when the review occurred. Some auditors, especially those performing the partner level review, may prefer documenting the evidence of their review in a memo that indicates the workpaper sections reviewed and the date(s) of their review. Checklists may also be used.

Documenting Significant Findings or Issues

AU-C 230.08 requires auditors to document significant findings or issues during the audit, actions taken, evidence obtained in addressing them, and significant professional judgments made in reaching conclusions. In particular, the documentation of significant professional judgments serves to explain conclusions and reinforce the quality of the judgments, which may be especially valuable to reviewers and to users of the workpapers in subsequent years (for example, when performing a retrospective review of accounting estimates).

Discussions of significant findings or issues that occur between the auditor and management should be documented in a timely manner, including the items discussed, and when and with whom they were discussed. In addition, the auditor should document similar information regarding any discussions of significant findings or issues with internal or external parties other than management. That may include those charged with governance, lower level employees, or professional service providers. (AU-C 260, *The Auditor's Communication With Those Charged With Governance*, requires auditors to communicate significant findings from the audit to those charged with governance.) Minutes of meetings attended by the auditor at which these matters were discussed can provide this documentation.

Auditors should also document how they addressed information that was contradictory or inconsistent with their final conclusion on a significant finding or issue. Such documentation might include the auditor's procedures to address the information or consultations regarding, or resolutions of, differences in professional judgment among audit team members or between the team and others consulted.

The matters discussed above related to significant findings or issues can be documented in a memorandum. It is a best practice for such a memorandum to begin with a description of the facts giving rise to the issue, followed with a discussion of the factors considered and evidence gathered in formulating the conclusion. The auditor's conclusion ought to be clearly stated, along with his or her reasoning process supporting the conclusion. Other items that ought to be documented include any discussions as noted above, the existence of conflicting evidence or guidance supporting contrary points of view, and any consultation that occurred in resolving the issue.

Assembling, Completing, and Making Changes to Audit Documentation

Timely completion of audit documentation is critical to assure audit quality. As a practical matter, the auditor ought to strive to prepare audit documentation as the audit progresses to avoid inadvertently omitting critical information or incorrectly recording aspects of the procedures that were completed or the evidence obtained. When concluding the audit, the auditor should ensure that the documentation meets the requirements and purpose of audit documentation discussed at the beginning of this section. Professional standards also include requirements for (a) assembling and completing the workpapers at the conclusion of the audit and (b) making revisions to the documentation after the date of the auditor's report. These requirements are centered on the following key dates:

- The audit report date.
- The report release date.

- The documentation completion date.

Those dates, as well as the requirements for assembling and completing the audit file and making changes to the workpapers, are discussed in the following paragraphs.

Audit Report Date. The audit report date represents the date that the auditor has obtained sufficient appropriate evidence to support his or her opinion on the financial statements. Typically, such evidence includes evidence that:

- The audit work has been reviewed.
- The financial statements, including disclosures, have been prepared.
- Management has taken responsibility for the financial statements.

This means that the auditor's report should be dated using a date that signifies the completion of workpaper review, the preparation of the financial statements, and the receipt of management's representation that it is responsible for the financial statements (ordinarily in the management representation letter). The auditor cannot simply use the date that the audit team left the field unless the requirements of this paragraph have been satisfied at that date.

Report Release Date. The *report release date* is the date that the auditor gives the client permission to use the auditor's report in connection with the financial statements. For most audits of construction contractors, this will be the date that the auditor delivers the report to the client. AU-C 230.15 requires the auditor to document the report release date in the workpapers. In most cases, the report release date will be close to the date of the auditor's report. If there are significant delays in releasing the report, auditors ought to consider the need to apply the guidance on subsequent events provided earlier in this lesson. If there is a delay in releasing the report of more than two weeks after the report date it is a best practice to extend the subsequent events review to the later date and redate the report. This matter may be covered in the firm's quality control policies and procedures.

Documentation Completion Date. SQCS No. 8 (QC 10.49) specifies that policies and procedures should be established by the firm requiring engagement teams to complete assembly of final engagement files within a reasonable time frame after engagement reports have been released. Those policies and procedures need to comply with any time limits established by professional standards, laws, or regulations that address the assembly of final engagement files for specific types of engagements. Professional standards require completing workpapers on a timely basis. However, the final assembly and completion of the audit file should occur within 60 days of the report release date. AU-C 230.06 refers to the date that workpapers should be completed as the *documentation completion date*. After that date, the auditor *should not* delete or discard any documentation prior to the required five-year retention period indicated by AU-C 230.17. Auditors may adopt documentation completion periods that are shorter than 60 days, either on an engagement-by-engagement basis, or as part of the firm's system of quality control. In addition, the auditor needs to consider whether there are regulatory or state requirements that require a shorter documentation completion period.

Assembling and Completing the Audit File. At any time prior to the documentation completion date, the auditor is permitted to make changes to the workpapers that are administrative in nature, such as to:

- Finalize the documentation and assemble the evidence that was obtained, discussed, and agreed among the audit team prior to the date of the auditor's report.
- Insert information that was received after the date of the auditor's report such as replacing faxed copies of confirmations with originals.
- Perform routine file assembly procedures that might include sorting, cross-referencing, collating, and deleting or discarding superseded documentation.
- Sign off on file completion checklists prior to completing and archiving the workpapers.

The examples provided in this paragraph emphasize that changes to the workpapers after the date of the auditor's report and prior to the documentation completion date constitute those that are part of the *wrap-up* or workpaper

filing process. Thus, an auditor would not be adding or changing information after the date of the auditor's report that was necessary to support the opinion on the financial statements. That is, the auditor should not make changes after the report date that would have impacted the documentation of the work performed, the evidence obtained, the conclusions reached, or the review that was conducted prior to that date.

Making Changes to the Workpapers. AU-C 230.14 provides requirements for audit documentation when the auditor determines that it is necessary to make additions or other changes to the audit workpapers after the date of the auditor's report other than for those activities noted in the previous paragraph. Such changes may relate to omitted procedures that would have been considered necessary at the time of the audit, subsequent discovery of facts that existed at the date of the report, or similar matters.

For those changes noted in the previous paragraph, the auditor should make changes to the audit documentation to record the performance of the new procedure or the new conclusions that were reached. The documentation of the changes should include:

- When and by whom the changes were made and reviewed.
- The specific reasons for the change.
- The procedures performed, audit evidence obtained, conclusions reached, and the effects, if any, on the auditor's report.

The auditor needs to also consider whether there are regulatory or state requirements that differ from GAAS.

Audit Documentation Recommendations

As long as the requirements discussed earlier in this lesson are met, most of the decisions about specific workpapers will relate to (a) identifying financial statement components for which workpapers need to be prepared and (b) the extent of detail on procedures and evidence for each component. When preparing workpapers, there are a number of practical workpaper documentation techniques that auditors can follow, including the following:

- Always identify the individuals who performed and reviewed the audit work and the dates completed and reviewed.
- Clearly describe the purpose of the workpaper and the nature of the audit steps performed. For example, state "Examined vendor's invoice, purchase order, and receiving report to determine that item is a proper charge to repairs and maintenance" rather than simply "Vouched."
- Identify client prepared schedules, including, if applicable, the title of the report, the period covered, and the date prepared.
- Initial and cross-reference from the audit program to the documentation supporting the completion of the related program step.
- Document the resolution of all significant questions and issues raised during the audit, including discussions with management and others.

DRAFTING THE FINANCIAL STATEMENTS AND THE ASSOCIATED AUDITOR'S REPORT

Drafting Financial Statements

In many construction contractor engagements, the auditor drafts or assists with drafting the financial statements. (Financial statement preparation is a nonattest service subject to the Code's ET 1.295 requirements.) Client management should understand that the auditor's involvement in drafting the financial statements does not change the fact that management is responsible for the financial statements. Management is expected to

acknowledge its responsibility in the management representation letter. Furthermore, for the auditor to remain independent, among other things, management should agree to accept that responsibility, and the auditor should be satisfied that management has the ability to do so.

Drafting the Auditor's Report

AU-C 700, *Forming an Opinion and Reporting on Financial Statements*, provides guidance for forming an opinion and reporting on financial statements. In-depth guidance on reporting is beyond the scope of this course, but more information is available in *PPC's Guide to Auditor's Reports*.

Preparing the Draft Auditor's Report. It may be convenient to prepare the draft auditor's report by revising last year's report. When doing so, it is particularly important to incorporate changes that might be caused by changes in titles of financial statements; new accounting or auditing pronouncements; and different circumstances that require modification of the opinion.

Referencing all names, titles, amounts, and representations in the report to supporting documentation in the audit workpapers helps assure an accurate auditor's report. For example, the company's name can be traced to the corporate charter or letterhead, amounts appearing in an emphasis-of-matter or other-matter paragraph can be traced to the trial balance or audited financial statements, and the type of opinion can be traced to a checklist or memo in the workpapers.

Dating the Auditor's Report. GAAS requires that the date of the auditor's report should be no earlier than the date sufficient appropriate audit evidence has been obtained to support the opinion on the financial statements. Among other items, sufficient appropriate audit evidence includes evidence that:

- The audit work has been reviewed.
- The financial statements, including disclosures, have been prepared.
- Management has taken responsibility for the financial statements.

The auditor needs to coordinate the following dates:

- Audit report date.
- Management representation letter date.
- Subsequent events evaluation footnote disclosure date.

Consistency of the Financial Statements

As part of the audit and reporting on financial statements, AU-C 708, *Consistency of Financial Statements*, requires the auditor to evaluate the consistency of financial statements between periods. The objectives of the auditor are to (a) evaluate whether the comparability of the financial statements between periods has been materially affected by a change in accounting principle or by adjustments to correct a material misstatement in previously issued financial statements, and (b) when that is the case, appropriately modify the audit report.

When the comparability of the financial statements is not materially affected by either changes in accounting principle or restatement of previously issued financial statements, the auditor need not refer to consistency in the auditor's report.

AU-C 708 includes specific reporting requirements when there are material changes that affect consistency in the financial statements. For example, when an entity adopts a new accounting principle and the comparability of the financial statements is materially affected by the change, AU-C 708 requires the auditor to refer to the change in an emphasis-of-matter paragraph of their report. In that case, the auditor should determine that (a) the newly adopted principle is a generally accepted accounting principle, (b) disclosure of the change and the method of accounting for the effect of the change is in accordance with FASB ASC 250, *Accounting Changes and Error Corrections*, or

other applicable pronouncement, and (c) management has justified that the alternative accounting principle is preferable. AU-C 708 also includes other reporting requirements, including requirements relating to changes in accounting principles, changes in accounting estimates effected by changes in accounting principles, error corrections involving accounting principles, changes in the reporting entity, and error corrections not involving accounting principles. *PPC's Guide to Auditor's Reports* includes an in-depth discussion of AU-C 708 and consistency matters affecting the auditor's report.

Contractor-specific Reporting Situations

The remainder of this section describes certain aspects of audit reports that are unique or of particular importance to construction contractors. It addresses the following major subsections:

a. Common reasons for a modified report.

b. Prequalification and contractor license applications.

Common Reasons for a Modified Report

AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, provides guidance to auditors when it is necessary to issue other than an unmodified opinion in the auditor's report. According to AU-C 705.07, the auditor should modify the opinion in the auditor's report when (a) the auditor concludes, based on audit evidence obtained, that the financial statements as a whole are materially misstated, or (b) the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement. AU-C 705.08–.10 describes the three possible types of modification to the auditor's opinion as a qualified opinion, adverse opinion, and disclaimer of opinion. A qualified opinion is issued when misstatements, individually or in the aggregate, are material but not pervasive to the financial statements, or when the auditor is unable to obtain sufficient appropriate evidence, but concludes that the possible effects of undetected misstatements, if any, could be material, but not pervasive to the financial statements.

The AICPA Guide, at Paragraph 11.18, describes the following examples of situations involving construction contractors in which the auditor would generally issue a modified report:

a. The auditor cannot determine whether significant amounts of contract revenue related to claims are proper or collectible.

b. A contractor fails to maintain detailed cost records by contract, and the auditor is unable to perform extended auditing procedures to obtain sufficient appropriate evidence that the supporting data represent accumulated costs to date that are reasonably correct.

c. A contractor has cash problems due to undercapitalization or because losses have eroded its net worth and threaten its viability.

The following report modifications seem appropriate for the example situations described in the previous paragraph:

a. The inability to evaluate the propriety of revenue or collectibility of related receivables, including those for contract-related claims, raises questions about the appropriateness of the accounting principles. Thus, the auditor may need to express a qualified or adverse opinion because of the departure from GAAP.

b. Inadequacies in the contractor's detailed cost records and the inability of the auditor to apply extended procedures result in a scope limitation. The auditor should express a qualified opinion or disclaim an opinion due to the scope limitation.

c. Cash problems that threaten the ability to operate create substantial doubt about the contractor's ability to continue as a going concern. In accordance with either AU-C 570, *Going Concern*, or AU-C 570A, of the same name, the auditor should add an emphasis-of-matter paragraph after the unmodified opinion paragraph that identifies the going concern problem and that refers to a note that explains the problem in more detail.

Of the three situations described in the AICPA Guide, only the third, related to going concern status, involves an uncertainty that could be handled by adding an emphasis-of-matter paragraph. The other situations, if material, would require at least a qualified opinion.

Prequalification and Contractor License Applications

A contractor may be required to obtain a contractor license before being permitted to bid on construction projects. The contractor may also be required to submit prequalification filings with certain government agencies to qualify for bidding on or performing work for the agency. The prequalification and contractor license applications generally request that contractors provide GAAP financial information; however, the filings often prescribe preprinted forms that do not conform with professional standards either as to the auditor's report or the financial information. Accrual basis financial statements that do not include all of the required financial statement disclosures because the regulations do not require the disclosures cannot be considered regulatory basis (a type of special purpose framework pursuant to AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*). Such financial statements should be reported on as explained in the following paragraphs. However, financial statements based on regulatory accounting (measurement) requirements other than GAAP should be reported on as discussed later in this lesson.

Because many of the prequalification and contractor license application forms do not ask for or require many of the disclosures required by generally accepted accounting principles, it will be necessary to attach any otherwise omitted disclosures. The attachment normally takes the form of notes to the financial statement(s). (Most filings require a contractor to submit only a balance sheet and related disclosures.) Because a qualified or adverse auditor's opinion for omitted disclosures may unfavorably affect obtaining the license, when practical, it would be a best practice for all disclosures not included in the preprinted filing form be attached.

The filing forms in some states include *schedules* that include much of the information required by GAAP. Some auditors report on these schedules as supplementary information while others report on the information as part of the balance sheet. The advantage of reporting on these schedules as part of the balance sheet is that having the information included in the schedules meets GAAP disclosure requirements. If the schedules are reported on as supplementary information, it is then necessary to attach the same disclosures in the notes to the balance sheet.

As indicated above, many of the filing forms include preprinted audit reports which do not conform to authoritative reporting standards. Some auditor report forms can be made acceptable by inserting and/or deleting words, whereas others may be made acceptable only by complete revision. When the preprinted form complies or can be made to comply with professional standards, the preprinted audit report may be signed. If it cannot be made to comply with professional standards, a properly drafted auditor's report should be attached to the filing.

As previously noted, state prequalification forms generally require that the contractor provide GAAP financial information. However, some states have developed detailed accounting (measurement) requirements that are not in accordance with GAAP and can be considered a regulatory basis of accounting. *PPC's Guide to Auditor's Reports* provides information about reporting under the regulatory basis of accounting.

CONSIDERATIONS FOR AUDITS OF GROUP FINANCIAL STATEMENTS

AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, addresses the special considerations that apply to audits of group financial statements (group audits), particularly those that involve component auditors. There are three important terms to understand in determining whether AU-C 600 applies to an audit. As defined in AU-C 600.11, they are as follows:

- *Group financial statements*—financial statements that include the financial information of more than one component.
- Component—an entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements.
- Component auditors—*auditors who perform work on the financial information of a component that will be used as audit evidence for the group audit.*

As explained in more detail in the following paragraphs, certain requirements of AU-C 600 apply anytime the auditor is auditing group financial statements, that is, when there is more than one component included in the financial statements. Other additional requirements apply when there are one or more component auditors.

Consolidated financial statements are obviously group financial statements, but also included are combined financial statements that aggregate the financial information of components under common control as well as financial statements that aggregate other organizational structures, such as branches, divisions, or geographical locations, for which group or component management prepares financial information. The most common situations in the audit of a construction contractor to which AU-C 600 would apply are joint ventures and a contractor with a head office with one or more geographically dispersed branches or divisions. Even job sites can be components if separate accounting records are maintained for the job sites and the financial information from those accounting records is aggregated by job site in the process of preparing financial statements. The AICPA Guide, at Paragraph 11.14, observes that due to the potential for involvement of component auditors in (a) audit processes such as job site visits and inventory considerations, and (b) joint venture audits, auditors should carefully consider the requirements of AU-C 600 when planning and performing audits of contractors.

A component auditor may be part of the group engagement partner's own firm, a network firm of the group auditor, or another auditing firm. Auditors who are not members of the group engagement team are considered to be component auditors. Even when firm offices other than the lead partner's office are involved in the audit, the requirements of AU-C 600 apply. AICPA Technical Question and Answer at Q&A 8800.24, *Applicability of AU-C Section 600 When Only One Engagement Team Is Involved*, explains that while certain considerations related to component auditors are not relevant, other considerations, such as understanding components, identifying significant components, and identifying component materiality are relevant to all group audits. As a practical matter, these requirements would not normally be difficult to meet, but may require additional documentation.

AU-C 600 establishes comprehensive requirements for the conduct of a group audit, including developing an overall audit strategy and audit plan, as well as audit reporting responsibilities, including the decision of whether to make reference to a component auditor in the auditor's report on the group financial statements. *PPC's Guide to Audits of Nonpublic Companies* provides extensive discussion of planning and performing a group audit and how to obtain sufficient appropriate evidence regarding the financial information of components. *PPC's Guide to Audit Reports* provides extensive discussion and examples of audit reports, including reports in which reference is made to component auditors.

DEALING WITH SUPPLEMENTARY INFORMATION

AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, applies whenever the auditor is engaged to report on whether supplementary information presented outside the basic financial statements is fairly stated, in all material respects, in relation to the financial statements as a whole. Construction contractors often include additional information with audited financial statements, such as schedules for bonding agencies, and expect the auditor to report on such information. AU-C 725 applies in these circumstances and specifies the required auditing procedures and reporting considerations. Those requirements are explained in the following paragraphs.

The Auditor's Procedures

To report on supplementary information presented outside the basic financial statements, the auditor should perform the following procedures:

- Determine that specified conditions are met, including that (a) the supplementary information is derived from, and relates directly to, the underlying accounting records used to prepare the financial statements, (b) the supplementary information relates to the same period as the financial statements, (c) the financial statements were audited and the auditor issued a report thereon, (d) neither an adverse opinion nor disclaimer was issued on the financial statements, and (e) the supplementary information will accompany the financial statements or the financial statements will be made readily available to users.

- Obtain the agreement of management that it acknowledges and understands its responsibility (a) for preparation of the supplementary information, (b) to provide written representations, (c) to include the

report on the supplementary information in any document that contains the supplementary information and indicates that the auditor reported on it, and (d) to present the supplementary information with the audited financial statements or make the financial statements readily available to users.

- Perform specified procedures in addition to the procedures performed during the audit of the financial statements.

The additional procedures should be performed using the same materiality level used in the audit of the financial statements and should include the following:

- Inquiring of management about the purpose of the information and criteria used to prepare it.
- Determining whether the supplementary information complies with the criteria.
- Obtaining an understanding of preparation methods and determining whether methods have changed and the reasons for changes.
- Comparing and reconciling the information to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves.
- Inquiring about significant assumptions or interpretations underlying measurement or presentation.
- Evaluating the appropriateness and completeness of the information considering the results and knowledge obtained during the audit of the financial statements.
- Obtaining certain specified written representations from management.

The auditor has no responsibility to consider subsequent events with respect to the supplementary information unless that information affects the financial statements and comes to the auditor's attention before release of the report on the financial statements. If information about subsequent events that may have resulted in a report revision comes to the auditor's attention after release of the report, the auditor should consider the requirements for subsequently discovered facts. *PPC's Guide to Audits of Nonpublic Companies* provides detailed information about that topic.

Reporting on Supplementary Information

The auditor may add a paragraph to the auditor's report on the financial statements or issue a separate report. In either case, the paragraph or report should include a statement that—

- the audit was conducted for the purpose of forming an opinion on the financial statements as a whole,
- the supplementary information is presented for purposes of additional analysis and is not a required part of the financial statements,
- the supplementary information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements,
- the supplementary information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures in accordance with U.S. generally accepted auditing standards,
- the additional procedures included comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves and other additional procedures,
- the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole (when the auditor has so concluded and has issued an unmodified opinion on the financial statements).

When the auditor has qualified the opinion on the financial statements and the qualification affects the supplementary information, the opinion on the supplementary information should also be qualified.

A separate report on supplementary information, in addition to the information listed above, should include a reference to the report on the financial statements, the date of that report, the nature of the opinion on the financial statements, and any report modifications. The date of the report on the supplementary information should not be earlier than the date on which the auditor completed the required procedures on the supplementary information. If the auditor expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor is precluded from expressing an opinion on the supplementary information as indicated at the beginning of this section. In that case, the auditor may withdraw from the engagement if permitted by law or regulation or may disclaim an opinion on the supplementary information.

If the supplementary information is materially misstated in relation to the financial statements as a whole, the auditor should discuss the matter with management and propose appropriate revisions. If the revisions are not made, the auditor should either modify the opinion on the supplementary information and describe the misstatement in the auditor's report or withhold the report on the supplementary information if it is being issued as a separate report.

USING A CONTRACTOR'S INTERNAL-AUDIT ACTIVITIES

The auditor's initial consideration with respect to a construction contractor's possible internal-audit-type activities is whether those activities constitute an internal audit function within the meaning of AU-C 610, *Using the Work of Internal Audit*. Unless the internal-audit-type procedures are performed by an objective and competent function with a systematic and disciplined approach, including quality control, AU-C 610.8 indicates that those procedures are only control activities of the entity and are not considered activities of an internal audit function. For example, a construction contractor might assign accounting personnel to periodically make job site visits to assess the operations and the effectiveness of controls performed at the site and to compare materials on hand to accounting records. If the personnel performing the procedures do not meet the requirements of AU-C 610.8, then the construction contractor is not considered to have an internal audit function, and the requirements of AU-C 610 do not apply. Further, the auditor would not be able to use the work of the construction contractor personnel to perform procedures to obtain audit evidence or to provide direct assistance.

In those instances in which the construction contractor has a formal internal audit function that meets the requirements of AU-C 610.8, as described above, the auditor may be able to use the work of that function in the following ways:

a. *Use of the Work of Internal Audit.* Use the regular work performed by the internal auditors during the period to:

   (1) assist in obtaining an understanding of internal control (such as by obtaining documentation relating to the construction contractor's internal control and responding to the auditor's inquiries about controls), and

   (2) modify the nature, timing, or extent of further audit procedures (i.e., tests of controls or substantive procedures).

b. *Direct Assistance.* Use internal auditors to perform certain tests of controls or substantive tests under the external auditor's direction, supervision, and review.

External auditors may use the work of internal auditors or use them to provide direct assistance in one way or a combination of ways on a given audit engagement.

When the construction contractor has an internal audit function that can be expected to meet the requirements of AU-C 610.8, as described above, the auditor should evaluate that function to determine whether it can be used by considering—

- How the internal audit function's organizational status and policies and procedures support the objectivity of the internal auditors.

- The competency of internal audit.
- Application of a systematic and disciplined approach, including quality control.

If the external auditor determines that the internal audit function lacks sufficient competence and objectivity, the auditor should not use the work of internal auditors in obtaining audit evidence or to provide direct assistance.

When the external auditor plans to use the work of the internal audit function, the external auditor should discuss the planned use with the internal auditor to coordinate their respective activities. If the work of the internal auditor is a significant factor in determining the nature, timing, and extent of the auditor's procedures, it is desirable for the internal auditor and external auditor to agree in advance on the extent of audit coverage (such as sample sizes for testing contract costs and job sites to be visited) and the extent of the external auditor's supervision and review of the internal auditor's work.

When using the work of the internal auditor, the external auditor has a responsibility to test the work of the internal auditor. Tests should include reperformance of some procedures performed by the internal auditor. The auditor, for example, might visit one or more job sites visited by the internal auditor and reperform the procedures the internal auditor performed. In addition, the external auditor may examine similar items and observe the internal auditor's procedures. The external auditor, for example, might perform certain procedures on selected contracts and then compare those results to the results of similar work performed by the internal auditor. The extent of the tests depends on the auditor's judgment about the importance of the audit objectives.

When using internal auditors to provide direct assistance, the external auditor ought to use them for routine, nonsubjective procedures and low-risk assertions, such as comparing direct costs to job cost records. As the materiality of financial statement amounts increases along with increases in the risk of material misstatement or amount of judgment involved, the external auditor needs to perform the procedures rather than using internal auditors. The auditor, for example, should perform the procedures for testing the construction contractor's revenue recognition.

For more information, see *PPC's Guide to Audits of Nonpublic Companies*, which provides extensive discussion on using the work of internal auditors to provide audit evidence and to provide direct assistance, as well as meeting the requirements under AU-C 610.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. To meet the guidelines set forth in professional standards, an auditor's workpapers should do which of the following?

    a. Further the understanding of the audit team and the client's management.

    b. Describe a sampling of the audit procedures performed in the engagement.

    c. Describe the results of audit procedures and the evidence obtained.

    d. Provide a record of issues found that are material weaknesses or greater.

22. Race Construction wants Melanie, its auditor, to draft its financial statements. How will this affect Melanie's engagement?

    a. Melanie will need to take responsibility for the content of the financial statements.

    b. The management of Race Construction will need to address the issue in the management representation letter.

    c. The management of Race Construction must assure Melanie that it is able to be responsible for the content of the financial statements.

    d. Melanie will have to withdraw from the engagement because drafting the financial statements impairs her independence.

23. If an auditor adds a paragraph to his or her report about supplementary information, the paragraph should include a statement that says which of the following?

    a. The audit was conducted to form an opinion on the supplementary information.

    b. The supplementary information is a required part of the basic financial statements.

    c. The supplementary information is fairly stated in relation to the financial statements as a whole.

    d. The supplementary information was not subject to audit procedures because it is not part of the financial statement presentation.

24. Which of the following statements best describes how an auditor can work with a construction contractor's internal auditors?

    a. External auditors must choose whether to use the work of internal auditors directly or indirectly and carry that through the engagement.

    b. Though the work done by internal auditors is more relaxed, it can still be used by an external auditor.

    c. The external auditor can use the work from the internal auditor as it is without further testing.

    d. When using the work of internal auditors, the external auditor should limit it to routine procedures requiring little judgment.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. To meet the guidelines set forth in professional standards, an auditor's workpapers should do which of the following? **(Page 95)**

    a. Further the understanding of the audit team and the client's management. [This answer is incorrect. According to AU-C 230.08, workpapers should be understandable for an experienced auditor who has no previous connection with the audit. The workpapers need to be able to stand on their own with little to no oral explanation. Therefore, if the auditor would have to have been involved with the audit or affiliated with the client to understand, the workpapers are not thorough enough.]

    b. Describe a sampling of the audit procedures performed in the engagement. [This answer is incorrect. Based on the guidance in AU-C 230-08, the workpapers should allow understanding of the nature, timing, and extent of auditing procedures that were performed to comply with GAAS and applicable legal or regulatory requirements. Therefore, merely noting a sample of the procedures performed in the workpapers would not be enough information.]

    c. Describe the results of audit procedures and the evidence obtained. [This answer is correct. As described in AU-C 230, one of the fundamental requirements of workpapers is that they allow understanding of the results of audit procedures performed and the evidence obtained. Doing so allows the auditor to be in compliance with GAAS.]

    d. Provide a record of issues found that are material weaknesses or greater. [This answer is incorrect. Under AU-C 230.08, the workpapers should allow understanding of the significant judgments made and conclusions reached on significant findings or issues. While any material weaknesses would obviously need to be discussed to meet this guideline, limiting the workpapers only to issues judged to be at the level of a material weakness would mean the workpapers do not include enough information, as there could be other significant issues that need to be included that may not be as pervasive as a material weakness.]

22. Race Construction wants Melanie, its auditor, to draft its financial statements. How will this affect Melanie's engagement? **(Page 99)**

    a. Melanie will need to take responsibility for the content of the financial statements. [This answer is incorrect. Even if Melanie drafts the financial statements, the management of Race Construction needs to understand that they are still responsible for the financial statements.]

    b. The management of Race Construction will need to address the issue in the management representation letter. [This answer is correct. In many construction engagements, the auditor drafts or assists with drafting the financial statements. This is a nonattest service subject to the Code's ET 1.295 requirements. For Melanie to retain her independence, one thing that must occur is for management to acknowledge its responsibility for the financial statements in the management representation letter.]

    c. The management of Race Construction must assure Melanie that it is able to be responsible for the content of the financial statements. [This answer is incorrect. Melanie needs to be satisfied that management has this ability. Merely taking their word for it may not be enough.]

    d. Melanie will have to withdraw from the engagement because drafting the financial statements impairs her independence. [This answer is incorrect. There are ways that Melanie can draft the financial statements while retaining her independence. She would not necessarily have to withdraw from the engagement as long as she follows the proper guidelines.]

23. If an auditor adds a paragraph to his or her report about supplementary information, the paragraph should include a statement that says which of the following? **(Page 104)**

    a. The audit was conducted to form an opinion on the supplementary information. [This answer is incorrect. The statement should say that the audit was conducted for the purpose of forming an opinion on the financial statements as a whole, not just the supplementary information.]

    b. The supplementary information is a required part of the basic financial statements. [This answer is incorrect. The statement should say that the supplementary information is presented for purposes of additional analysis and is *not* a required part of the financial statements.]

    c. The supplementary information is fairly stated in relation to the financial statements as a whole. [This answer is correct. The paragraph in the auditor's report needs to include specific information. One of the statements that should be included is that the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole (when the auditor has so concluded and has issued an unmodified opinion on the financial statements).]

    d. The supplementary information was not subject to audit procedures because it is not part of the financial statement presentation. [This answer is incorrect. The statement should say that the supplementary information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures in accordance with U.S. generally accepted auditing standards.]

24. Which of the following statements best describes how an auditor can work with a construction contractor's internal auditors? **(Page 106)**

    a. External auditors must choose whether to use the work of internal auditors directly or indirectly and carry that through the engagement. [This answer is incorrect. External auditors may use the work of internal auditors or use them to provide direct assistance in one way or a combination of ways on a given audit engagement.]

    b. Though the work done by internal auditors is more relaxed, it can still be used by an external auditor. [This answer is incorrect. Unless the internal-audit-type procedures are performed by an objective and competent function with a systematic and disciplined approach, including quality control, AU-C 610.8 indicates that those procedures are only control activities of the entity and are not considered activities of an internal audit function. Therefore, when the work done by the internal auditors is more relaxed, they would not be considered auditors under the professional standards, and, therefore, the external auditor could not use their work in the same way.]

    c. The external auditor can use the work from the internal auditor as it is without further testing. [This answer is incorrect. When using the work of the internal auditor, the external auditor has a responsibility to test the work of the internal auditor. Tests should include reperformance of some procedures performed by the internal auditor.]

    d. When using the work of internal auditors, the external auditor should limit it to routine procedures requiring little judgment. [This answer is correct. When using internal auditors to provide direct assistance, the external auditor ought to use them for routine, nonsubjective procedures and low-risk assertions, such as comparing direct costs to job cost records. As the materiality of financial statement amounts increases along with increases in the risk of material misstatement or amount of judgment involved, the external auditor needs to perform the procedures rather than using internal auditors.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Construction Contractors—Construction Contracts, Audit Programs and Procedures, and Concluding the Audit (CONTG171)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

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   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

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   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you

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EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Construction Contractors—Construction Contracts, Audit Programs and Procedures, and Concluding the Audit (CONTG171)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which contract document includes boilerplate language and clauses that apply to most construction contracts?

   a. Addenda.

   b. Contract Agreement.

   c. General Conditions of the Contract.

   d. Project Plans.

2. What contract document confirms the official date that the project begins and could, therefore, be used when calculating penalties?

   a. Bid documents.

   b. General Conditions of the Contract.

   c. Notice of Award.

   d. Notice to Proceed.

3. A unit-price contract is a variation on what other type of contract?

   a. The American Institute of Architects contract.

   b. A cost-plus-fee contract.

   c. A customized contract.

   d. A lump-sum contract.

4. When would the owners of a construction contract generally prefer a cost-plus-fee contract?

   a. They need the project to be completed quickly.

   b. They need the project to be completed for a fixed amount.

   c. They need the project completed with little or no change.

   d. They do not have much confidence in the ability of their general contractor.

5. What is an advantage of using a standard contract?

   a. They are based on the body of existing legal experience.

   b. They are expensive to write and not easily attainable.

   c. They are likely to include conditions specific to a particular project.

   d. The assumptions included should be valid in all similar engagements.

6. Rockin' M Construction has already started construction on a building when the owner decides to add an additional room. Which of the following clauses should be used to adjust the contract?

   a. A changed conditions clause.

   b. A change order clause.

   c. An extension of time clause.

   d. A warranty.

7. How does a pay-when-paid clause work?

   a. It allows owners to retain a percentage of the progress payments until the job is finished.

   b. It allows contractors to pay subcontractors when the owner pays the contractor.

   c. It allows the owner to require the general contractor to insure the property during construction.

   d. It requires the contractor to pay the owner a daily rate when completion of a project is delayed.

8. When a surety issues a contract bond, what is it guaranteeing?

   a. To complete a construction project if the contractor cannot.

   b. To pay the contractor for the project if the owner cannot.

   c. To pay any subcontractors or suppliers if the owner and the general contractor cannot.

   d. That the contractor is of good character.

9. Marktown Bonding is a surety that provides contract bonds to construction contractors. The surety requires contractors provide their financial statements before they can be considered for a bond. What type of basic financial statements would be the most useful to Marktown?

   a. Statements presented using the income tax basis of accounting.

   b. Comparative financial statements for a five-year period.

   c. Compiled or reviewed annual financial statements.

   d. Concise statements with no additional supplementary schedules.

10. How can a CPA help a construction contractor secure bonding?

    a. Alter records so the contractor's finances look more secure.

    b. Develop the contractor's financial reporting system to ensure appropriate records.

    c. Choose accounting treatments that the surety will favor.

    d. Advise the contractor about how proposed transactions may affect its accounting.

11. When Cannon Construction cannot complete its construction contract on a new office complex, A&B Bonds, the surety, selects a new contractor to finish the job and then pays the owner of the project the difference between the balance on the bonded contract and the new contract. This is an example of which of the following?

    a. The finance option.

    b. The settlement option.

    c. The takeover option.

    d. The tender option.

12. What is the main disadvantage when a surety uses the settlement option?

    a. Higher risk of additional loss.

    b. Higher legal fees.

    c. The high cost of the settlement.

    d. The likelihood of resistance by the owner.

13. Which of the following auditors would be most likely to use the specific risk approach for his or her construction contractor audit?

    a. Allison's construction contractor client is a large, public entity.

    b. Brandon reduces his assessment of control risk by relying on the effectiveness of his client's controls.

    c. Carolina's client has an accounting staff that is competent at processing data and making necessary decisions.

    d. Douglas modifies his audit programs when he discovered a material weakness in the control environment.

14. What theory best describes how an auditor should choose between basic, limited, and extended audit approaches?

    a. Unless there are significant circumstances to mitigate associated risks, auditors should use the most detailed approach available.

    b. The auditor should default to use of the basic approach unless the customer indicates more or less detail is required.

    c. The auditor needs to balance efficiency and effectiveness so audit risk is covered but the time commitment is not too excessive.

    d. To avoid overauditing and inflating the budget, auditors should stick with the limited approach as often as possible.

15. Which of the following would be considered a test of details?

    a. Confirming account balances.

    b. General analytical procedures.

    c. Making inquiries of the client.

    d. Scanning accounting records.

16. According to U.S. GAAP, how do contractors have to accumulate their costs?

    a. On a monthly basis.

    b. On an annual basis.

    c. On a payment-by-payment basis.

    d. On a contract-by-contract basis.

17. When is it most efficient for an auditor to confirm a contractor's contract prices and billings?

    a. Monthly.

    b. Quarterly.

    c. At year end.

    d. At the conclusion of each contract.

18. When might an auditor want to use audit sampling to perform detailed tests of a contractor's payroll transactions?

    a. The contractor has a large labor force.

    b. The contractor worked on a large number of contracts.

    c. The contractor is a nonpublic entity.

    d. The contractor is a high-risk client.

19. In which area would auditors most likely need to provide substantial bookkeeping assistance to their construction contractor audit clients?

    a. Allocating direct labor costs to individual contracts.

    b. Allocating direct costs other than labor to individual contracts.

    c. Allocating indirect costs to individual contracts.

    d. Allocating costs for contracts that are not considered significant.

20. Which of the following costs can be deferred in anticipation of future contracts?

    a. One-time costs that are considered start-up activities.

    b. Architectural costs for negotiating a contract.

    c. Construction period interest on discrete projects.

    d. Indirect costs that are allocated to individual contracts.

21. An asset account for underbillings and a liability account for overbillings are used for which of the following?

    a. The completed-contract method.

    b. The cost-to-cost method.

    c. The percentage-of-completion method.

    d. The calculation of construction period interest.

22. How often are job site visits needed in construction contractor audits?

    a. Job site visits should not occur because they are not generally accepted audit procedures.

    b. Job site visits may not be necessary if the auditor can get the necessary information from confirmations instead.

    c. At least one job site visit is required for each individually significant construction contract.

    d. Multiple job site visits will be required for each audit to ensure that the auditor gathers enough audit evidence at each site.

23. What is the purpose of a state lien law?

    a. To make sure that contractors do not default on job contracts made in that state.

    b. To make sure that contractors keep in reserve any amounts necessary to satisfy potential claims against them on a specific contract.

    c. To make sure that contractors only take out liens if they have a certain amount of available collateral.

    d. To make sure funds received/receivable by a contractor are used to pay specific contract-related costs.

24. Assuming all other conditions are met, when might a significant estimate need to be disclosed?

    a. The possibility of change is reasonably possible.

    b. The amount it affects is insignificant.

    c. Any change is at least a year away.

    d. There are no existing conditions to indicate change.

25. Greenleaf Construction forms a separate legal entity so that it can own property on which it will create a housing development. This is an example of what?

    a. A concentration.

    b. A going concern consideration.

    c. A related party.

    d. A variable interest entity.

26. Which of the following contractors is more likely to trigger doubts about its ability to continue as a going concern?

    a. Western Contracting paid off a long-term loan during the financial statement period.

    b. Eastern Contracting had a surplus of operating capital during this financial statement period.

    c. Northern Contracting was forced to stop work on a big contract for an indeterminate length of time.

    d. Southern Contracting was granted a large surety bond so that it can perform a job for a big client.

27. Existence of which of the following might support an auditor's belief that fraud has occurred?

    a. The contractor's significant transactions were authorized and supported.

    b. The contractor provides the auditor original versions of requested documents.

    c. Employees who accessed the financial systems were authorized to be there.

    d. The contractor attempts to intimidate members of the audit team.

28. Why are analytical procedures required by AU-C 520 during the final stage of an audit?

    a. To determine overall materiality of uncorrected misstatements.

    b. To help auditors assess the validity of their conclusions.

    c. To evaluate significant unusual transactions.

    d. To re-evaluate auditors' initial assessments of risk.

29. What is the correct term when a contractor has a deficiency (or deficiencies) in internal control that is less severe than some but important enough to alert those charged with governance?

    a. A deficiency in internal control.

    b. A significant deficiency.

    c. A material weakness.

    d. A going concern issue.

30. What is an auditor's responsibility in relation to internal control deficiencies under AU-C 265?

    a. The auditor is responsible for detecting and reporting them.

    b. The auditor is responsible for reporting them, but not detecting them.

    c. The auditor is responsible for detecting them, but not reporting them.

    d. The auditor's responsibility will vary for each audit engagement.

31. Can the auditor draft the client's financial statements?

    a. Yes, but the client must retain responsibility for them.

    b. Yes, but only if the auditor takes responsibility for them.

    c. No, because it will automatically cause a material weakness in internal control.

    d. No, the auditor will lose his or her independence by drafting the financial statements.

32. What is an auditor required to communicate to those charged with governance?

    a. Material weaknesses.

    b. Significant deficiencies.

    c. Significant deficiencies and material weaknesses.

    d. A statement that there were no significant deficiencies.

33. According to AU-C 260, what is the term for people or organizations responsible for overseeing an entity's strategic direction and obligations related to the entity's accountability?

    a. Management.

    b. The audit team.

    c. Third parties.

    d. Those charged with governance.

34. Which communication is an auditor required to make to those charged with governance?

    a. A statement that management and those charged with governance are relieved of their responsibilities related to financial reporting after the audit occurs.

    b. A detailed outline of the planned scope and timing of the audit that will allow the client to anticipate when the auditor will perform certain tasks.

    c. Significant audit findings, such as qualitative aspects of the auditee's significant accounting practices.

    d. The effect of uncorrected misstatements on the financial statements, including those that are immaterial or trivial in nature.

35. While workpapers can serve many purposes, what is their main purpose, as described in AU-C 230.02?

    a. To provide the main evidence for the auditor's report.

    b. To guide new audit team members.

    c. To keep a record of matters that may affect future audits.

    d. To help with planning and performing the engagement.

36. Which of the following statements best describes the requirements for audit workpapers?

    a. They need to document every item the auditor considered during the audit.

    b. They need to note who performed the work and when it was performed.

    c. Discussions with management should not be included as they are confidential.

    d. Once the workpapers are finalized, they cannot be changed or amended.

37. What happens on the *report release date*?

    a. The auditor has obtained enough evidence to support the opinion on the financial statements.

    b. The audit team has completed its assembly of the final engagement workpapers.

    c. The client has permission to use the auditor's report in connection with the financial statements.

    d. The date of the management representation letter.

38. Jim is engaged to audit the financial statements of Corbin Construction. The construction company's detailed cost records are inadequate, so Jim is unable to apply extended procedures. Therefore, the audit engagement has a scope limitation. How will this affect the auditor's report?

    a. If Jim can mitigate the scope limitation, he can still express an unmodified opinion in his report.

    b. Jim will either need to express a qualified opinion in his report or disclaim an opinion because of the scope limitation.

    c. Because this is considered a departure from GAAP, Jim will need to express an adverse opinion in his report.

    d. Jim will need to include an emphasis-of-matter paragraph explaining the scope limitation to his report after the unmodified opinion paragraph.

39. Megan audits the Dallas branch of Morris & Sons Contracting. The contractor's head office is located in Oklahoma City, and its audit is done by a different firm. Megan would be considered what?

    a. The group auditor.

    b. The predecessor auditor.

    c. The successor auditor.

    d. The component auditor.

40. Which of the following should occur if the auditor is reporting on supplementary information?

    a. The auditor performs specific procedures related to this information, including verifying where it derives from and how it relates to the records used to prepare the statements.

    b. Because the information is not part of the basic financial statements, the auditor can use a lower materiality level.

    c. The auditor will need to consider how subsequent events affect the supplementary information even if the financial statements are unaffected.

    d. The auditor can have an unmodified opinion on the supplementary information even if it has a qualified opinion on the financial statements.

GLOSSARY

Addenda: Issued by the owner or architect to supplement, modify, or amend the original *Project Plans.*

Alternative dispute resolution (ADR): The use of methods such as mediation and arbitration to try to resolve claims without a lengthy court case.

Audit plan: More detailed than an audit strategy, the audit plan includes a detailed description of audit procedures to be performed by members of the engagement team to obtain sufficient audit evidence to reduce audit risk to an acceptably low level. It includes descriptions of (1) the nature and extent of planned risk assessment procedures; (2) the nature, timing, and extent of planned further procedures at the relevant assertion level; and (3) other planned procedures that are required to be carried out so that the engagement complies with GAAS. It is also referred to as the audit program.

Bid documents: Documents used when there is competitive bidding on a construction project. Typically, they include some or all of the following: (1) invitation to bid, (2) instructions to bidders, (3) bid form, and (4) notice of award.

Bonds: A guarantee of the performance of a *contract* or another obligation. It is a three-party contract between the surety, the principal, and the obligee. In a construction bond, these are the bonding company, the contractor, and the owner.

Change orders: These clauses permit additions, deductions, or changes to the *contract* after work has begun. They generally include the date, a description of the work to be performed, the price of the change (or a method for determining the price), an estimate of how long the work is expected to take, and any exceptions or objections to what is being resolved by the change order.

Component: An entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the *group financial statements.*

Component auditors: Auditors who perform work on the financial information of a *component* that will be used as evidence for the group audit.

Contract: An agreement entered into voluntarily by two or more parties who promise to exchange money, goods, or services according to an agreed-upon schedule.

Contract Agreement: Entered into by the contractor and the owner (and possibly others) after the bidding process. It is a concise statement of the major contract terms. Usually includes identification of the owner and contractor, the contract price, a description of the project, a list of all documents in the contraction, the contract's duration, and signatures of the appropriate parties.

Cost-plus contracts: Under this type of *contract,* the owner agrees to pay the contractor a fee in addition to the costs the contractor incurs in completing the project. This type of contract shifts much of the risk to the owner, however they are favored when speed and flexibility are important.

Deficiency in internal control: This exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

Document completion date: The date that the workpapers for an audit engagement should be completed. After this date, the auditor should not delete or discard any information prior to the required five-year retention period indicated in AU-C 230.17.

Group financial statements: Financial statements that include the financial information of more than one *component.*

Guaranteed Maximum Price (GMP) contract: A *contract* that establishes the project's maximum cost for the owner and, generally, allows the owner and the contractor to share in any savings if the project is completed at less than the maximum price.

General Conditions of the Contract for Construction: The clauses generally applicable to virtually all contracts (i.e., boilerplate language). May cover *change orders,* payment terms, use of subcontractors, insurance, arbitration of disputes, and termination of the contract.

Lump-sum contract: Also known as a fixed-fee or fixed-price contract. Under this type of *contract,* the contractor warrants (except when errors are encountered in the plans and specifications) that he will complete the project for an agreed-upon price regardless of the problems or difficulties that may be encountered. Inherent risks for things like inaccuracies in the estimate, weather delays, or material shortages are borne by the contractor.

Material weakness: A deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. The likelihood of the event occurring must be either *reasonably possible* or *probable.*

Notice to Proceed: Also known as an Authorization to Proceed. At the beginning of the project, this typically establishes the commencement date. It may be important for computing penalties, and it can also apply to *change orders.*

Omitted contract costs: Contract costs that are not allocated to individual contracts.

Overbilling: Billings in excess of costs and estimated earnings.

Probable: The future events are likely to occur.

Project Plans: These include both drawings and specifications. Together they should clearly describe and illustrate the desired end result, specific materials to be used, and the particular details that are important to the structure and its architectural appearance.

Punch list: A list made near the completion of a project that contains items to be furnished or work to be performed to complete the project in accordance with the *contract.*

Reasonably possible: The chance of the future event or events occurring is more than remote but less than likely.

Report release date: The date that the auditor gives the client permission to use the auditor's report in connection with the financial statements.

Senior management: In relation to the identification of fraud, this includes the principal executive, financial officers, and any other members of senior management who have a significant role in the entity's financial reporting process.

Significant deficiency: A deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Those charged with governance: The persons or organizations with responsibility for overseeing the strategic direction of an entity and the obligations related to the accountability of the entity, including overseeing the financial reporting process.

Total estimated contract price: This price includes consideration of (1) basic contract price, (2) options and additions, (3) change orders, and (4) claims.

Underbilling: Having costs and estimated earnings in excess of billings on contracts in progress.

Unit-price contract: A type of *lump-sum contract* in which the contractor bids a set price on a unit item, but the total number of units required has not been determined when the contract is made. It is often used in public utility or road building or for items such as light fixtures or electrical outlets. They are not typically used for entire construction projects, but can be combined with other contracts on the same project.

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COMPANION TO PPC'S GUIDE TO CONSTRUCTION CONTRACTORS

COURSE 2

ACCOUNTING FOR CONSTRUCTION CONTRACTS (CONTG172)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses accounting for construction contracts. Lesson 1 covers GAAP for construction contractors, the financial reporting system, cost accumulation, and methods for revenue recognition (the percentage-of completion method and the completed-contract method). Lesson 2 examines considerations for a construction contractor's financial statements, investments in ventures, accounting for similar operations, and common problems that occur when applying contract accounting rules.

PUBLICATION/REVISION DATE: August 2017

RECOMMENDED FOR: Users of *PPC's Guide to Construction Contractors*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of construction contractors

CPE CREDIT: 8 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

FIELD OF STUDY: Accounting

EXPIRATION DATE: Postmark by **August 31, 2018**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—GAAP, Financial Reporting, Cost Accumulation, Revenue Recognition, the Percentage of-completion Method, the Completed-contract Method, and Related Accounting Considerations for Construction Contractors

Completion of this lesson will enable you to:

- Recognize appropriate generally accepted accounting principles for construction contractors and the elements of a typical financial reporting system for this industry.
- Identify the rules for cost accumulation.
- Recognize the two methods construction contractors use for revenue recognition (the percentage-of-completion method and the completed-contract method) and identify the rules for each.

Lesson 2—Financial Statement Presentation Rules and Other Accounting Issues That Affect Construction Contractors

Completion of this lesson will enable you to:

- Identify considerations that may apply to the financial statements of a construction contractor.
- Determine the best methods for dealing with investments in ventures, accounting for similar operations, and common problems that can arise when applying contract accounting rules.

TO COMPLETE THIS LEARNING PROCESS:

Submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
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ADMINISTRATIVE POLICIES:

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Lesson 1: GAAP, Financial Reporting, Cost Accumulation, Revenue Recognition, the Percentage-of-completion Method, the Completed-contract Method, and Related Accounting Considerations for Construction Contractors

INTRODUCTION

Whenever one thinks about accounting for the construction industry, two accounting concepts normally come immediately to mind—the percentage-of-completion (PC) method and the completed-contract (CC) method. The accounting profession has accepted and used these two accounting methods for many years, and an abundance of literature has been written to explain their use. However, even seasoned accountants find the methods extremely complex and difficult to master. Moreover, confusion often exists regarding whether the PC method and the CC method are alternatives or whether their use is dictated by the unique economic, industry, and accounting circumstances of each contractor.

Perhaps one reason that contract accounting is difficult to master is because it is difficult to explain in a logical and concise manner. One common approach to explaining the subject is a detailed discussion of the mechanics of the PC and CC methods. However, that approach bypasses many of the important underlying concepts common to both methods. Another approach is to start at the concept level, then gradually progress to a final explanation of the PC and CC methods. However, the underlying concepts are so numerous and complex that this building block approach often leaves the busy accountant frustrated because of the need to know the final answer, now!

Given those difficulties, this course uses a presentation approach that attempts to reach a compromise between the two approaches. In Lesson 1, the discussion first presents an overview of the PC and CC methods along with a list of the other accounting conventions unique to contractors, including an introductory overview discussion of the FASB's revenue recognition guidance issued in May 2014, but not yet effective. Next, the discussion focuses on a more detailed discussion and explanation of the accounting concepts common to both the PC and CC methods. Finally, the PC and CC methods are revisited for a nuts and bolts discussion that includes illustrations.

The financial statement presentation rules for contractors and other accounting issues are discussed in Lesson 2. While construction contractors are generally subject to the same reporting and disclosure requirements as other commercial entities, some unique factors need to be considered when preparing financial statements and related footnotes for a contractor. Contractors frequently participate jointly with other entities to share risks, combine financial and other resources, or obtain financing or bonding. Applying contractor accounting principles is appropriate for some similar business activities, including homebuilders and certain manufacturing activities. Finally, this course concludes with a presentation of summarized information about some common problems associated with construction accounting.

This course provides accounting guidance for GAAP. It does not include information covering international accounting standards. Information about international accounting standards can be obtained from the website of the International Accounting Standards Board at **www.ifrs.org**. In addition, a number of international accounting standards related products can be obtained on Checkpoint at **checkpoint.riag.com**.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize appropriate generally accepted accounting principles for construction contractors and the elements of a typical financial reporting system for this industry.

- Identify the rules for cost accumulation.
- Recognize the two methods construction contractors use for revenue recognition (the percentage-of-completion method and the completed-contract method) and identify the rules for each.

GAAP CONSIDERATIONS THAT APPLY TO CONSTRUCTION CONTRACTORS

Generally accepted accounting principles (GAAP) are applicable to all financial statements (except statements presented on a special purpose framework) and are important to accountants in industry as well as accountants in public practice.

The FASB Accounting Standards Codification

The FASB Accounting Standards Codification (FASB ASC or the Codification) is the single source of authoritative accounting principles used by nongovernmental entities when preparing financial statements in accordance with GAAP in the United States.

The Organization of the Codification. The Codification is organized by subject matter in a hierarchy using areas, topics, subtopics, and sections as follows:

a. *Areas* represent the nine large collections of accounting guidance included in the Codification, such as general principles and presentation. Those areas and their related topics are further discussed below.

b. *Topics* reside in areas and represent a collection of related guidance, such as leases. The following are the main types of topics by area:

   (1) *General Principles (Topic Codes 105–199)* relate to broad conceptual matters, such as generally accepted accounting principles.

   (2) *Presentation (Topic Codes 205–299)* relates only to presentation matters and does not address recognition, measurement, or derecognition matters. Such topics include income statement, balance sheet, statement of cash flows, etc.

   (3) *Assets (Topic Codes 305–399)* relate to asset accounts, such as cash, receivables, investments, etc.

   (4) *Liabilities (Topic Codes 405–499)* include liability accounts, such as debt, guarantees, commitments, etc.

   (5) *Equity (Topic Codes 505–599)* contains guidance about equity accounts.

   (6) *Revenue (Topic Codes 605–699)* contains guidance about revenues, such as revenue recognition.

   (7) *Expenses (Topic Codes 705–799)* include cost of sales, compensation, income taxes, etc.

   (8) *Broad Transactions (Topic Codes 805–899)* relate to multiple financial statement accounts and are generally transaction-oriented. Such topics include leases, business combinations, derivatives, nonmonetary transactions, etc.

   (9) *Industries (Topic Codes 905–999)* relate to accounting that is unique to an industry or type of activity. Such topics include airlines, software, real estate, etc. The construction contractor industry is topic code 910.

c. *Subtopics* represent subsets of a topic and are generally distinguished by type or by scope. For example, capitalization of interest and imputation of interest are two subtopics of the interest topic. Each topic contains an overall subtopic that generally represents the pervasive guidance for the topic, followed by additional subtopics containing incremental or unique guidance not contained in the overall subtopic.

d. *Sections* represent the nature of the content in a subtopic such as recognition, measurement, disclosure, and so forth.

The FASB revises the Codification through the issuance of Accounting Standards Updates (ASUs). When released, an ASU is not authoritative but is a transient document to initiate the FASB's process of amending the Codification. ASUs are available on Checkpoint, the Codification, and the FASB websites. As the FASB amends existing Codification paragraphs, both the current paragraph and the updated paragraph reside in the Codification until such time that the new guidance is completely effective. The FASB identifies amended guidance as "Pending Content" within the Codification. When the newly amended paragraphs are fully effective, the outdated guidance is removed and only the amended paragraphs remain.

What Is GAAP for Contractors?

GAAP for construction contractors can be found in the revenue and industry topic codes—

- FASB ASC 605-35 provides guidance on accounting for contracts of commercial organizations engaged wholly or partly in the contracting business. The guidance in FASB ASC 605-35 originated from ARB No. 45, *Long-Term Construction-Type Contracts*, and SOP 81-1, *Accounting for Performance on Construction-Type and Certain Production-Type Contracts*.

- FASB ASC 910, provides additional accounting guidance, much of which originated from the AICPA Audit and Accounting Guide, *Construction Contractors* (the AICPA Guide). The AICPA Guide continues to be updated annually by the AICPA and also includes information about operations and auditing guidance.

The 2017 edition of the AICPA Audit and Accounting Guide, *Construction Contractors*, was not available at the time this course went to press; therefore, all references are to the 2016 edition.

Revenue Recognition Methods Used by Construction Contractors

GAAP provides two methods of recognizing revenues on construction contracts—

a. The percentage-of-completion (PC) method, which must be used in most instances, allows the contractor to recognize income throughout a contract's life. Under this method, a contractor computes the extent of progress toward completion for each contract in progress at a given point in time. For example, if a contract is 68% complete on a particular date, the contractor recognizes 68% of the contract's revenues, estimated costs, and gross income at that date.

b. The completed-contract (CC) method, which defers income recognition until a contract is substantially complete, should be used only in those rare instances when the PC method cannot be used. Under this method, revenues, costs, and gross income are not recognized throughout the life of a contract. Instead, the income statement amounts are recognized only when the project is complete.

These two methods do not represent alternatives from which a contractor is free to choose. FASB ASC 605-35 establishes a strong preference for the PC method, virtually requiring that it be used as the basic method of accounting by most contractors. The PC method depends upon a contractor's ability to make reasonably dependable estimates regarding the extent of progress toward completion for each contract. Since estimating is an essential part of a contractor's business, there is a general presumption that most contractors can make sufficiently dependable estimates.

The only time the CC method should be used is when either of the following conditions exists:

a. the results do not vary materially from those achieved under the PC method, or

b. with persuasive evidence, the contractor can overcome the basic presumption that it has the ability to make reasonably dependable estimates.

The PC and CC methods are discussed in more detail at the end of this lesson.

Other Accounting Considerations Unique to Contractors

Beyond the GAAP requirement to use the PC method for most contract situations, several other accounting conventions are important or unique to construction contractors, including—

a. The accrual method must be used to account for billings and costs.

b. Construction-related costs, revenues, and earnings must be summarized by profit center. Although each contract normally represents one profit center, there are exceptions to this rule. It is therefore important to properly identify the appropriate profit centers.

c. Types of costs to be allocated to contracts generally fall into three categories—

   (1) Directly identifiable costs that relate specifically to a construction project.

   (2) Indirect costs that relate to the construction process in general. (These indirect costs are normally included in an overhead pool and then allocated to individual contracts using some rational basis.)

   (3) Construction period interest on debt that is necessary to finance construction activity.

d. Costs (and estimated earnings) in excess of billings on contracts in progress (commonly referred to as *underbillings*) are recorded as assets. Billings in excess of costs (and estimated earnings) (commonly referred to as *overbillings*) are shown as liabilities. An overbilling situation, while a liability account, indicates that the contractor has bid its work in a manner such that the contract owner assists the contractor in financing the job. An underbilling situation, although an asset on the balance sheet, may indicate poor billing or bidding practices, or might also indicate overly aggressive profitability forecasts.

e. All losses expected to be realized on contracts in progress should be recorded in the period they become known.

f. Investments in construction ventures must be accounted for as follows:

   (1) If the contractor exercises *control* over a venture as a result of its investment, the venture normally must be consolidated with the contractor for reporting purposes. A contractor that owns more than 50% of a venture usually exercises sufficient control to justify using the consolidation method.

   (2) If the contractor is the primary beneficiary of a variable interest entity created after December 31, 2003 and control is achieved other than through voting interests, the venture must be consolidated. FASB ASC 810-10, however, provides small and midsize private companies with a limited accounting alternative that allows a narrow, optional exemption for private company-related party lessees when certain criteria are met. See further discussion of variable interest entities and the accounting alternative in Lesson 2.

   (3) If the contractor exercises *significant influence* over a venture, but does not control it (which generally occurs when the ownership percentage is between 20% and 50%), the contractor normally should use the equity method of accounting for its investment. See further discussion in Lesson 2.

   (4) If the contractor is unable to exert significant influence over a venture, the cost method of accounting for the contractor's investment is generally appropriate. The cost method is generally used for investments of less than 20% of a venture.

Those unique accounting considerations apply regardless of whether the PC or the CC revenue recognition method is used. The next several sections address these unique accounting considerations in greater detail.

Revenue from Contracts with Customers

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*.The ASU introduces a comprehensive, principles-based framework for recognizing revenue. The new revenue guidance

introduces FASB ASC 606 and supersedes the revenue recognition requirements in FASB ASC 605 and most industry-specific revenue guidance in the FASB ASC, including the accounting guidance that the construction contractor industry currently follows. The ASU is intended to improve GAAP by providing a framework to address revenue recognition issues, creating more consistency and comparability of revenue recognition practices across entities and industries, and improving the usefulness of information provided to financial statement users through more robust disclosure requirements. In August 2015, the original effective dates of ASU 2014-09 were deferred by one year by the issuance of ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*. ASU 2014-09 (as revised) is effective for construction contractors other than public business entities for annual reporting periods beginning after December 15, 2018, and interim periods within annual reporting periods beginning after December 15, 2019. Although such entities may elect to apply the guidance earlier, the earliest it may be applied is for an annual reporting period beginning after December 15, 2016, and interim periods within that period.

The FASB also issued, subsequent to ASU 2014-09, a number of ASUs to address various ASU 2014-09 implementation issues that have been identified. The amendments do not change the core principle in FASB ASC 606. These ASUs, which have the same effective dates as ASU 2014-09 (as revised), are as follows:

- ASU 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*, (March 2016).

- ASU 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, (April 2016).

- ASU 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*, (May 2016).

In addition, in December 2016, the FASB issued ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*, which addresses technical corrections and improvements to FASB ASC 606 and other topics amended by ASU 2014-09.

The new guidance is based on the principle that revenue from contracts with customers should be recognized when an entity transfers goods or services to the customer at the amount the entity expects to be entitled to receive from the customer. In applying ASU 2014-09 (as revised), entities should consider the terms of each contract and all relevant facts and circumstances. Additionally, the guidance should be applied consistently to contracts with similar characteristics and in similar circumstances. The following paragraphs provide an overview of certain information in the new revenue recognition standard. A comprehensive discussion of the new requirements will be included in a future edition of this course.

A Five-step Approach. Under ASU 2014-09 (as revised), entities should recognize revenue from contracts by applying the following five-step process:

a. *Identify the Contract With the Customer.* Contracts may be written, oral, or implied, but must contain certain criteria in order to be considered a contract. Contracts may have to be combined or separated based on certain criteria, and the ASU includes guidance on accounting for contract modifications.

b. *Identify the Separate Performance Obligations in the Contract.* Representing a significant change to existing guidance, the ASU requires contracts to be broken into separate performance obligations when certain criteria are met.

c. *Determine the Transaction Price.* The transaction price is the amount of consideration that an entity receives or expects to receive in exchange for the transfer of goods or services promised in a contract. The transaction price can be fixed, include variable consideration, and/or may be adjusted for the time value of money.

d. *Allocate the Transaction Price to the Separate Performance Obligations.* This step requires an allocation based on the stand-alone selling prices of the goods or services, which requires an estimate when no stand-alone prices are directly observable. Such an allocation includes consideration of whether any

discount or variable amount applies to one or some of the performance obligations, rather than to all performance obligations in the contract.

e. *Recognize Revenue When (or As) the Entity Satisfies Each Performance Obligation.* The entity recognizes an amount of revenue equal to the amount of the transaction price allocated to that performance obligation. A performance obligation may be satisfied at a point in time or over time. For those satisfied over time, revenue is recognized by selecting an appropriate method for measuring the entity's progress toward complete satisfaction of that performance obligation. That concept has similarities to the percentage-of-completion method of revenue recognition allowed under existing revenue recognition guidance.

New Terms. Several new terms are important to understanding the five-step process, including—

- *Contract*—an agreement between two or more parties that creates enforceable rights and obligations.
- *Customer*—a party that contracts with an entity to obtain goods or services in exchange for due consideration, where the goods or services are an output of the entity's normal activities.
- *Performance obligation*—a promise in a contract with the customer to transfer a good or service to the customer.
- *Stand-alone selling price*—the price for which an entity would sell a promised good or service separately to a customer.
- *Transaction price*—the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.

Contract Costs. ASU 2014-09 (as revised) provides accounting guidance for costs incurred to obtain or fulfill a contract with a customer. Generally, incremental costs incurred to obtain a contract should be recognized as an asset if the entity expects to recover such costs. However, expensing such costs is allowed if the amortization period is one year or less. Accounting for costs to fulfill a contract is more complicated.

Disclosures. The financial statement disclosures required under ASU 2014-09 (as revised) include comprehensive information about the nature, amount, timing, and uncertainty of revenue and cash flows that result from an entity's contracts with customers. Both quantitative and qualitative information are required to be disclosed for contracts with customers, significant judgments made and any changes in those judgments, and any assets recorded that are associated with the costs to obtain or fulfill a contract. The following information is required to be disclosed:

- Revenue recognized from contracts with customers, including an appropriate category breakdown.
- Contract balances, including the beginning and ending balances of receivables, contract assets, and contract liabilities.
- Performance obligations, including when the entity typically satisfies its performance obligations and the transaction price allocated to the remaining performance obligations in a contract.
- If performance obligations are satisfied over time (rather than at a point in time), the methods used to recognize revenue, such as the input or output methods utilized and how they were applied.
- Significant judgments and changes in judgments that are made in applying the requirements to those contracts.
- Significant payment terms, including any significant financing components, presence of variable consideration, and any constraints on the estimate of variable consideration.
- Any obligations for returns, refunds, and any warranties associated with performance obligations.

Additional Guidance The AICPA has issued an Audit and Accounting Guide, *Revenue Recognition* (AICPA Revenue Guide), to assist entities and auditors with their implementation of ASU 2014-09 and the other related

subsequently-issued ASUs. In addition to highlighting certain of the requirements of the ASU and related auditing considerations, the AICPA Revenue Guide provides the views of the AICPA's Financial Reporting Executive Committee (FinREC) on the application of the new standards to certain industries.

As of the date this course was published, the AICPA Revenue Guide did not address the accounting implications for construction contractors. Future editions of the AICPA Revenue Guide will address additional accounting and auditing implications for other industries, including construction contractors. (Sixteen AICPA industry task forces are addressing these matters.)

In addition, the AICPA Audit Risk Alert, *General Accounting and Auditing Developments—2016/17* includes a section on revenue recognition that provides an overview of the new guidance in ASU 2014-09 and catalogs the latest developments.

The AICPA Audit Risk Alert, *Revenue Recognition: Accounting and Auditing Considerations—2016/17* (the AICPA Revenue Risk Alert) provides comprehensive coverage of the guidance in ASU 2014-09 and other related subsequently-issued ASUs. The AICPA Revenue Risk Alert also explains the significant auditing considerations relevant to the new guidance, including an explanation of the audit approach and procedures for auditing the five steps for recognizing revenue, as well as auditing considerations for a client's adoption and transition to the new accounting standard.

A CONSTRUCTION CONTRACTOR'S FINANCIAL REPORTING SYSTEM

Fundamental to an understanding of the GAAP accounting rules that should be followed by a construction company is a basic understanding of the financial reporting systems contractors most often use. The following aspects of a contractor's financial reporting system are discussed in this section:

a. Determining the profit center.

b. Field reports.

c. Subsidiary records.

d. The general ledger.

e. Adjusting the financial statements.

Determining the Profit Center

While the profit center for most entities is the company as a whole, the profit center for a construction company is normally each individual contract. Authoritative guidance for construction contractors defines the profit center as the unit for the accumulation of revenues and costs and the measurement of income. GAAP further states that the basic presumption should be that each contract represents a separate profit center; that is, costs and revenues are generally accumulated and income is normally measured on a contract-by-contract basis. This basic presumption can only be overcome by persuasive evidence to the contrary. Unless clearly indicated otherwise, the terms *contract* and *profit center* are used interchangeably in this course.

In specific limited circumstances, the profit center can be defined as something other than each contract. If certain conditions are met, a group of contracts can sometimes be *combined* into one profit center, or a single contract can sometimes be *segmented* into more than one profit center.

General Rules for Combining Contracts. FASB ASC 605-35-25-8 states that a group of contracts may be combined for accounting purposes if the contracts—

a. Are negotiated as a package in the same economic environment with an overall profit margin objective. Contracts not executed at the same time may be considered to have been negotiated as a package in the same economic environment only if the time period between the commitments of the parties to the

individual contracts is reasonably short. The longer the period between the commitments of the parties to the contracts, the more likely it is that the economic circumstances affecting the negotiations have changed.

b. Constitute, in essence, an agreement to do a single project. A project for this purpose consists of construction, or related service activity, with different elements, phases, or units of output that are closely interrelated or interdependent in terms of their design, technology, and function or their ultimate purpose or use.

c. Require closely interrelated construction activities with substantial common costs that cannot be separately identified with, or reasonably allocated to, the elements, phases, or units of output.

d. Are performed concurrently or in a continuous sequence under the same project management at the same location or at different locations in the same general vicinity.

e. Constitute, in substance, an agreement with a single customer. In assessing whether the contracts meet this criterion, the facts and circumstances relating to the other criteria should be considered. In some circumstances, different divisions of the same entity would not constitute a single customer if, for example, the negotiations are conducted independently with the different divisions. On the other hand, two or more parties may constitute, in substance, a single customer if, for example, the negotiations are conducted jointly with the parties to do what in essence is a single project.

Contracts that meet all of these criteria may be combined for profit recognition and for determining the need for a provision for loss in accordance with FASB ASC 605-35-25-5. The criteria should be applied consistently to contracts with similar characteristics in similar circumstances. These considerations should be documented.

When the combining criteria are met, the group of combined contracts becomes a profit center for purposes of accumulating costs, revenues, and earnings. The combined results of operations could vary significantly from the results obtained if each contract were accounted for separately. Thus, care must be taken to ensure that contracts are not combined into a profit center solely to prevent losses on a particular contract from being recognized early in the estimating process.

General Rules for Segmenting Contracts. FASB ASC 605-35-25-12 and 13 states that a project may be segmented if *all* of the following steps were taken and *are documented and verifiable*: [emphasis added]

a. The contractor submitted bona fide proposals on the separate components of the project and on the entire project.

b. The customer had the right to accept the proposals on either basis.

c. The aggregate amount of the proposals on the separate components approximated the amount of the proposal on the entire project.

A project that does not meet the (aforementioned) criteria may be segmented *only if it meets all* of the following criteria: [emphasis added]

a. The terms and scope of the contract or project clearly call for separable phases or elements.

b. The separable phases or elements of the project are often bid or negotiated separately.

c. The market assigns different gross profit rates to the segments because of factors such as different levels of risk or differences in the relationship of the supply and demand for the services provided in different segments.

d. The contractor has a significant history of providing similar services to other customers under separate contracts for each significant segment to which a profit margin higher than the overall profit margin on the project is ascribed.

e. The significant history with customers who have contracted for services separately is one that is relatively stable in terms of pricing policy rather than one unduly weighted by erratic pricing decisions (responding, for example, to extraordinary economic circumstances or to unique customer-contractor relationships).

f. The excess of the sum of the prices of the separate elements over the price of the total project is clearly attributable to cost savings incident to combined performance of the contract obligations (for example, cost savings in supervision, overhead, or equipment mobilization). Unless this condition is met, segmenting a contract with a price substantially less than the sum of the prices of the separate phases or elements would be inappropriate even if the other conditions are met. Acceptable price variations should be allocated to the separate phases or elements in proportion to the prices ascribed to each. In all other situations a substantial difference in price (whether more or less) between the separate elements and the price of the total project is evidence that the contractor has accepted different profit margins. Accordingly, segmenting is not appropriate, and the contracts should be the profit centers.

g. The similarity of services and prices in the contract segments and services and the prices of such services to other customers contracted separately should be documented and verifiable.

If the criteria for segmenting are met, the individual phase would become the profit center for purposes of accumulating costs and recognizing revenue and income/loss. The profit margin for each phase may differ from the profit margin obtained if the phases were treated as one contract.

Conclusion Regarding Combining and Segmenting Contracts. Rarely are the criteria for either segmenting or combining met. Therefore, in nearly all situations, the profit center will be an individual contract. If significant contracts are to be combined or segmented, the accountant (especially in an audit, review, or compilation engagement) should consider documenting the justification for the accounting.

Field Reports

Construction companies have traditionally experienced problems collecting information from the field. Many contractors require daily reports while others require them less frequently. Each contractor should develop its own report based on its size, location of projects, and other needs. Whether the reports are submitted daily or less frequent, some of the information should be detailed daily.

Some contractors have created field reports that may be electronically transmitted to the office. The person responsible for completing the field reports logs onto the contractor's website and completes the field report online. Additionally, some construction management software systems include electronic field report capability. An electronic submission process may improve the timeliness of the filing of field reports.

The need for faster access to information and the rapid advances in technology now have many contractors providing field reports and acting on issues identified in the field through the use of mobile devices, such as a Blackberry, a smart phone, or an iPad.

While the use of such technology has increased rapidly, there are still construction companies that prepare field report information by hand. To help streamline this manual process, the report could be preprinted with spaces for the requested information. The following information is generally considered for inclusion in the report:

- Timecard summaries.
- New employees.
- Employee terminations and resignations.
- Description of injuries during the period.
- Supplier invoices received.
- Daily weather information.

- Narrative description of job progress.
- Change orders received during the period, including who received from, when received, summary description of conditions relating to the order, and whether signed or not signed.
- Summary of important discussions with planning and zoning personnel, union leaders, suppliers, etc.
- Description of other job site conditions.
- Other information.

Photographs, video, and/or audio can be important supplements to the field reports, especially when claims are or may be involved.

Subsidiary Records

Because each individual contract is a profit center, the financial reporting system for a construction contractor needs to identify and accumulate revenue, cost, gross profit, and billing information on a contract-by-contract basis. Most contractors accomplish this through subsidiary records. Subsidiary records often contain both legal documents and accounting information. The records vary in degree of sophistication from file folders and hand-posted ledger cards to computer generated reports. In general, these records should contain the following information:

a. Legal documents, including the signed contract, change orders, correspondence, etc.

b. Cost estimation worksheets, blueprints, plans, status reports, etc.

c. Cost accumulation records that capture material costs, labor charges, and overhead allocations for each contract.

d. Billing and accounts receivable records for each contract.

e. Worksheets showing how periodic revenue, cost, and gross profit totals were determined.

To be meaningful, the accounting information posted to the subsidiary records needs to be complete and accurate. Each contractor is responsible for designing procedures and controls to allocate all contract costs, billings, and other information to the appropriate subsidiary records. Although not intended to be comprehensive, the following factors ought to be considered in designing such a system:

a. Many direct costs, such as subcontractor charges and material purchases, are supported by vendor invoices. In some cases, the charges being invoiced will relate to only one contract, making the allocation easy. However, in other cases, charges on a single invoice will relate to more than one contract. For example, a painting subcontractor may work on several of a contractor's projects during a given week and send only one bill covering all work performed during the period. When this occurs, the contractor is responsible for obtaining enough information from the subcontractor to properly allocate the total invoice amount to the appropriate subsidiary contract records.

b. Many contract charges are allocated to contracts on a *time and usage* basis. Some construction employees, for example, may work on several projects during a pay period. The payroll costs for these employees may be allocated based on time sheets. Equipment charges, such as gasoline, maintenance, and depreciation, may be allocated to contracts based on equipment usage logs or some other rational basis.

c. Contractors often purchase large quantities of common inventory items, which is usually stored in a warehouse until it is needed at a job site. The transfer of inventory from the warehouse to a job site should be supported by a transfer or requisition form. Completing this form facilitates the posting of this transaction in the subsidiary records.

d. Overhead charges and interest should be allocated to all contracts in a consistent, rational manner.

These cost allocation issues, as well as other matters that should be considered in designing a subsidiary recordkeeping system, are discussed in more detail throughout the remainder of this course.

The General Ledger

There is a direct relationship between the subsidiary records previously discussed and the general ledger of a construction contractor. Information that is recorded on a contract-by-contract basis in the subsidiary records should also be recorded in the general ledger. In fact, a contractor's accounting staff should periodically reconcile contract information accumulated in the subsidiary records to the general ledger.

As previously mentioned, most contractors do not maintain their general ledgers on a GAAP basis. Many small contractors maintain their general ledgers in accordance with the methods used to file their tax returns, which might be the cash basis, accrual basis, or completed-contract basis of accounting. Regardless of size, very few contractors actually use a pure percentage-of-completion basis of accounting (which is usually the preferred method of recognizing revenues under GAAP) throughout the year.

Contractors use a variety of methods to record contract activity. Two of the more commonly used methods are—

a. The direct P&L approach.

b. The construction-in-progress approach.

The Direct P&L Approach. Under this approach, revenue is recognized on each contract as billings are rendered (or collected if the cash method is used), regardless of whether those billings correspond to the actual work completed on the contract. Contract costs are charged directly to expense accounts when they are incurred (or paid if the cash method is used). No attempt is made to capitalize any construction costs in an inventory or construction-in-progress asset account.

This approach is popular because it is easy to apply and does not require a great deal of judgment. In some ways, it may also approximate the results obtained from the percentage-of-completion method if billings occur based on the achievement of certain stages of completion. Proponents of this method argue that contract costs should be expensed as incurred because title passes to the project owner immediately as work progresses. Since construction in progress is not owned by the contractor, it should not be recorded on the balance sheet.

The Construction-in-progress Approach. This approach is similar to the direct P&L approach in that revenue is recognized when billings are rendered or collected. However, this approach calls for a two-step process for recording contract costs. Costs are first debited to a construction-in-progress asset account as incurred or paid. They are not expensed until a bill is rendered.

Adjusting Financial Statements to a GAAP or Tax Basis

Contractors should determine the adjustments that are required to properly state financial statements at the appropriate basis. One method to do this is using the "Percentage-of-completion Calculation Workpaper" in *PPC's Guide to Construction Contractors*, which can be filled out for each contract in progress as of the balance sheet date.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following construction contractors should consolidate the venture they invested in for reporting purposes?

    a. Alex owns 15% of Venture A.

    b. Barbara owns 30% of Venture B.

    c. Craig owns 50% of Venture C.

    d. Dina owns 55% of Venture D.

2. Which of the following steps will help a contractor recognize revenue from construction contracts?

    a. Identify the contract that was made with the customer.

    b. Aggregate the total of the contract's performance obligations.

    c. Identify the stand-alone selling price.

    d. Recognize revenue at the completion of the contract.

3. Assuming all other necessary qualifications were met, which of the following construction contracts can be *segmented*?

    a. Contract 1 was negotiated as a package with two other contracts.

    b. Contract 2 was negotiated in separate phases.

    c. Contract 3 was submitted to the customer as a whole by the contractor.

    d. Contract 4 is performed concurrently with another contract.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following construction contractors should consolidate the venture they invested in for reporting purposes? **(Page 132)**

   a. Alex owns 15% of Venture A. [This answer is incorrect. If the contractor is unable to exert significant influence over a venture, the cost method of accounting for the contractor's investment is generally appropriate under GAAP. The cost method is generally used for investments of less than 20% of a venture, as Alex has in this scenario.]

   b. Barbara owns 30% of Venture B. [This answer is incorrect. Based on the percentage of the venture Barbara owns, she would be considered to have *significant influence,* but not control. Therefore, to comply with GAAP, Barbara would use the equity method of accounting for this investment.]

   c. Craig owns 50% of Venture C. [This answer is incorrect. By owning 50% of the venture, Craig would be seen has having *significant influence,* not control, of the venture. Therefore, under GAAP Craig should use the equity method of accounting for this investment.]

   d. Dina owns 55% of Venture D. [This answer is correct. If the contractor exercises *control* over a venture as a result of its investment, the venture normally must be consolidated with the contractor for reporting purposes, per GAAP. A contractor that owns more than 50% of a venture, as Dina does in this scenario, usually exercises sufficient control to justify using the consolidation method.]

2. Which of the following steps will help a contractor recognize revenue from construction contracts? **(Page 133)**

   a. Identify the contract that was made with the customer. [This answer is correct. Under ASU 2014-09 (as revised), entities should recognize revenue from contracts by applying a five-step process. The first step in this process is to identify the contract with the customer. Contracts may be written, oral, or implied, but they must contain certain criteria in order to be considered a contract.]

   b. Aggregate the total of the contract's performance obligations. [This answer is incorrect. One of the steps provided by ASU 2014-09 (as revised) is to identify the *separate* performance obligations in the contract. Representing a significant change to existing guidance, the ASU requires contracts to be broken into separate performance obligations when certain criteria are met.]

   c. Identify the stand-alone selling price. [This answer is incorrect. One of the steps provided by ASU 2014-09 (as revised) is for the contractor to determine the transaction price. The transaction price is the amount of consideration that an entity receives or expects to receive in exchange for the transfer of goods or services promised in a contract. The stand-alone selling price is different—it is the price for which an entity would sell a promised good or service separately to a customer.]

   d. Recognize revenue at the completion of the contract. [This answer is incorrect. The last of the five steps provided by ASU 2014-09 (as revised) for recognizing income from contracts is to recognize revenue when (or as) the entity satisfies each performance obligation. The entity recognizes an amount of revenue equal to the amount of the transaction price allocated to that performance obligation.]

3. Assuming all other necessary qualifications were met, which of the following construction contracts can be *segmented*? **(Page 136)**

   a. Contract 1 was negotiated as a package with two other contracts. [This answer is incorrect. According to FASB ASC 605-35-25-8, if contracts are negotiated as a package in the same economic environment with an overall profit margin objective, the contracts may be combined. Therefore, it is more likely that Contract 1 can be combined than segmented.]

   b. Contract 2 was negotiated in separate phases. [This answer is correct. If a contract does not meet the qualifications of FASB ASC 605-35-25-12 and 13, it can only be segmented if it meets all of a series of criteria. One of those criteria is that the separable phases or elements of the project are often bid or negotiated separately. Because Contract 2 was negotiated in this type of separate phases, if it meets the other criteria it can be segmented.]

   c. Contract 3 was submitted to the customer as a whole by the contractor. [This answer is incorrect. According to FASB ASC 605-35-25-12 and 13, for a contract to be segmented, the contractor must have submitted bona fide proposals on the separate components of the project and on the entire project. Therefore, Contract 3 could not be segmented because it has not been documented that such separate components were submitted.]

   d. Contract 4 is performed concurrently with another contract. [This answer is incorrect. According to FASB ASC 605-35-25-8, if contracts are performed concurrently or in a continuous sequence under the same project management at the same location or at different locations in the same general vicinity they could be combined. Because of this, it is more likely that Contract 4 would be combined with other contracts instead of segmented.]

COST ACCUMULATION WHEN USING THE PC AND CC METHODS

GAAP Cost Accumulation Rules

One of the most critical requirements for properly applying either the PC or CC method is the identification and accumulation of project costs on a contract-by-contract basis. Historically, cost accumulation has been accomplished within the financial reporting system by using separate contract cost records, cards, or ledgers for each contract in progress. However, in recent years, the cost of computer hardware, as well as accounting and job-cost application software available to contractors, have decreased enough so that even small contractors can operate more effectively by using a computerized information-gathering and job-cost tracking system.

Guidance about the types of costs that should be accumulated for each contract in accordance with GAAP is found in FASB ASC 605-35-25-34, which is partially reproduced as follows:

> Contract costs are accumulated in the same manner as inventory costs . . . (they) generally include all *direct costs*, such as materials, direct labor, and subcontracts, and *indirect costs* identifiable with or allocable to the contracts. [Emphasis added.]

Besides the above required contract cost components, FASB ASC 835-20-15-5 requires the capitalization of interest costs on assets that are constructed as discrete projects for sale or lease to customers. Construction projects usually qualify for interest capitalization. If contract costs cannot be clearly associated with production and charged either directly or indirectly to specific contracts, FASB ASC 605-35-25-35 requires the costs be expensed during the period they were incurred.

When contractors accumulate construction costs, their accountants can consider the following:

- Has the contractor developed allocation methods that result in a high degree of comparability between actual costs and estimated costs? If not, the contractor's allocation methods should be revised to accomplish that result.

- Has the contractor compared its operating margins and overhead percentages with others in the same industry segment? Such a comparison will provide an indication if the construction contractor has appropriately developed cost allocation methods.

The importance of proper job costing (and job estimating) cannot be overstated as it impacts not only revenue recognition, as further explained later in this lesson, but also the contractor's cash flow (due to underbilling for work already performed) and profitability (due to the lack of including all properly chargeable costs incurred in the performance of the work). To help reduce the risks of estimating, it is important for contractors to have a job costing system or process that reliably captures all direct and indirect costs for individual contracts.

Direct Costs

It is often easy to identify and properly classify direct costs because they are normally unique to a specific contract. Examples of direct costs include the following:

a. Materials used directly in the construction of a project.

b. Construction labor.

c. Subcontractor charges.

d. Other direct costs that can be easily identified with a specific contract, such as travel and other costs incurred by construction crews who work on out-of-town jobs, rental costs of equipment used only on specific jobs, performance bond premiums, etc.

Direct Materials. Materials that are used directly to construct a project should be capitalized as a project cost component for both GAAP and tax purposes. The amount capitalized should include all cost components, including freight costs. Recording direct materials generally occurs in two ways—

a. Certain materials are common to many jobs and are routinely purchased in bulk and kept in the contractor's warehouse. These materials are normally carried as inventory until needed for a particular job, at which time the materials are assigned to the specific contract. The materials are then physically moved to and installed at the job site, and an accounting entry should be made to debit job costs and to credit inventories.

b. Other materials may be purchased for use only on a specific contract, either because they are unique to that contract or because sufficient levels are not already available in the warehouse. Most contractors will not actually record these materials as inventory, choosing instead to debit job costs directly when the materials are received.

To illustrate the preceding process, assume an electrical contractor is awarded a contract to install the electrical wiring and fixtures for a new art museum. The contractor may already have most of the materials that will be used on this project, such as wire, cables, breaker boxes, sockets, and switches; however, the contractor must order certain other materials specifically for this project. In this example, contract costs will include both materials transferred from inventory and materials purchased specifically for the museum contract.

Leftover Materials. After a project has been completed, leftover materials are normally returned to the warehouse if the contractor feels that they can be used on future jobs. These returned materials should be recorded as inventory at the lower of original cost or net realizable value. Any declines in value that have occurred before the materials are returned should be charged to the related contract. Certain inventory costs, such as idle facility expense, excessive spoilage, double freight, and rehandling costs, should be recognized as current-period charges.

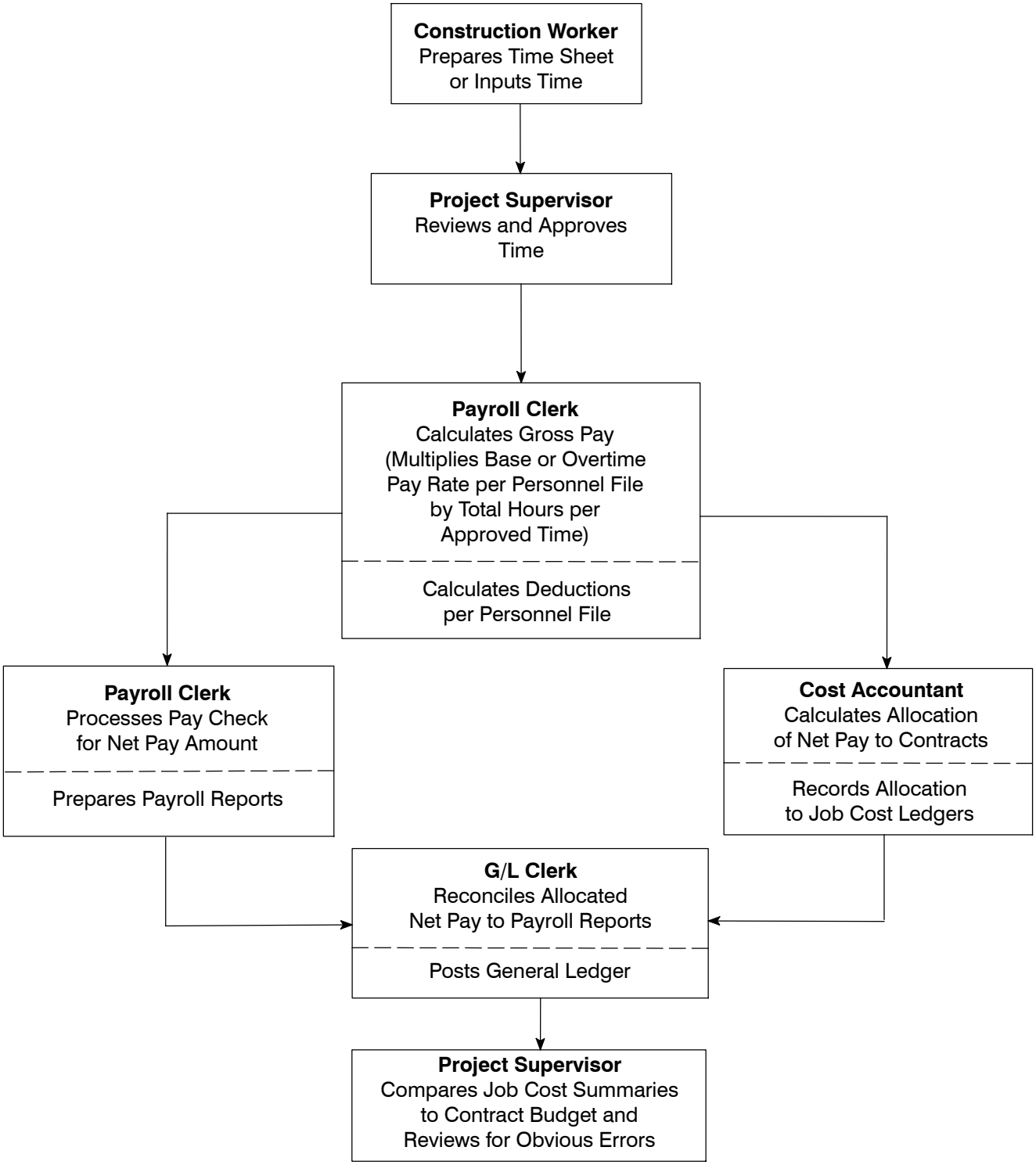
Direct Labor. Direct labor includes the payroll cost of construction workers, field supervisors, and others who charge time directly to contracts. The payroll cost charged to contracts should include wages, vacation and holiday pay, as well as all payroll-related costs (for example, payroll taxes, workers' compensation insurance, and fringe benefits, such as health insurance and retirement plans). As a practical matter, many contractors treat payroll taxes, workers' compensation insurance, and fringe benefits as indirect costs to be allocated as overhead costs.

Besides being an important component of total contract costs, direct labor hours or dollars is one of the most commonly used bases for allocating indirect costs among the contracts in progress during a period. If an error occurs in accumulating labor hours, the error can have a compounded effect on the contractor's financial statements; that is, not only may the direct labor component of total job costs be wrong, indirect costs may also be incorrectly allocated to the contracts. Exhibit 1-1 presents an overview of a typical direct labor processing stream that has been designed to minimize errors of a manual process. Several of the individual steps illustrated in Exhibit 1-1 may be performed automatically if the contractor uses an electronic payroll system designed for the construction industry.

Subcontractor Costs. Construction contractors often use other companies or individuals to perform a segment of the work required on a contract. This practice is especially common among general contractors, who frequently engage construction industry specialists, such as electricians, brick masons, painters, and heating and air contractors, to complete a project. These specialists are normally hired under subcontract agreements, which are often similar to the agreements between general contractors and owners. Costs incurred under subcontract agreements represent direct costs that should be capitalized directly to the related contracts.

Exhibit 1-1

Overview of a Typical Direct Labor Processing Stream



* * *

Billings from subcontractors will typically be made in accordance with the subcontract terms. To ensure completion of the subcontract project, the general contractor will pay only a portion of the subcontractor's bills throughout the subcontract life, with the remainder being held as retainage until satisfactory completion of the project. The amount that should be recorded as a direct contract cost is the total amount of the billing, not just the amount paid. For example, assume that a general contractor has a subcontract agreement with a landscape contractor that allows the subcontractor to bill $20,000 per month during the five-month life of the project. Assume further that the contractor pays only 90% of this amount, or $18,000 per month, with the remaining unpaid retainage due upon the owner's acceptance of the landscaping. The general contractor should record the following entry as the monthly bills are received and paid:

	DR	CR
Contract costs	$ 20,000	
Cash		$ 18,000
Account payable to subcontractor		2,000

When the five-month life of the project is completed, the general contractor should have charged $100,000 of direct contract costs relating to the landscaping subcontract, of which $90,000 will have been paid and $10,000 will still be due.

Other Direct Costs. Other direct costs are costs related to a specific contract, not included in one of the preceding categories. Other direct costs generally include such items as short-term equipment rental costs, surety bonds, job site utilities, and certain precontract costs.

Indirect Costs

Identifying and properly allocating indirect costs is less straight-forward and more complex than allocating direct costs. Confusion often occurs in determining whether indirect costs relate to specific contracts or to the general operating expense of the contractor. Contractors who fail to properly allocate indirect job costs to construction projects run the risk of not recouping expenses or submitting inaccurate bids, which could lead to cost overruns and lost profits. Underestimating indirect costs during bidding often results in contract losses, while overestimating may prevent the contractor from obtaining jobs in a competitive environment. Quantifying indirect costs involves the following two steps:

a. Determining the kinds of indirect costs that should be capitalized; and

b. Developing a systematic and rational method for allocating those costs to individual contracts.

Common Indirect Costs. Determining which types of indirect costs should be allocated to contracts is a judgmental process that involves the same basic considerations that a manufacturer uses to allocate overhead costs to inventory. Examples of indirect costs that are normally allocated to contracts are—

a. Rent, utilities, depreciation, and other costs related to construction facilities, such as storage buildings and assembly plants.

b. Rent, depreciation, repairs, and other operating costs of general construction equipment used on many jobs.

c. Compensation, fringe benefits, workers' compensation insurance, and payroll taxes for indirect labor, such as foremen. Also, if direct labor costs charged directly to contracts do not include related payroll taxes, workers' compensation insurance, medical insurance, and other fringe benefits, those components of direct labor should be categorized as indirect costs to be allocated to the contracts.

d. Quality control and inspection.

e. Small tools and general construction supplies.

f. Contractor's liability insurance.

Identifying the Components of an Overhead Pool. All indirect costs related to the construction process should be identified and included in an overhead pool or pools to be allocated to the construction costs of individual contracts. Overhead pools are most often used by contractors for labor burden, equipment ownership and operating costs, materials handling, shop and yard costs, vehicle costs, job management overhead costs, and general conditions cost. Determining overhead pools and the allocation of those costs generally depend on the type of work and amount of costs incurred. For example, a general contractor may choose to lump various costs together in one pool because they account for a small percentage of the general contractor's total cost, while a subcontractor may use two or more separate cost pools for those same costs because they represent a significant percentage of the subcontractor's total costs. It is a good idea to consider the following guidelines when determining the components of the overhead pool(s):

a. If the indirect cost was incurred solely to benefit the construction activity, all of that cost should be included in the overhead pool. For example, small tools and contract supplies would normally meet that criterion. Also, costs other than direct costs, specified as reimbursable costs in cost-type contracts, also would be considered overhead.

b. If the indirect cost does not relate to the construction activity, none of it should be considered in the overhead pool. For example, the salary of an administrative employee, such as the receptionist or an administrative vice president, should not be included in the overhead pool.

c. If a portion of the cost relates directly to the construction activity, consider only that portion in the overhead allocation. Gasoline, for example, may be used in construction equipment and in a salesman's car. Only that portion relating to the construction activity should be included in the overhead pool. The portion to be capitalized should be based on reasonable estimates, and, if that portion is likely to be material year after year, a consistent approach should be used.

Methods of Allocating Overhead. GAAP for construction contracts allows a variety of methods for allocating overhead costs among contracts. They include allocations based on direct labor hours, direct labor costs, or combinations of direct labor and material costs. Because significant variations can result in contract costs and resulting operations depending on which method is selected, the contractor must be sure that the method used is systematic, rational, and consistent from year to year. For example, a landscaping contractor is highly labor intensive and would probably not want to allocate overhead based on materials costs.

The approach most contractors use to allocate overhead involves using overhead burden rates. In this approach, a burden rate is computed by dividing total overhead by the total of the allocation base selected, for example, total direct labor costs or total materials costs. This burden rate is then applied to the allocation base for each contract to arrive at the amount of overhead to be allocated to the contract.

Exhibit 1-2 illustrates the use of this method to allocate overhead of $17,500.

Indirect costs and estimating processes change over time. Accordingly, contractors should periodically consider the appropriateness of the allocation method used and revise the process as necessary to maintain accuracy.

Capitalizing Construction Period Interest. If a company constructs an asset for its own use or constructs *discrete projects* for sale or lease, FASB ASC 835-20-15-5 requires that interest costs be capitalized as a part of the asset's cost. Normally, any contractor who has substantial outstanding debt to finance ongoing construction activities will have interest cost that is a candidate for allocation to individual contract costs. Both GAAP and tax rules require the capitalization of construction period interest.

Exhibit 1-2

Examples of Overhead Allocation Methods

Allocation based on direct labor costs of $59,000

Burden rate: $17,500 ÷ $59,000 = 29.66%

	Direct Labor	×	Burden Rate	=	Allocated Overhead
Contract A	$ 23,000		29.66%		$ 6,822
Contract B	4,000		29.66%		1,186
Contract C	32,000		29.66%		9,492
	$ 59,000				$ 17,500

Allocation based on materials costs of $63,700

Burden rate: $17,500 ÷ $63,700 = 27.47%

	Materials	×	Burden Rate	=	Allocated Overhead
Contract A	$ 21,000		27.47%		$ 5,769
Contract B	13,200		27.47%		3,626
Contract C	29,500		27.47%		8,105
	$ 63,700				$ 17,500

* * *

Other Cost Considerations

Costs in Cost-plus Contracts. Costs reimbursable under cost-plus contracts may or may not qualify for capitalization under GAAP. For example, certain contracts may not allow the contractor to bill for interest costs even though they qualify for interest capitalization under GAAP. Alternatively, other contracts may allow the contractor to bill for certain selling expenses even though those expenses are not capitalizable under GAAP. Costs under cost-plus contracts should be capitalized according to GAAP even if they conflict with the terms of the contract. If the estimated capitalized costs ever exceed the amounts billable, the contractor should consider establishing a reserve for loss.

Equipment Costs. Different contractors take varying approaches to owning or leasing construction equipment. Some contractors own little or no equipment and rent whatever is necessary to complete a given job, while other contractors invest heavily in construction equipment. Whether leased or owned, all contractors must establish a method to allocate equipment costs to specific contracts. Equipment costs, which include depreciation, repairs, maintenance, taxes, interest, and insurance, can be charged to contracts in a variety of ways, including—

a. Charging the cost of equipment used on the job to the contract as a direct charge and charging costs that cannot be specifically identified to overhead.

b. Allocating depreciation directly to the job and charging other equipment costs, such as repairs or maintenance, to overhead.

c. Charging all equipment costs to an equipment cost pool and allocating to jobs.

d. Charging all equipment costs to overhead and allocating the costs along with the other overhead expenses.

Some contractors use combinations of these methods. Regardless of the method or methods adopted, equipment costs should be allocated to contracts consistently, using methods that reflect the extent that construction equipment was used on specific jobs.

Equipment Cost Pools. Some construction contractors establish equipment cost pools to accumulate equipment costs. Standard equipment usage rates (such as hours, days, miles, etc.) are charged to contracts as the equipment is used. The rates are generally based on projected equipment usage and the total costs projected for the year. The difference between the actual costs incurred (total costs charged to the cost pool) for the year and the total credits to the cost pool (total amounts charged to contracts at standard rates) is referred to as an equipment variance.

The occurrence of a variance indicates that standard rates differ from actual costs. Since GAAP requires that construction in progress be stated at cost net of billings (unless projected costs exceed contract revenue, as discussed later in this lesson), the variance, if material, should be allocated in a logical and consistent manner between completed contracts and contracts in progress. One logical method of allocation is the ratio of the total credits to the cost pool for completed contracts to the total credits for contracts in progress for the year (or period). This method is illustrated as follows:

Assumptions:		
Credits to cost pool for:		
Completed contracts	$ 70,000	70%
Contracts in progress	30,000	30%
Total	$ 100,000	100%
Variance remaining in cost pool	$ 10,000	

Allocation of variance:
Completed contracts—$7,000 (70% × $10,000)
Contracts in progress—$3,000 (30% × $10,000)

The variance can be further allocated between specific completed contracts and contracts in progress using the same method.

Some accountants question this method when a contractor's equipment is idle for significant periods of time such as during the winter season. FASB ASC 910-20-25-3 indicates that it is proper to allocate idle equipment costs to jobs. It points out that this practice is consistent with the rates lessors charge (except for the profit element).

In many instances, the variance is not a material amount and need not be allocated. In these cases, the variance is usually charged or credited to the cost of completed contracts.

Selling, General, and Administrative Expenses. As a general rule, all costs that are not directly or indirectly associated with the construction process should be classified as selling, general, and administrative expenses. The only exception relates to the possible capitalization of certain general and administrative costs if the completed-contract method is used, particularly in years when no contracts are completed.

Precontract Costs. Contractors sometimes incur costs in anticipation of future contract sales in situations such as the following:

a. Costs are incurred in anticipation of obtaining a specific contract. The costs will have no future benefit if that contract is not obtained. A common example is architectural and engineering fees incurred to develop specifications that are submitted in a proposal to construct a project such as a city stadium.

b. Costs are incurred for assets to be used in connection with specific anticipated contracts. For example, a contractor might acquire a portion of the building materials required for a job before acceptance of the proposal because of favorable supplier terms.

c. Learning or start-up costs are incurred in connection with existing contracts and in anticipation of similar follow-on contracts. For example, an electrical subcontractor installing video monitoring systems under a contract to construct a jail may do additional circuitry work on monitors in anticipation of obtaining a similar contract with the same general contractor.

Except as discussed in the next paragraph, the precontract cost situations described in items a. and b. above, may be accounted for as follows:

a. If recovery of the costs is probable, they should be recorded as deferred costs separate from the contracts in progress accounts. The deferred costs should be either—

   (1) transferred to contracts in progress when the contract is received, or

   (2) expensed to construction costs of the period when it is no longer probable that the costs will be recovered through the contract.

b. If recovery is not probable, the costs should be expensed directly to construction costs of the period. If recovery subsequently becomes probable, the costs should not be capitalized retroactively.

GAAP for construction contract accounting requires precontract costs that qualify as start-up activities to be expensed as incurred. FASB ASC 720-15-20 defines *start-up activities* as "those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with an entirely new class of customers . . . or beneficiary, initiating a new process in an existing facility, or commencing some new operation."

Accordingly, if precontract learning or start-up costs such as those described in item c. above are incurred in connection with existing contracts and in anticipation of similar follow-on or future contracts, they should be charged to existing contracts. However, if the costs are not incurred in connection with existing contracts or are not incurred in anticipation of similar contracts, they should be expensed as construction costs of the period. If recovery subsequently becomes probable, the costs should not be capitalized retroactively.

Cost Adjustments Due to Back Charges. FASB ASC 605-35-25-42 defines *back charges* as "billings for work performed or costs incurred by one party that, in accordance with the agreement, should have been performed or incurred by the party to whom billed." Due to the relationship between the general contractor and the various subcontractors who assist on a project, cost adjustments often occur from back charges. For example, the general contractor may have to clean up after a subcontractor, or a subcontractor may use equipment that is owned by the general contractor. Back charges may also occur because of the relationship between the owner and the general contractor. For example, the owner may bill the contractor for materials purchased on the contractor's behalf. Back charges should be accounted for as follows:

a. *Back Charges by the Contractor, for Example, a General Contractor's Billing to a Subcontractor for Use of the General Contractor's Equipment.*

   (1) If both the responsibility for and the amount of the charge are undisputed, the general contractor should charge them to trade receivables net of a provision for any uncollectible portion, with a credit to contracts in progress.

   (2) If either the responsibility for or the amount of the charge is disputed, they should be treated as a claim, as discussed later in this lesson.

b. *Back Charges from Others, for Example, a Billing by the Owner for Materials Acquired on Behalf of the Contractor.*

   (1) If the probability tests of accounting for contingencies are met, the contractor should record a debit to contracts in progress and a credit to trade payables.

(2) If the probability tests are not met, the item should be considered for disclosure following the GAAP guidelines of accounting for contingencies.

GAAP requires that back charges be accrued when both of the following conditions exist at the balance sheet date:

a. It is probable that a liability has been incurred; and

b. The amount can be reasonably estimated.

If those two tests are not met, back charges from others should generally not be accrued. However, FASB ASC 450-20-50-4 requires disclosure of the following information unless the likelihood of a liability being incurred is remote:

a. Nature of the contingency.

b. Estimate of the amount (or range) or a statement that such an estimate cannot be made.

Consideration should also be given to the disclosure requirements related to risks and uncertainties discussed beginning in Lesson 2.

Comparison of GAAP to Tax Cost Capitalization Rules

In general, GAAP and tax contract cost capitalization rules are the same, but tax rules tend to be more specific about the types of indirect costs that should be capitalized. For some contractors, that specificity may create situations where indirect costs capitalized for GAAP vary from those capitalized for tax.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

4. How should a contractor treat materials that are left over after a construction project, if such materials can be used on future jobs?

    a. They should be capitalized as a component of project cost for both income tax and GAAP purposes.

    b. They should be allocated to overhead using the appropriate overhead burden rate.

    c. They should be recorded as inventory at the lower of net realizable value or original cost.

    d. The cost should be attributed to a pool, and then standard usage rates charged to contracts as the materials are used.

5. Janet is having her home remodeled. Hardhat Construction won the contract for this job. Janet has a particular idea about the backsplash for her new kitchen, so she purchases the materials herself and then bills Hardhat Construction for them. This is an example of which of the following?

    a. Back charges.

    b. Precontract costs.

    c. Start-up activities.

    d. Subcontractor costs.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

4. How should a contractor treat materials that are left over after a construction project, if such materials can be used on future jobs? **(Page 145)**

   a. They should be capitalized as a component of project cost for both income tax and GAAP purposes. [This answer is incorrect. Materials that are used directly to construct a project should be capitalized as a project cost component for both GAAP and tax purposes. The amount capitalized should include all cost components, including freight costs. However, this treatment does not apply to materials that were originally slated for the job and then left over for use on future jobs.]

   b. They should be allocated to overhead using the appropriate overhead burden rate. [This answer is incorrect. GAAP for construction contracts allows a variety of methods for allocating overhead costs among contracts. The approach most contractors use to allocate overhead involves using overhead burden rates. In this approach, a burden rate is computed by dividing total overhead by the total of the allocation base selected. This burden rate is then applied to the allocation base for each contract to arrive at the amount of overhead to be allocated to the contract. However, allocating overhead is different from dealing with the cost of leftover materials.]

   c. They should be recorded as inventory at the lower of net realizable value or original cost. [This answer is correct. After a project has been completed, leftover materials are normally returned to the warehouse if the contractor feels they can be used on future jobs. These returned materials should be recorded as inventory at the lower of original cost or net realizable value. Any declines in value that have occurred before the materials are returned should be charged to the related contract.]

   d. The cost should be attributed to a pool, and then standard usage rates charged to contracts as the materials are used. [This answer is incorrect. Some construction contractors establish equipment cost pools to accumulate equipment costs. Standard equipment usage rates (such as hours, days, miles, etc.) are charged to contracts as the equipment is used. The rates are generally based on projected equipment usage and the total costs projected for the year. However, this method for dealing with equipment is not applicable to leftover materials.]

5. Janet is having her home remodeled. Hardhat Construction won the contract for this job. Janet has a particular idea about the backsplash for her new kitchen, so she purchases the materials herself and then bills Hardhat Construction for them. This is an example of which of the following? **(Page 151)**

   a. Back charges. [This answer is correct. FASB ASC 605-35-25-42 defines *back charges* as "billings for work performed or costs incurred by one party that, in accordance with the agreement, should have been performed or incurred by the party to whom billed." Back charges can occur between the general contractor and a subcontractor or because of the relationship between the owner and the general contractor. For example, the owner may bill the contractor for materials purchased on the contractor's behalf, as Janet did in this scenario.]

   b. Precontract costs. [This answer is incorrect. Contractors sometimes incur costs in anticipation of future contract sales, such as architectural and engineering fees incurred to develop specifications that are submitted in a proposal to construct a project such as a city stadium. However, as the contract was already signed when Janet bought the materials for the backsplash, this term does not apply in this scenario.]

   c. Start-up activities. [This answer is incorrect. FASB ASC 720-15-20 defines *start-up activities* as "those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with an entirely new class of customers or beneficiary, initiating a new process in an existing facility, or commencing some new operation." However, since none of those things accurately describes Hardhat Construction's situation in this scenario, this term would not apply.]

d. Subcontractor costs. [This answer is incorrect. Construction contractors often use other companies or individuals to perform a segment of the work required on a contract. This practice is especially common among general contractors, who frequently engage construction industry specialists, such as electricians, brick masons, painters, and heating and air contractors, to complete a project. These specialists are normally hired under subcontract agreements. However, since Janet is the owner, not a subcontractor with a contract, this term does not apply to this scenario.]

REVENUE RECOGNITION METHODS USED BY CONSTRUCTION CONTRACTORS

Revenue recognition issues for construction contractors are different from those addressed by most other commercial entities. Most companies recognize revenue when inventory is delivered to a customer at the conclusion of a sale transaction. If this general rule were followed by construction contractors, revenue would not be recognized until the point of sale, which is normally the point a project is completed and delivered at the conclusion of the construction process.

However, Statement of Financial Accounting Concepts No. 5 gives the following guidance in Paragraph 84:

> If product is contracted for before production, revenues may be recognized by a percentage-of-completion method as earned—as production takes place—provided reasonable estimates of results at completion and reliable measures of progress are available. If production is long in relation to reporting periods, such as for long-term, construction-type contracts, recognizing revenues as earned has often been deemed to result in information that is significantly more relevant and representation ally faithful than information based on waiting for delivery, although at the sacrifice of some verifiability.

For GAAP purposes, two methods of recognizing revenues from construction contracts have evolved—

a. Under the percentage-of-completion (PC) method, revenues, costs, and profits are recognized in each accounting period as the contract progresses to completion.

b. Under the completed-contract (CC) method, revenues, costs, and profits are deferred until the project is substantially complete.

Note that if a company builds without a contract, all income should be recognized at the point of sale. An example of that construction type is speculative building by homebuilders, which is discussed in Lesson 2.

To illustrate the concepts behind the two methods of recognizing revenue, assume the following facts:

Earnings information:	
Fixed contract price	$ 50,000
Estimated total cost of the contract	40,000
Estimated total gross profit	$ 10,000
Costs incurred to date	$ 26,000
Percent complete ($26,000 costs incurred ÷ $40,000 estimated total cost)	65 %
Progress billings collected	$ 5,000

Illustration of the Percentage-of-completion Method

Under the percentage-of-completion method, earnings of $6,500 (or 65% of the estimated total gross profit of $10,000) would be recognized. That amount would be recognized by recording proportional amounts of revenue and cost. For example, recognizing gross profit of $6,500 might require recognition of 65% of both the contract price and the estimated total costs (or $32,500 and $26,000, respectively). An asset would be established to

account for costs, billings, and accrued gross profit. The following entries would be needed for the contract illustrated in the preceding paragraph:

	DR	CR
Costs and estimated earnings in excess of billings	$ 26,000	
Cash		$ 26,000
To record costs incurred.		
Contract receivable	5,000	
Costs and estimated earnings in excess of billings		5,000
To record progress billings.		
Cash	5,000	
Contract receivable		5,000
To record collection of progress billings.		
Construction expenses	26,000	
Costs and estimated earnings in excess of billings	6,500	
Construction revenues		32,500
To accrue earned gross profit.		

The following summarizes the effect of the preceding entries:

BALANCE SHEET	
Costs and estimated earnings in excess of billings	$ 27,500
INCOME STATEMENT	
Construction revenues	32,500
Construction expenses	26,000
Gross profit	$ 6,500

Note that the balance sheet account equals unbilled costs plus gross profit recognized to date (or $26,000 costs incurred to date−$5,000 billings to date + $6,500 gross profit).

Illustration of the Completed-contract Method

Under the completed-contract method, the following entries would be made:

	DR	CR
Costs in excess of billings	$ 26,000	
Cash		$ 26,000
To record costs incurred.		
Contract receivable	5,000	
Costs in excess of billings		5,000
To record progress billings.		
Cash	5,000	
Contract receivable		5,000
To record collection of progress billings.		

As a result of the preceding entries, the balance sheet would report costs in excess of billings as an asset of $21,000, and there would be no income statement transactions. The asset essentially represents unrecovered costs.

The Two Methods Contrasted

The following contrasts the results under the two methods assuming the contract is completed the following year in line with the original estimates:

	% of Completion		Completed Contract	
	Year 1	Year 2	Year 1	Year 2
BALANCE SHEET				
Construction asset	$ 27,500	$ —	$ 21,000	$ —
INCOME STATEMENT				
Revenue	32,500	17,500	—	50,000
Cost	(26,000)	(14,000)	—	(40,000)
Gross profit	$ 6,500	$ 3,500	$ -0-	$ 10,000

Percentage of Completion and Completed Contract Are Not Alternatives

The two methods of accounting for construction contracts are not alternatives, that is, a contractor is not free to choose one of the two methods. Instead, the GAAP rules for accounting for long-term construction contracts specify when each method should be used. Generally, the PC method will be used except in rare circumstances.

Preferences Established by the Authoritative Literature. The preferences established by the authoritative literature are summarized as follows:

a. The PC method is preferable when *all* of the following conditions exist (FASB ASC 605-35-25-57):

   (1) Reasonably dependable estimates can be made;

   (2) The contract clearly specifies the enforceable rights of both the contractor and the buyer, the consideration to be exchanged, and the manner and terms of settlement;

   (3) The buyer can be expected to satisfy its obligations under the contract; and

   (4) The contractor can be expected to perform its contractual obligations.

b. The CC method is preferable when lack of dependable estimates or the existence of inherent hazards cause forecasts to be doubtful (FASB ASC 605-35-25-90).

c. Additionally, use of the CC method is allowed when the financial results would not vary materially from those resulting from use of the percentage-of-completion method (FASB ASC 605-35-25-92).

The use of the word *preferable* by the authoritative literature in describing which revenue recognition method should be used for construction-type contracts has often created some uncertainty. Practitioners have questioned whether the completed-contract method could be used, especially by entities that qualify as small contractors for tax purposes, thus avoiding the need to compute deferred taxes.

This course suggests that the use of the word *preferable* be followed as a requirement rather than a preference. Additionally, Paragraph 10.43 of the AICPA Guide, indicates that practitioners should be satisfied that contractors follow the guidance in FASB ASC 605-35-25-57 regarding the use of the percentage-of-completion method when the contractor meets the authoritative conditions stated. This seems to mean that contractors should always use the percentage-of-completion method unless the contractor meets either of the two conditions for use of the completed-contract method listed above.

Criteria for Reasonably Dependable Estimates. One of the conditions for determining which revenue recognition method to select is the ability to make reasonably dependable estimates. The ability to estimate involves two separate assessments—

- The ability to make estimates in the normal course of business; and
- The ability to make estimates when there are inherent hazards related to the particular contract.

The authoritative literature assumes that the ability to make estimates in the normal course of business is essential to continuing as a going concern. Estimates are required to prepare most bids and many off-the-shelf software packages are available to assist in making estimates and tracking contract costs. The position of FASB ASC 605-35-25-58 and 25-66 is essentially that (a) there is a basic presumption that all construction contractors have the ability to make estimates in the normal course of business and (b) overcoming that presumption should be on a contract-by-contract basis and requires specific persuasive evidence of inherent hazards.

FASB ASC 605-35-25-65 establishes two characteristics of inherent hazards: they are unusual events that would not be considered in the ordinary preparation of contract estimates, and they would not be expected to recur frequently given the contractor's normal business environment. Although inherent hazards should be rare, common examples might be litigation that threatens continuance of the project (for example, because of changes in zoning ordinances or suits filed because of negligent or faulty construction) and questions about the customer's ability to continue as a going concern.

Inherent hazards require the following special accounting considerations:

a. As previously mentioned, if inherent hazards cause forecasts to be doubtful, the completed-contract method is the preferred approach for recognizing revenue. An entity using the percentage-of-completion method as its basic accounting policy should use the completed-contract method for a single contract or a group of contracts when inherent hazards make estimates doubtful. (FASB ASC 605-35-25-61 and 25-90)

b. If reasonably dependable forecasts can be prepared and the contractor believes a loss will not be incurred on the contract, the PC method should be applied assuming a zero profit margin. (FASB ASC 605-35-25-67)

c. In some cases, when reasonably dependable estimates can be prepared, a contractor may be able to estimate total revenues or total costs in ranges of amounts. If the contractor can determine the amounts within the ranges that are most likely to occur, those amounts should be used in applying the PC method. If the most probable amounts cannot be determined, the lowest probable profit level within the ranges should be used. (FASB ASC 605-35-25-60)

Using Zero Profit Margin under the Percentage-of-completion Method. Applying the PC method assuming a zero profit margin requires equal amounts of revenues and costs to be recognized during the construction period; therefore, the PC method differs from the CC method. To illustrate, assume that a fixed-price contract for $150,000 is obtained, and costs are expected to total $110,000. When the project is 60% complete and the contractor has progress billed $45,000, the county files suit to annex property that includes the construction site. Since the county has zoning ordinances that preclude using the property for its intended purpose and may well lead to abandonment of the project, the contractor anticipates that a settlement will ultimately be reached with the county that will at least provide for recovery of the costs already incurred. Under the PC method, since only cost recovery is expected, no profit would be recognized, and the asset would be equal to costs incurred (or $66,000). The income statement would show revenues and costs of $66,000.

If future events enable the contractor to estimate profit or loss on the contract, a cumulative catch-up adjustment would be made and accounted for as a change in estimate. The effects of the change in estimate should be reported in the period of the change and subsequent periods. Restatement of prior periods is not appropriate. For example, if, in the preceding illustration, the suit is dropped and the project is continued under its original terms, earned gross profit of $24,000 (or 60% of the $40,000 estimated total gross profit) would be accrued as a change in estimate in the year the uncertainty is resolved. In that case, all $24,000 would be recorded as revenue since costs incurred were charged in the prior year's income statement. In addition, the change in estimate should also be disclosed based on FASB ASC 250-10-50-4 if the effect of the change in estimate is considered material to either revenues or costs. See additional discussion of changes in estimates in Lesson 2.

When Completed Contract and Percentage of Completion Are Not Materially Different. The CC method may be used if the results do not differ materially from those that would be obtained using the PC method. The following are common practice situations in which using one method may not differ materially from using the other:

a. If the year end is typically at the down point of the business cycle, jobs in process may be small enough so that using the PC method would not materially affect earnings. In that situation, the adjustment needed to convert CC information into PC would probably not be material either to earnings or to the balance sheet.

b. If the volume and profitability of jobs in process at the beginning and end of the year are approximately the same, both the PC and CC methods might produce approximately equal earnings. In other words, the adjustment needed at the beginning and end of the year to convert CC records to PC would be approximately the same. However, in that situation, the balance sheet effect could be quite large, and the materiality of the effect on the balance sheet would need to be considered in addition to the effect on earnings.

c. If the contractor primarily performs short-term contracts during an accounting period; for example, a small plumbing contractor that generally works in the homebuilding industry.

Does the Length of the Contract Affect the Method Chosen?

No. The requirements in the authoritative literature apply to all construction contracts, regardless of length, and exceptions are justified only when the methods do not differ materially. In some situations, the methods will not differ materially for short-term contracts; but in other situations, there may be a material difference. For example, if a contractor performs primarily under contracts with relatively short terms, contracts in progress may remain at approximately the same volume and profitability at each balance sheet date so that the two methods do not differ materially. However, if substantial progress has been made on an especially large and profitable contract, the results may differ materially.

Departures from the Basic Revenue Recognition Policy

After applying GAAP requirements to decide between the PC method and the CC method, the contractor should establish a basic policy to account for construction contracts. FASB ASC 910-605-50-1 and FASB ASC 605-35-50-1 require the contractor to disclose in the summary of significant accounting policies the method or methods of determining revenue and cost recognition. Contractors who use the percentage-of-completion method as their basic accounting policy should use the completed-contract method when reasonably dependable estimates cannot be made or inherent hazards make estimates unlikely. Likewise, contractors who use the completed-contract method as their basic accounting policy should use the percentage-of-completion method when all of the conditions discussed earlier exist. Departures from the basic policy for a single contract or a group of contracts should be disclosed.

Deciding Which Method to Use for Interim Financial Reporting

FASB ASC 270-10-45-2 requires using the same accounting principles in both interim and annual financial statements. Therefore, if a contractor uses the PC method in its annual statements, using the CC method in its interim statements would be a departure from GAAP and any accountant who compiled, reviewed, or audited the interim statements would be required to issue a modified report in those circumstances. However, because converting is costly, the client may view the departure as a cost-effective alternative for the interim statements. In that case, a note such as the following would be presented in the summary of significant accounting policies in the interim statements:

> Revenue and Cost Recognition
>
> In the Company's annual financial statements, construction revenues and costs are recognized using the percentage-of-completion method and, accordingly, are reported in earnings as construction progresses. Applying that method requires estimates and computations for each contract that management believes are not practical for interim presentations. Accordingly, in the accompanying interim financial statements, construction revenues and costs are recognized using the completed-contract method.

Under the completed-contract method, direct material and labor costs and indirect costs related to contract performance are capitalized, and contract revenues and capitalized costs are recognized in earnings when the customer accepts the work.

Estimating Contract Costs and Revenues

As is apparent from the illustration of the two methods earlier in this section, a critical part of the percentage-of-completion computation is the estimation of costs to complete the project and the estimation of total contract revenue. These estimations are also crucial in determining the need for a provision for anticipated losses as discussed later in this lesson.

Estimated Costs to Complete. FASB ASC 605-35-25-44 provides the following guidelines for estimating costs to complete a project:

a. The accounting records should provide a basis for periodically comparing actual and estimated costs.

b. In estimating total contract costs, the quantities and prices of all significant cost elements should be identified.

c. The estimating procedures should ensure that estimated cost to complete includes the same elements of cost that are included in actual accumulated costs; also, those elements should reflect expected price increases.

d. The effects of future wage and price escalations should be taken into account in cost estimates when the length of the contract makes such factors material.

e. Estimates of cost to complete should be reviewed periodically and revised as appropriate to reflect new information.

Estimating costs to complete may involve either forecasting or projecting additional costs or reviewing original estimates to determine whether revisions are needed. For example, if, after reviewing and considering any new information (including costs to date), the contractor believes the contract is progressing in line with the original estimates, it may be appropriate to determine estimated costs to complete as the difference between the original cost estimates less costs incurred. Similarly, if the original cost estimates are believed to be understated by approximately $20,000, the same computation could be made and $20,000 added to estimated costs to complete.

Estimated costs to complete also should include liquidated damages that have been incurred and any other liquidated damages expected to be paid. The contractor should also consider whether the estimated liquidated damages cause the contract to go into a loss position. Finally, the contractor should understand the reason for the liquidated damages and determine whether there will be a claim made by the contractor against the owner.

It is critical that costs incurred and estimated costs to complete include the same components of contract costs. For example, if costs incurred include overhead allocation and capitalized interest, but total cost estimates do not, recognized profit will be overstated during that period and understated during subsequent periods.

Estimated Total Contract Revenues. Estimating contract revenues involves consideration of (a) the basic contract price, (b) change orders, (c) options and additions, and (d) claims.

Basic Contract Price. Determining the basic contract price varies according to the type of contract. FASB ASC 605-35-20 lists several types of contracts used by construction contractors. A detailed discussion of the types of construction contracts most often found in practice is beyond the scope of this course, but more information is available in *PPC's Guide to Construction Contractors*.

To estimate contract revenues, all clauses in the contract that might affect revenues ultimately generated must be considered. Fixed-price contracts (also known as lump-sum contracts) with no provision for adjustment pose no problems in estimating contract revenues because the fixed price is the total revenue expected from the job. However, other types of contracts require judgment in estimating contract revenues. For example, for

cost-plus-incentive-fee contracts with incentives based on cost, allowable costs must be estimated; this may entail interpreting which costs are allowable. The accuracy of the estimate also varies with the contract's length; for example, early estimates in a three-year contract with target cost incentives would require more subsequent revisions than a one-year contract with those same incentives. Similarly, the accuracy of the estimates will improve as the contract progresses because management's performance in comparison with performance incentives will become clearer. But difficulty in estimating and the imprecision of the estimate do not change the selection of the basic accounting method (percentage-of-completion or completed-contract) or its application. Estimates should preferably be single point estimates, but estimates in ranges are acceptable alternatives if single point estimates are not reasonably determinable.

As a general rule, estimated contract revenues should include all items for which the contractor has risk or that were included in determining the project fee. Therefore, if the contractor requests the customer to purchase materials to the contractor's specifications (for example, because of the customer's leverage with suppliers), the cost of those materials should be included in the estimated revenues. On the other hand, if the contractor uses some of the customer's employees to help with the construction under a cost-type contract and the employees are paid by the customer, the contractor would not include those labor costs in the computation of revenues as reimbursable costs. Therefore, any cost-based fee would not consider those because the contractor has no risk.

Change Orders. Change orders modify provisions of the original contract but do not add new provisions. Any aspect of a contract, such as specifications or design, the method or manner of performance, the site, facilities, equipment, or the construction period, could be the subject of a change order. A change order could be initiated either by the contractor or the customer. Accounting for change orders depends on the factors that create the change, which differ for each change order.

Some change orders generate no additional revenues (such as when the initial contract provides that specified changes can be made at no charge, and therefore, require no consideration in estimating contract revenues). However, others generate additional revenues and require consideration in the estimate. Including the price of a change order in estimated contract revenues depends on whether it has been priced and whether the price and scope have been approved. For example—

a. If a change order is priced and both parties have approved the scope and price, estimated contract revenues would include the price of the change order.

b. If a change order is unpriced but both parties have approved the scope, treatment varies with the accounting method.

c. If a change order is priced but the parties have not approved the price or the scope, it would be evaluated as a claim.

The following summarizes the accounting treatment for change orders that are unpriced but for which the scope has been approved:

Percentage-of-completion method

a. If it is probable that the costs of the change order will be recovered by changing the contract price, the costs should be charged to contracts in progress, and either of the following is acceptable:

   (1) Recognize none of the costs in the income statement until pricing has been approved; or

   (2) Recognize costs incurred and equal amounts of revenue in the income statement.

b. If it is probable that the change order will generate additional gross profit, it should be recognized prior to pricing only if realization is assured beyond a reasonable doubt. Realization may be assured beyond a reasonable doubt in situations such as when the contractor's historical experience provides such assurance or when a contractor has received a bona fide pricing offer and only the amount of the offer is added as additional revenue.

c. Any portion of the contract costs, including change orders, for which recovery is not probable (which may be all of the cost of the change order or only a portion of it) should be charged to current operations.

Completed-contract method

d. If it is probable that the contract cost, including change orders, will be recovered, the cost of the change order should be included in contracts in progress.

e. Any portion of the contract cost, including change orders, for which recovery is not probable (which may be all of the cost of the change order or only a portion of it) should be charged to current operations.

These considerations should be documented.

Options and Additions. An option or addition to a basic contract adds a provision to the original contract. For example, if a customer changed the layout of an office building, the change would be accounted for as a change order. However, if a customer originally contracted for building a plant but decided to add a wing to the original structure, the change would probably be accounted for as an addition.

Deciding whether to include the option or addition in estimated contract revenues first requires assessing whether the change is, in substance, a new contract. FASB ASC 605-35-25-29 requires treating options or additions to an existing contract as a separate contract in *any* of the following circumstances:

a. The product or service to be provided differs significantly from the product or service provided under the original contract.

b. The price of the new product or service is negotiated without regard to the original contract and involves different economic judgments.

c. The products or services to be provided under the exercised option or addition are similar to those under the original contract, but the contract price and anticipated contract cost relationship are significantly different.

An option or addition should be accounted for as follows:

a. If it meets the criteria for a new contract and the criteria for combining discussed earlier in this lesson, it should be combined with the original contract. The price of the option or addition would be added to the basic contract price in estimating contract revenues.

b. If it meets the criteria for a new contract but does not meet the criteria for combining discussed earlier in this lesson, it should be treated as a separate contract. The price of the option or addition would be the estimated contract revenues for the profit center.

c. If it does not meet the criteria for a new contract discussed above, it should be treated as a change order. Its treatment in estimating contract revenues from the contract would be determined by the criteria discussed earlier in this section.

These considerations should be documented.

Claims Made by the Contractor against the Owner. Claims made by the contractor against the owner are attempts by the contractor to collect additional revenues (that is, revenues that exceed the agreed contract price), typically because of unforeseen circumstances the contractor could not have avoided. Common reasons for claims listed in FASB ASC 605-35-25-30 include owner-caused delays, errors in specifications and designs, contract terminations, and unapproved or disputed change orders. When claims are made against the owner, GAAP permits either (a) including the claim in revenues in the period it is made under certain specified conditions (which is an accrual approach) or (b) only recording revenue from claims when awarded (which is a cash approach). The authoritative literature indicates that the alternatives are equally acceptable, so the contractor may elect either one. Although consistency is not addressed, it is a best practice to adopt a basic policy and apply it to all claims, even when there is an anticipated contract loss.

FASB ASC 605-35-25-31 allows claims made by the contractor against the owner to be included in contract revenues to the extent contract costs relating to the claims have been incurred if *all* of the following conditions exist:

a. The contract or other evidence provides a legal basis for the claim, or a legal opinion has been obtained stating that under the circumstances there is a reasonable basis to support the claim. If legal proceedings have concluded favoring the contractor, most likely the test has been met. Even if appeals are expected, the initial opinion may be enough to support revenue recognition. If legal proceedings are not complete, the contractor should obtain representation from counsel that there is a reasonable basis for the claim. If a reasonable basis for the claim does not exist, it is unnecessary to go any further.

b. Additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance. To identify those situations, the company needs to be very aware of the specific terms, specifications, and conditions of the contract. That knowledge will assist in quickly identifying the areas requiring contract modification. Typical events that can cause contract modification are discussed in Lesson 2.

c. Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed. Answers to the following questions might help in evaluating this condition:

   (1) Is the contractor's job cost system set up to identify the cost?

   (2) If the cost system cannot identify the cost, can the work be segregated from other contract work and reliable estimates be prepared?

   (3) Would another contractor doing the same job likely have incurred similar costs?

   The contractor has an obligation to keep the additional costs to a minimum. The general terms of many contracts require contractors to proceed in an efficient and timely manner.

d. The evidence supporting the claim is objective and verifiable and not based on management's *feel* for the situation or on unsupported representations. The absence of a summarized, quantified claim usually would prevent passing this test. Claim proceedings will require documents and schedules to be prepared and possibly audited by opposing counsel's accountants.

If some but not all of these conditions are met, the claim is a contingent gain, and FASB ASC 450-30-25-1 prohibits recording those gains before realization.

If all of the preceding conditions are met, revenue recognition is limited to costs recognized under the particular contract accounting method (percentage-of-completion or completed-contract). In addition, special disclosures are required. If one or more of the conditions is not met, the claim should be excluded from contract revenues and the related costs should be charged to expense as period costs (FASB ASC 605-35-25-35). These considerations should be documented.

Provision for Anticipated Losses

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

a. Costs incurred to date.

b. Estimated costs to complete.

c. Estimated total contract revenues.

In essence, a loss provision should be recorded on a contract if the total of costs incurred to date plus estimated costs to complete exceed the estimated total contract revenues. The components that should be included in costs incurred to date, the estimated cost to complete, and estimated total revenues were all discussed earlier in this lesson.

Accrual of Anticipated Losses. If, after comparing the estimated total contract revenue to the costs incurred to date plus the estimated costs to complete, a loss is expected on a particular contract, the loss should be charged to a special loss account. The required entry will debit a special loss account, such as *Provision for Losses on Contracts in Progress*, with a corresponding credit to an accrued liability, such as *Accrued Losses on Contracts in Progress*. Regardless of the revenue recognition method used by the contractor, the contractor should ensure that—

a. the loss is included in contract costs for the period,

b. the loss and the accrued liability should be disclosed separately in the financial statements, if material, and

c. the accrual is reversed against contract costs when the project is substantially complete.

The revenues and costs that would be recognized under the percentage-of-completion and the completed-contract methods whenever a loss contract is encountered are discussed next.

Revenue and Cost Recognition Issues Involving Loss Contracts. As previously stated, losses must be accrued during the period they become known regardless of the revenue recognition method used. However, the recognition of revenues and costs incurred differs under the two revenue recognition methods as follows:

a. Under the percentage-of-completion method, the loss would be recognized in the period determined, and revenues would be recorded based on the percentage of completion.

b. Under the completed-contract method, the loss would still be recorded in the period it is determined, but no revenues related to the contract would be recognized and costs would be deferred. As with profitable contracts, contract revenues would be recorded during the period of substantial completion, and related costs would be charged against them in that period.

Illustration Involving a Loss Contract. Regardless of the revenue recognition method used, the total anticipated loss on a given contract would be accrued in the period it is determined, with no profit or loss to be reported during future periods (unless the estimated amount of the anticipated loss changes during future periods). To illustrate, assume that a fixed-price contract for $100,000 that was originally expected to cost $80,000 has incurred actual costs of $32,000, prior to any loss accrual. At the balance sheet date (end of Year 1), the contractor believes that cost overruns will be $40,000 resulting in a loss of $20,000. Progress billings of $30,000 had been made as of the end of Year 1. Thus, at the end of Year 1, the cost-to-cost percentage of completion is 26.67% ($32,000÷$120,000). The following compares the accounting treatment under the percentage-of-completion and the completed-contract methods:

	% of Completion		Completed Contract	
	Year 1	Year 2	Year 1	Year 2
Revenues	$ 26,667	$ 73,333	$ —	$ 100,000
Costs incurred	32,000	88,000	—	120,000
Accrued loss (reversal)	14,667	(14,667)	20,000	(20,000)
	46,667	73,333	20,000	100,000
Gross profit (loss)	$ (20,000)	$ -0-	$ (20,000)	$ -0-

The following journal entries would be needed for this contract using the percentage-of-completion method:

Year 1

	DR	CR
Costs and estimated earnings in excess of billings	$ 32,000	
Cash		$ 32,000
To record costs incurred.		
Contract receivable	30,000	
Costs and estimated earnings in excess of billings		30,000
To record progress billings.		
Cash	30,000	
Contract receivable		30,000
To record collection of progress billings.		
Provision for losses on contracts in progress	14,667	
Accrued losses on contracts in progress		14,667
To record estimated loss.		
Construction expenses	32,000	
Contract revenues ($100,000 × 26.67%)		26,667
Costs and estimated earnings in excess of billings		5,333
To record costs and revenues to date.[a]		

Year 2

	DR	CR
Costs and estimated earnings in excess of billings	$ 73,333	
Accrued losses on contracts in progress	14,667	
Cash		$ 88,000
To record costs incurred and reverse accrued loss.		
Contract receivable	70,000	
Costs and estimated earnings in excess of billings		70,000
To record progress billings.		
Cash	70,000	
Contract receivable		70,000
To record collection of progress billings.		
Construction expenses	73,333	
Construction revenues		73,333
To record costs and revenues in Year 2.		

Note:

[a] Note that because the actual costs incurred in Year 1 of $32,000 exceeded the contract revenue recognized of $26,667 (contract price of $100,000 × the percentage of completion of 26.67%), a portion of the loss ($32,000−$26,667 = $5,333), or 26.67% of the loss, was already recognized in the income statement. Thus, the remaining amount of the loss to be accrued at the end of Year 1 was $14,667 ($20,000−$5,333), resulting in a total recognized loss at the end of Year 1 of $20,000.

USING THE PERCENTAGE-OF-COMPLETION METHOD

As previously discussed, the percentage-of-completion method should be used to account for substantially all contracts in progress at a specific point in time. There are certain alternative approaches that may be used in

applying this method and they are discussed in this section. Specifically, the accounting considerations that will be discussed are as follows:

a. Determining the percentage of completion.

b. Two alternative approaches to determining revenues and costs to be recognized.

Determining the Percentage of Completion

FASB ASC 605-35-25-52 provides the following guidance related to determining the extent of progress toward completion of a contract in progress under the percentage-of-completion method:

a. "Income recognized shall be that percentage of estimated total income, either:

(1) That incurred costs to date bear to estimated total costs after giving effect to estimates of costs to complete based on most recent information.

(2) That may be indicated by such other measure of progress toward completion as may be appropriate having due regard to work performed."

In practice, many methods are used, but all can be grouped into the following two classifications:

a. *Input methods* base the percentage of completion on efforts devoted to a contract. One of the most common bases is contract costs, which is the method described at item a. above, but other methods such as engineering estimates and direct labor hours also are acceptable.

b. *Output methods* base the percentage of completion on results achieved. A common basis is preestablished milestones. For example, the contract will be 10% complete after the foundation is dug and footings poured and 45% complete after the building is under roof; but, other methods such as yards-of-concrete-poured and units-produced also are acceptable.

Cost-to-cost Method. One widely used method of determining the percentage of completion is the *cost-to-cost* method, whereby costs incurred to date are compared to the estimated total costs to be incurred. The percentage of completion is calculated by dividing the costs incurred to date (the numerator) by the estimated total costs to be incurred for a contract (the denominator). For example, if $12,000 of costs have been incurred on a contract with an estimated total cost of $30,000, the contract is 40% complete using the cost-to-cost method. Although this method seems to be fairly easy to apply, the following factors should be kept in mind when the cost-to-cost method is used:

a. The cost-to-cost calculation of percentage of completion should not be performed until all costs have been accrued. Before applying this method, the accountant should identify and correct all cost accumulation errors. For example, the ledgers may be on a cash rather than accrual basis, overhead costs may have been expensed rather than properly allocated to the contracts in progress during the period, or construction period interest may not have been properly capitalized. It is impossible to accurately assess the extent of progress toward completion using the cost-to-cost method unless all costs are included in the numerator of the calculation.

b. The estimate of total costs to be incurred on a project must also be complete and accurate. Several factors to consider in estimating the costs to complete a given contract were discussed earlier in this lesson. Some contractors routinely divide the costs incurred to date by the original cost estimate, even though it may no longer be appropriate. Since the estimate of total job costs will be the denominator in the percentage-of-completion calculation, the resulting percentage will be reliable only if the estimate of total costs is recalculated at each balance sheet date using all of the appropriate factors listed in the previous section.

c. Costs that do not relate to contract performance should be disregarded in applying the cost-to-cost method. Costs incurred to date (the numerator) should normally be reduced by the cost of uninstalled materials, unless those materials have been specifically produced, fabricated, or constructed for a project.

Uninstalled Materials. In using the cost-to-cost method, the contractor is attempting to obtain an accurate estimate of the extent of contract performance to date. Because uninstalled materials do not generally relate to job performance, the cost of those materials that are not unique to the project should be excluded from actual costs incurred to date in applying the cost-to-cost method. This does not mean that all uninstalled materials should be omitted from the percentage-of-completion calculation. FASB ASC 605-35-25-76 provides the following guidance regarding the types of uninstalled materials that should be included in the calculation:

> The cost of uninstalled materials specifically produced, fabricated, or constructed for a project should be included in the costs used to measure extent of progress. Such materials consist of items unique to a project that a manufacturer or supplier does not carry in inventory and that must be produced or altered to meet the specifications of the project.

For example, assume a drywall contractor has the following contract:

Total contract price	$ 112,000
Total estimated costs	92,000
Estimated gross profit	$ 20,000

If actual costs incurred at the contractor's year end are $38,640, the contract is 42% complete ($38,640 ÷ $92,000) using the cost-to-cost method, and the gross profit that would be recognized at that date would be 42% × $20,000, or $8,400. The direct materials included in the $38,640 of costs incurred to date should include all materials already installed, but should generally omit all uninstalled materials—

a. Sheetrock and other direct materials used by drywall contractors are common materials used in the construction of most buildings and thus would not be included in contract costs until they are installed.

b. However, certain moldings and other materials might have been fabricated for the specific project and should be included in contract costs even if they have not yet been installed.

To illustrate this distinction, assume that the $38,640 of costs incurred to date in the previous example includes the following components:

Sheetrock and other common materials delivered to the job site	$ 25,600
Unique materials fabricated for the project	4,540
Direct labor	5,500
Other costs	3,000
Total	$ 38,640

If only $3,520 of the sheetrock and other common materials had been installed as of the balance sheet date, the cost of uninstalled common materials ($25,600−$3,520=$22,080 in this example) should be subtracted from the estimate of costs incurred to date. This would lower the estimate of costs incurred as of the balance sheet date from $38,640 to $16,560. The following analysis illustrates the effect of the adjustment of costs incurred to date for uninstalled materials:

	Before Adjustment	After Adjustment
Costs incurred to date	$ 38,640	$ 16,560
Percentage complete	42%	18%
Revenues	$ 47,040	$ 20,160
Cumulative profit	8,400	3,600

It is clear from the preceding illustration that the proper exclusion of uninstalled materials can have a significant impact on the revenues, costs, and profits recognized under the percentage-of-completion method for contracts in progress at a given balance sheet date. Not only can the adjustment of percentage completion for uninstalled materials be significant, it usually leads to a temporary difference because tax law requires that such materials be

included in the cost-to-cost determination. Discussion of the tax treatment is beyond the scope of this course, but more information is available in *PPC's Guide to Construction Contractors*.

Conclusion Regarding the Determination of Percentage of Completion. Selecting the method or methods of measuring the extent of progress toward completion involves a great deal of judgment. GAAP does not require the use of a particular method; however, the method selected for a particular type of contract should be representative of performance. The method or methods selected should also be applied consistently to all contracts having similar characteristics. Because the methods used by a company will have a direct impact on the amount of revenues, costs, and profits recognized on contracts in progress, great care should be exercised in selecting the appropriate methods and in applying them at each balance sheet date.

Determining Revenues and Costs to Be Recognized

After the percentage of completion of a particular contract has been determined, the next step is to use this percentage in calculating the amount of revenues, costs, and profits to be recognized. FASB ASC 605-35-25-82 through 25-84 provides two methods for recognizing revenues, costs, and profits—

a. *Alternative A* applies the percentage of completion to total estimated contract revenue and total estimated contract costs. Gross profit recognized is the difference between the two products.

b. *Alternative B* applies the percentage of completion to total estimated gross profit from the contract, and the profit is added to costs incurred to determine revenues recognized.

Both methods produce the same gross profit, that is, total estimated gross profit times the percentage of completion, but do not always produce the same revenues and costs. If the percentage of completion is determined based on the relationship of costs incurred to estimated total costs, both methods produce the same results. To illustrate, assume that costs of $120,000 have been incurred on a fixed-price contract for $200,000 expected to yield gross profit of $40,000. Total estimated contract costs are $160,000. Using the cost-to-cost approach, the percentage of completion is 75% (or $120,000 ÷ $160,000). Revenue and cost to be recognized under the two methods would be as follows:

Alternative A

Revenues (75% of the $200,000 total contract revenues)	$ 150,000
Costs (75% of the $160,000 total contract costs)	(120,000)
Gross profit	$ 30,000

Alternative B

Gross profit (75% of the $40,000 total contract gross profit)	$ 30,000
Costs incurred	120,000
Revenues	$ 150,000

But different answers would be obtained if other methods were used to compute the percentage of completion. To illustrate, assume that the percentage of completion is 60% based on direct labor hours—

Alternative A

Revenues (60% of the $200,000 total contract revenues)	$ 120,000
Costs (60% of the $160,000 total contract costs)	(96,000)
Gross profit	$ 24,000

Alternative B

Gross profit (60% of the $40,000 total contract gross profit)	$ 24,000
Costs incurred	120,000
Revenues	$ 144,000

A contractor may use either of the preceding methods, but it is a best practice to select one method and apply it to all contracts.

USING THE COMPLETED-CONTRACT METHOD

As previously noted, the percentage-of-completion method must be used by most contractors, and the completed-contract method will normally not be encountered. Although the CC method is much easier to apply than the PC method, there are two issues that must be addressed in those rare instances when it is used—

a. Determining the point of substantial completion is critical because it determines when all profit is recognized.

b. The allocation of general and administrative expenses to contracts rather than to periodic income may be appropriate in certain circumstances.

Determining the Point of Substantial Completion

Determining the point of substantial completion is critical to the CC method because it determines when all profit is recognized. The following guidelines have been summarized from FASB ASC 605-35-25-96 and 605-35-50-4:

a. As a general rule, the point is reached when remaining costs and potential risks are insignificant.

b. Use consistent criteria for determining substantial completion and avoid arbitrary acceleration or deferral of income.

c. Disclose the criteria in the summary of significant accounting policies.

Examples of common criteria are final acceptance by the customer and acceptance subject to completion of a *punch list*. Also, standard percentages may be used as guidelines. For example, if a job is 95% complete, many contractors view it as complete.

Capitalization of General and Administrative Expenses

General and administrative (G&A) expenses would never be capitalized under the PC method. However, because most construction contracts are long-term in nature, it may sometimes be appropriate to capitalize G&A costs into contracts if the CC method is used. FASB ASC 605-35-25-99 allows the allocation of G&A costs to contracts rather than to periodic income if a better matching of costs and revenues would result, particularly in years when no contracts are completed. It seems likely that capitalization of G&A costs will be rare.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. A construction contractor can use the completed-contract (CC) method instead of the percentage-of-completion (PC) method under which of the following circumstances?

   a. It is reasonably possible that dependable estimates can be made.

   b. The buyer is financially sound and, therefore, likely to satisfy its contract obligations.

   c. Rights of the buyer and contractor are specified in the contract.

   d. Due to inherent hazards, forecasts are doubtful.

7. Which of the following statements best describes use of the PC and CC methods?

   a. The CC method can be used when results from each method are similar.

   b. The PC method must be used if the contract duration is less than one year.

   c. The CC method can be used for interim financial reporting even if the PC method is used for the annual financial statements.

   d. Use of the PC method is required if the contract is modified by a change order.

8. Assuming all other qualifications are met, which of the following claims can a contractor include in contract revenues?

   a. Claim 1 is based on the contractor's feel for the situation after many years of experience.

   b. Claim 2's costs ballooned because the contractor used luxury materials.

   c. Claim 3 has no legal basis or opinion to support it.

   d. Claim 4 occurred due to circumstances that the contractor could not have foreseen.

9. Which of the following would be considered an *input method* for determining a construction contract's percentage of completion?

   a. Contract costs.

   b. Preestablished milestones.

   c. Units-produced.

   d. Yards-of-concrete-poured.

10. Blazing Builders recognizes gross profit on a contract as the difference between the percentage of completion of total estimated contract revenue and total estimated contract costs. What method has Blazing Builders used?

    a. Alternative A of the PC method.

    b. Alternative B of the PC method.

    c. The cost-to-cost method.

    d. The CC method.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. A construction contractor can use the completed-contract (CC) method instead of the percentage-of-completion (PC) method under which of the following circumstances? **(Page 158)**

    a. It is reasonably possible that dependable estimates can be made. [This answer is incorrect. According to FASB ASC 605-35-25-57, the PC method is preferred when all appropriate conditions are met. One of those conditions is that reasonably dependable estimates can be made.]

    b. The buyer is financially sound and, therefore, likely to satisfy its contract obligations. [This answer is incorrect. The PC method is preferred when the specific conditions outlined in FASB ASC 605-35-25-57 are met. One of those conditions is that the buyer can be expected to satisfy its obligations under the contract.]

    c. Rights of the buyer and contractor are specified in the contract. [This answer is incorrect. According to FASB ASC 605-35-25-57, this is one of the conditions that must exist for the PC method to be used.]

    d. Due to inherent hazards, forecasts are doubtful. [This answer is correct. According to FASB ASC 605-35-25-90, the CC method is preferable when lack of dependable estimates or the existence of inherent hazards cause forecasts to be doubtful.]

7. Which of the following statements best describes use of the PC and CC methods? **(Page 160)**

    a. The CC method can be used when results from each method are similar. [This answer is correct. Under GAAP, the CC method may be used if the results do not differ materially from those that would be obtained using the PC method.]

    b. The PC method must be used if the contract duration is less than one year. [This answer is incorrect. The requirements in the authoritative literature apply to all construction contracts, regardless of length. Therefore, the length of the contract does *not* affect which method the contractor will use to recognize revenue.]

    c. The CC method can be used for interim financial reporting even if the PC method is used for the annual financial statements. [This answer is incorrect. FASB ASC 270-10-45-2 requires using the same accounting principles in both interim and annual financial statements. Therefore, if a contractor uses the PC method in its annual statements, using the CC method in its interim statements would be a departure from GAAP.]

    d. Use of the PC method is required if the contract is modified by a change order. [This answer is incorrect. Change orders modify provisions of the original contract but do not add new provisions. The existence of a change order does not affect whether the contractor uses the CC or the PC method.]

8. Assuming all other qualifications are met, which of the following claims can a contractor include in contract revenues? **(Page 164)**

    a. Claim 1 is based on the contractor's feel for the situation after many years of experience. [This answer is incorrect. Per FASB ASC 605-35-25-31, the evidence supporting the claim must be objective and verifiable, not based on management's *feel* for the situation or on unsupported representation. Therefore, Claim 1 cannot be included in contract revenues.]

    b. Claim 2's costs ballooned because the contractor used luxury materials. [This answer is incorrect. According to FASB ASC 605-35-25-31, costs associated with the claim must be identifiable or otherwise determinable, as well as reasonable in view of the work performed. Using luxury materials that were not requested by the owner would not be reasonable, so Claim 2 cannot be counted in contract revenues.]

c. Claim 3 has no legal basis or opinion to support it. [This answer is incorrect. Per FASB ASC 605-35-25-31, one of the conditions that must exist for a claim to be included in contract revenues is that the contract or other evidence must provide a legal basis for the claim, or a legal opinion must have been obtained stating that under the circumstances there is a reasonable basis to support the claim. Since Claim 3 has no such basis, it should not be included in contract revenues.]

d. Claim 4 occurred due to circumstances that the contractor could not have foreseen. [This answer is correct. FASB ASC 605-35-25-31 allows claims made by the contractor against the owner to be included in contract revenues to the extent that contract costs relating to the claims have been incurred if *all* of a specific set of conditions exists. One of those conditions is that the additional costs were caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance. Because Claim 4 was unforeseen, its amount can be included in the contractor's revenues as long as all the other conditions in FASB ASC 605-35-25-31 are met.]

9. Which of the following would be considered an *input method* for determining a construction contract's percentage of completion? **(Page 167)**

a. Contract costs. [This answer is correct. FASB ASC 605-35-25-52 says that income recognized under the PC method shall be that percentage of estimated total income, either (1) that incurred costs to date bear to estimated total costs after giving effect to estimates of costs to complete based on the most recent information or (2) that may be indicated by such other measure of progress toward completion as may be appropriate having due regard to the work performed. In practice, many methods are used, but all can be grouped into either input or output methods. Input methods base the percentage of completion on efforts devoted to a contract. One of the most common bases is contract costs, which is the method described in item (1), but other methods are also acceptable.]

b. Preestablished milestones. [This answer is incorrect. According to the guidance provided by FASB ASC 605-35-25-52, this would be considered an *output method.* Preestablished milestones is a common basis when output methods are used. Under this method, the contract could be considered 10% complete after the foundation is dug and footings poured and 45% complete after the building is under roof.]

c. Units-produced. [This answer is incorrect. This is an *output method* based on the information supplied in FASB ASC 605-35-25-52. An example of an input method would be direct labor hours.]

d. Yards-of-concrete-poured. [This answer is incorrect. Per FASB ASC 605-35-25-52, yards-of-concrete-poured is an *output method.* An example of an input method would be the use of engineering estimates.]

10. Blazing Builders recognizes gross profit on a contract as the difference between the percentage of completion of total estimated contract revenue and total estimated contract costs. What method has Blazing Builders used? **(Page 169)**

a. Alternative A of the PC method. [This answer is correct. After the percentage of completion of a particular contract has been determined (when using the PC method), the next step is to use this percentage in calculating the amount of revenues, costs, and profits to be recognized. FASB ASC 605-35-25-82 through 25-84 provides two methods for recognizing revenues, costs, and profits. Alternative A applies the percentage of completion to total estimated contract revenue and total estimated contract cost, as Blazing Builders did in this scenario. Gross profit recognized is the difference between the two products.]

b. Alternative B of the PC method. [This answer is incorrect. As described in FASB ASC 605-35-25-82 through 25-84, Alternative B applies the percentage of completion to total estimated gross profit from the contract and the profit is added to costs incurred to determine revenues recognized. Based on the calculation Blazing Builders performed in this scenario, they did not use Alternative B.]

c. The cost-to-cost method. [This answer is incorrect. In the cost-to-cost method, costs incurred to date are compared to the estimated total costs to be incurred to determine the percentage of completion. Since Blazing Builders has already determined the percentage of completion prior to this scenario, this is not the method being described.]

d. The CC method. [This answer is incorrect. The CC method is an alternative to the PC method; the two methods are not used concurrently. Therefore, since Blazing Builders is making a calculation based on the percentage of a contract's completion, it is not using the CC method in this scenario.]

Lesson 2: Financial Statement Presentation Rules and Other Accounting Issues That Affect Construction Contractors

INTRODUCTION

This lesson discusses the financial statement presentation rules for construction contractors, as well as other accounting issues. The other issues discussed include investments in ventures, accounting for similar operations, and common problems that can arise when applying contract accounting rules.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify considerations that may apply to the financial statements of a construction contractor.
- Determine the best methods for dealing with investments in ventures, accounting for similar operations, and common problems that can arise when applying contract accounting rules.

FINANCIAL STATEMENT CONSIDERATIONS FOR CONSTRUCTION CONTRACTORS

Construction contractors are generally subject to the same reporting and disclosure requirements as other commercial entities. Chapter 6 of the AICPA Guide, includes information unique to construction contractors in the area of financial statement presentation. This section addresses various financial statement considerations, with emphasis on areas that most commonly occur and/or are unique in the financial statements of construction contractors. If an overall financial statement preparation manual is needed, consider *PPC's Guide to Preparing Financial Statements*, which provides comprehensive information for a thorough understanding of the authoritative standards for measurement, presentation, and disclosure over financial statement preparation.

Deciding Whether to Present a Classified Balance Sheet

A classified balance sheet distinguishes current assets and current liabilities from other assets and liabilities. The general criteria for separating current and noncurrent items are specified by FASB ASC 210-10, *Balance Sheet* and are summarized as follows:

a. *Operating Cycle.* The time needed to convert cash first into materials and services, then into products, then by sale into receivables, and finally by collection back into cash.

b. *Current Assets.* Cash and other assets that are reasonably expected to be realized in cash or sold or consumed during one year, or within the company's normal operating cycle if it is longer than a year.

c. *Current Liabilities.* Obligations whose liquidation is reasonably expected to require the use of current assets or the creation of other current liabilities.

Although construction contractors often have contracts of varying durations, the normal operating cycle is measured by the average time between the inception of a contract and its substantial completion. Estimated time remaining to complete contracts *should not be used* to determine classification. For example, if a contractor usually builds under contracts lasting 18 to 24 months and most of the contracts have 6 to 9 months remaining to completion at year end, the normal operating cycle is 18 to 24 months.

Operating Cycle of One Year or Less. The contracts of most small contractors can generally be completed in one year or less. Although an unclassified balance sheet may be presented, a classified balance sheet is preferable and is normally presented in practice. If some assets and liabilities are classified as noncurrent because the related contracts have terms of greater than one year, information about their realization and maturity should be disclosed.

Operating Cycle Longer Than One Year. In most other industries, an unclassified balance sheet is preferable when the operating cycle exceeds one year. Although this is an acceptable option that may be used by construction contractors, the predominant practice is to classify all contract-related assets and liabilities as current based on the operating cycle concept and to classify other assets and liabilities based on the general guidance found in FASB ASC 210-10 (amounts expected to be realized or liquidated during the year would be classified as current).

The following assets and liabilities are generally considered to be contract-related for purposes of applying the guidance in the preceding paragraph:

Contract-related assets include—

a. Accounts receivable on contracts, including retentions (unless retentions will not be realized within the company's normal operating cycle, in which case they should be classified as noncurrent. However, the AICPA Guide at Paragraph 6.14, indicates that many contractors prefer to present retentions receivable as current and instead disclose that presentation election in a note to the financial statements.)

b. Unbilled contract receivables.

c. Costs and estimated earnings in excess of billings.

d. Other deferred contract costs.

e. Equipment and small tools specifically purchased for, or expected to be used solely on, an individual contract.

Contract-related liabilities include—

a. Accounts payable on contracts, including retentions (unless retentions will not be paid within the company's normal operating cycle, in which case they should be classified as noncurrent. However, the AICPA Guide at Paragraph 6.14, indicates that many contractors prefer to present retentions payable as current and instead disclose that presentation election in a note to the financial statements.)

b. Accrued contract costs.

c. Billings in excess of costs and estimated earnings (unless billings exceed total estimated costs at completion of the contract plus contract profits earned to date, in which case such an excess should be classified as deferred income).

d. Deferred taxes caused by temporary differences in contract revenue and expense recognition methods.

e. Advanced payments on contracts for mobilization or other purposes.

f. Obligations for equipment specifically purchased for, or expected to be used solely on, an individual contract regardless of the payment terms of the obligations.

g. Provision for losses on contracts.

If a contractor has an investment in a construction joint venture that is presented on the cost or equity basis, the investment should be classified as noncurrent unless the venture is expected to be completed and liquidated during the current operating cycle of the contractor.

Offsetting or Netting Overbilling and Underbilling Amounts

A basic reporting principle is that assets and liabilities should not be offset or netted against each other unless a *legal* right of setoff exists. In determining certain of the unique report line items that will be recorded on the construction contractor's balance sheet, the following procedures are performed:

a. For each contract in progress at year end, the total cost incurred to date (including estimated earnings under the PC method) is reduced by the total amount of bills rendered to arrive at a net balance. The net

balance will be a debit if total costs exceed total billings (underbillings) and a credit if total billings exceed total costs (overbillings).

b. All debit balances (costs exceed billings) are added together with the total shown as an asset on the balance sheet.

c. All credit balances (billings exceed costs) are added together with the total shown as a liability on the balance sheet.

d. Footnote disclosure should include the following components of uncompleted contracts:

(1) total costs incurred,

(2) total estimated earnings recognized (on the percentage-of-completion method), and

(3) total billings.

Unique Disclosures for Construction Contractors

Besides the financial statement disclosures generally required to be included in a commercial entity's financial statements, several other disclosures must be included by construction contractors. Chapter 6 of the AICPA Guide, discusses most of the additional disclosures that are required.

Supplementary Information May Be Required

Creditors and bonding companies often require construction contractors to provide audited financial statements within a short time after year end. They may also require additional information in the form of supplemental schedules accompanying the basic financial statements. A discussion of this information is beyond the scope of this course, but more information is available in *PPC's Guide to Construction Contractors*.

Derivative Instruments

FASB ASC 815, *Derivatives and Hedging*, establishes accounting and reporting standards for derivative instruments and hedging activities. A summary of the standard's guidance is provided in the following paragraphs.

A derivative instrument is a financial instrument or other contract that has all three of the following characteristics:

a. It has at least one underlying (such as an interest rate, security price, commodity price, foreign exchange rate, price or rate index, or other variable, including the occurrence or nonoccurrence of a specified event) and at least one notional amount (such as a specified number of currency units, shares, bushels, pounds or other units) or payment provision (such as a fixed or determinable settlement to be made if the underlying performs in a specified manner) or both.

b. It requires no initial net investment or an initial net investment less than required for other types of contracts expected to respond similarly to changes in market factors.

c. Its terms require or allow net settlement; it can readily be settled net by a method outside the contract; or it provides for delivery of an asset that puts the recipient in a position similar to net settlement.

According to FASB ASC 815-10-15-13, derivative instruments do not include items such as normal purchases and normal sales, *regular-way* security trades (trades providing for delivery of a security that is readily convertible to cash within customary timeframes established by marketplace regulations), certain investments in life insurance, certain loan commitments, certain insurance and investment contracts, certain financial guarantee contracts, certain contracts not traded on an exchange, or derivatives that prevent sales accounting. In addition, derivative instruments do not include contracts that are issued as contingent consideration in a business combination.

Derivative instruments subject to the provisions of FASB ASC 815 should be measured at fair value and recognized in the balance sheet as either assets or liabilities, depending on the rights or obligations under the contracts.

Changes in the fair value of derivative instruments should generally be recognized in earnings in the period of change.

Embedded Derivatives. Certain contracts that do not, in their entirety, meet the criteria listed above may have embedded derivative instruments; that is, instruments that have implicit or explicit terms that affect some or all of the cash flows or value of other exchanges required by the contract, similar to derivative instruments. Contracts that have embedded derivative instruments may include items such as bonds, insurance policies, and leases. An embedded derivative instrument should be separated from the host contract only if all of the following conditions are met:

a. The economic characteristics and risks of the embedded instrument are not clearly and closely related to those of the host contract.

b. The hybrid contract (the one that contains both the embedded and host instrument) is not remeasured at fair value with changes recognized as a change in financial position when they occur.

c. A separate instrument with the same terms as the embedded derivative instrument would meet the derivative instrument definition listed above. However, this condition is not met if the standalone contract would be classified as a liability (or an asset in certain situations) under the provisions of FASB ASC 480, *Distinguishing Liabilities from Equity*, but would be reported in stockholder's equity without those provisions.

Disclosures. FASB ASC 815 also establishes disclosure requirements related to derivative instruments and hedging activities.

Is a Construction Contract a Financial Instrument? The definition of a financial instrument requires that there be an exchange of financial instruments. Since the contractor receives cash, and the owner receives a combination of goods and services (goods and services are not financial instruments), construction contracts are not financial instruments.

Weather Derivatives. Weather derivatives are financial instruments often used to manage risk related to weather or geological variables. FASB ASC 815-45, *Weather Derivatives*, provides guidance on accounting for weather derivatives. However, the guidance does not apply to contracts written by insurance companies that compensate the contractor for a liability or a change in the value of a specific asset that is the result of an insurable event.

FASB ASC 815-45-30 provides the following methods to account for weather derivatives depending on the purpose of the contract:

a. *Contracts Entered into for Speculative or Trading Purposes.* These contracts should be recorded at fair value with subsequent fair value changes reported in earnings.

b. *Contracts Entered into for Nontrading Purposes.* These contracts should be accounted for using the intrinsic value method of accounting. The intrinsic value method is the difference between actual period results and expected results of an upfront allocation of the cumulative strike based on reasonable expectations, multiplied by the contract price. The initial allocation of the cumulative strike amount should not be adjusted over the term of the contract to reflect actual results and contractors should quantify and remove any embedded premium or discount from the calculated benchmark strike. The premium should be amortized systematically to expense.

Because weather derivatives are financial instruments, they are subject to the disclosure requirements discussed in FASB ASC 815.

Fair Value Accounting Considerations

FASB ASC 820-10, *Fair Value Measurements and Disclosures*, applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. It provides a common definition of fair value, establishes a framework to measure fair value within GAAP, and provides disclosures about fair value measurements.

FASB ASC 820-10-20 defines *fair value* as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. That is, fair value is based on an exit price, which may differ from the price paid to acquire the asset or received to assume the liability (i.e., an entry price). A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability. Absent a principal market, then the most advantageous market for the asset or liability is assumed. FASB ASC 820-10-20 defines *principal market* and *most advantageous market.*

FASB ASC 820-10 looks at how fair value should be determined by providing a fair value hierarchy consisting of three levels—levels 1, 2, and 3—generally ranging from the most objective determination of fair value to the most subjective. The levels vary depending on the objectivity of the information used in valuation techniques to determine fair value. GAAP refers to the levels as categories of input into those techniques.

a. *Level 1 inputs* are quoted prices in active markets for identical assets or liabilities.

b. *Level 2 inputs* generally are available indirect information, such as quoted prices for similar assets or liabilities in active markets, or quoted prices for identical or similar assets or liabilities in markets that are not active.

c. *Level 3 inputs* are the most subjective, are generally based on the entity's own assumptions on how knowledgeable parties would price assets or liabilities, and are developed using the best information available in the circumstances.

Fair value measurements generally should be based on the most objective information available. For example, level 1 inputs should be used whenever possible, and level 3 inputs should only be used when level 1 or level 2 inputs are not available. This three-level hierarchy should accommodate most fair value measurements of small and midsize construction contractors.

Certain disclosures are required about fair value measurements that indicate to financial statement users how the fair value estimates were produced, including information on whether the measurements are made on a recurring or nonrecurring basis. Those disclosures are generally designed to provide information about the subjectivity of the fair value measurements and are required in addition to any other disclosures required about fair value measurements.

Common Fair Value Areas for Contractors. Generally accepted accounting principles include a number of requirements for fair value measurements, as well as requirements for measurements that, while they do not use the term *fair value*, are similar to fair value measurements. *PPC's Guide to Preparing Financial Statements* provides an overview of authoritative accounting literature requiring *fair value* measurements. Construction contractors may be subject to fair value measurement requirements in the following areas:

- Debt and equity securities
- Derivatives
- Long-term receivables (retentions)
- Long-lived assets
- Long-term debt

A comprehensive discussion of fair value considerations is beyond the scope of this course. Accordingly, the following paragraphs provide general information only about fair value requirements that may commonly be encountered by contractors. Comprehensive information on these fair value topics is available in *PPC's Guide to Preparing Financial Statements*.

Debt and Equity Securities. FASB ASC 320-10, *Debt and Equity Securities*, requires the carrying amount of debt and equity securities whose fair value is readily determinable and that are either trading securities or available for sale to be adjusted to their fair value. The underlying presumption is that, because fair value is readily determinable,

it is an objective measurement and could readily be realized. Small and midsize contractors generally hold securities (if they hold any) that are traded on public stock exchanges. Accordingly, determining the fair value of such securities is simple. The accounting for unrealized appreciation and depreciation in the fair value of the securities generally depends on their use, with the change in the fair value of trading securities recognized in earnings and the change in the fair value of securities available for sale recognized in other comprehensive income. *PPC's Guide to Preparing Financial Statements* provides detailed information on accounting for debt and equity securities.

Derivatives. As mentioned earlier in this lesson, derivative instruments should be measured at fair value and recognized in the balance sheet as either assets or liabilities, depending on the rights or obligations under the contracts. One form of derivative—the interest rate swap—is relatively common to small and midsize contractors. Typically in this situation, the bank that holds a variable-rate note of the contractor enters into an interest rate swap with the contractor that is designed to effectively convert the note from a variable-rate note to a fixed-rate note. Accounting for the change in the fair value of derivatives depends primarily on whether hedge accounting is elected. If hedge accounting is elected, generally the portion of the change in fair value that is effective as a hedge is recorded as other comprehensive income and the ineffective portion is reported as earnings. If hedge accounting is not elected, all of the change is reported in earnings.

ASU 2014-03, *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach*, provides a simplified hedge accounting approach for private companies that enter into certain plain vanilla interest rate swaps solely to convert variable rate debt to a fixed rate. For interest rate swaps that meet the criteria specified in the guidance, the entity can assume that there is no ineffectiveness in the hedging relationship. Under the simplified hedge accounting approach, an entity is allowed the option to measure these swaps at settlement value rather than fair value, and the hedge documentation is allowed to be completed up to the date that the financial statements are available to be issued. ASU 2014-03 is effective for years beginning after December 15, 2014, and interim periods within years beginning after December 15, 2015, with early adoption permitted. The simplified hedge accounting approach may be applied on a modified retrospective or full retrospective approach. In March 2016, the FASB issued ASU 2016-03, *Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), and Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance*, to amend ASU 2014-03 to (a) remove the effective date and make the guidance effective immediately and (b) remove the requirement to justify the use of the accounting alternative as preferable when adopting the guidance. However, any subsequent change to the election requires justification that the change is preferable. ASU 2016-03 was effective immediately.

Additional information about accounting for derivative instruments was provided earlier in this lesson. Additionally, *PPC's Guide to Preparing Financial Statements* provides extensive information on derivative instruments, including interest rate swap contracts.

Long-term Receivables. Contractors often have amounts withheld from payment on in-process contracts until the contract is completed successfully. Such withheld amounts are known as *retention receivables*. When retention receivables are not expected to be collected within nine to twelve months of the balance sheet date, the face value of the receivable may be different than its fair value because generally there is no stated interest rate associated with retention receivables. *PPC's Guide to Preparing Financial Statements* provide detailed information on fair value measurement and disclosure of financial instruments, including receivables.

Long-lived Assets. In troubling economic times, contractors with significant property and equipment should carefully consider the possible impairment of long-lived assets. When it is determined that the carrying value of a long-lived asset will not be fully recovered, the asset is considered impaired. To calculate an impairment loss, the fair value of the affected asset(s), as well as the expected cash flows, must be determined. For long-lived assets (including asset groups) that have uncertainties both in timing and amount, an expected present value technique will often be the appropriate technique with which to estimate fair value. See the discussion of the impairment of long-lived assets later in this lesson for further information. Additionally, *PPC's Guide to Preparing Financial Statements* provides detailed information on the impairment of long-lived assets and estimating the fair value of long-lived assets.

Long-term Debt. In depressed economic times where market interest rates are dropping, contractors may have fixed-rate long-term debt with a stated interest rate that is higher than the current market interest rate for a similar

loan. In that situation, contractors should consider whether a fair value measurement for the long-term debt is required. Applying the definition of fair value to debt requires assuming that a party would assume the debt of the reporting entity. There is not likely to be a market for the assumption of the debt of most small and midsize nonpublic contractors; therefore, the determination of fair value will need to be based on the assumption of a hypothetical market. A participant in a hypothetical market would likely assume debt for a price equal to the expected cash payments discounted at a current interest rate. That would require the buyer to estimate the payments the *contractor* expects to make and to estimate the rate the creditor would charge based on the *contractor's* credit standing. Even though the determination of fair value assumes a hypothetical market, there is likely to be observable data in analogous markets to select a discount rate. *PPC's Guide to Preparing Financial Statements* provides further information on applying fair value measurement requirements to debt.

Guarantees

Contractors may guarantee the debt or other obligations of an equipment company, subcontractor, real estate venture, or a joint venture that it does not control. Contractors participating in joint ventures may also indemnify the surety against loss and thus be the responsible party for performing all contract obligations including construction, payment, and warranty. This indemnification normally qualifies as a guarantee under FASB ASC 460-10, *Guarantees*. The guidance clarifies that a guarantor is required to recognize a liability for the fair value of a guarantee at the inception of the guarantee, and provides disclosure requirements.

Recognition and Measurement Provisions. FASB ASC 460-10-25-1 excludes several types of guarantees from the recognition and measurement provisions, including the following:

a. Guarantees issued between parent entities and their subsidiaries,

b. Guarantees between corporations under common control, and

c. A parent company's guarantee of its subsidiary's debt to a third party.

However, these guarantees are not excluded from the disclosure provisions discussed below.

When a guarantee is issued, the guarantor is obligated in two ways: (a) a contingent obligation to perform when a specified triggering event occurs, such as the original debt issuer failing to make the required payments of its debt facilities, and (b) a noncontingent obligation to be ready to perform during the term of the guarantee if one or more specified triggering events or conditions occur. The contingent liability should be accounted for; that is, a liability should be recorded when it is probable that a loss has been incurred and the amount is reasonably estimable. The accounting for the noncontingent obligation is discussed in the following paragraph.

According to FASB ASC 460-10-30-2, the fair value of the guarantee is determined differently depending on the circumstances of the guarantee. If the guarantee is issued in a standalone, arm's-length transaction with a third party, the fair value is generally the premium received or receivable by the guarantor. However, in an arm's-length transaction with a third party that includes several elements, such as in conjunction with selling an asset, the fair value may be measured by comparing to similar transactions where the value of the guarantee was determined.

Recording the debit side of the transaction depends on the circumstances causing the guarantee to be issued. FASB ASC 460-10-55-23 presents several examples. One of the more common situations could be when a guarantee is issued at the formation of a joint venture accounted for under the equity method by the guarantor. In that situation, the offsetting debit would be to increase the investment in the entity. Other situations may require the debit to be to an expense account, to a cash or receivable account, or to the gain or loss recorded on a transaction.

Disclosure Provisions. FASB ASC 460-10-50 provides the financial disclosure requirements for off balance sheet guarantees. Contractors should consider accrual of liabilities and/or disclosure of guarantees related to warranties, self-insurance deductibles, non-bonded subcontractors, bid prices, and similar items.

Environmental Cleanup Costs

Environmental cleanup costs can significantly impact contractors. There are numerous federal, state, and local environmental laws and related regulations. Construction companies can become involved in environmental claims in various situations including, but not limited to, the following:

- Fuel and chemical storage tanks leak hazardous substances into the soil and ground water at construction sites and on properties owned by the company.
- Excavating contractors grade land that is later discovered to contain hazardous substances.
- Excavating and demolition contractors or others transport materials containing hazardous substances.
- Contractors dump materials containing hazardous wastes into landfills.
- A project involves asbestos or other hazardous waste removal.
- Hazardous wastes, such as buried drums of toxic materials, are discovered on a job site.
- Chemicals or other materials used on a job site are considered hazardous.
- Real estate transactions or mergers involve property with environmental risks.
- Contractors who generate *regulated substances*.
- Purchases of real estate at bargain prices.
- Acquisitions of new or increased insurance coverage against environmental risks or liability to third parties.

The contractor need not be aware that the material is hazardous to be held liable. Many unsuspecting contractors find themselves facing claims for the cleanup of hazardous material left over from or removed from a project site when they had no knowledge of the hazardous substance. Some of the ways that contractors can minimize their risks of being involved in environmental claims include—

- Inspect the site for environmental warning signs, such as discolored soil or exposed pipes, prior to bidding on a project.
- Look for signs of past industrial activities on the property and consider reviewing public records for registered storage tanks.
- Review the property's environmental history included in EPA and federal and state agency records.
- Obtain a copy of the owner's environmental survey or audit of the property, if one was conducted.
- Include a contract clause that makes the owner responsible for all such claims. (This clause is only as good as the owner providing it. If the owner becomes insolvent or fails to honor the agreement, the government or other third parties can still pursue the contractor as a responsible party.)
- Purchase environmental liability insurance. However, the insurance might be cost prohibitive and difficult to acquire.

Federal Environmental Laws. The following are the federal environmental laws that most environmental cleanup obligations are based on:

a. *Superfund Laws.* The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the Superfund Amendments and Reauthorization Act established the Superfund, which is used primarily to clean up facilities that are abandoned or inactive or whose owners are insolvent. The

Environmental Protection Agency (EPA) has the authority to order responsible parties to remediate contaminated sites, or to use Superfund money to remediate the sites and then seek reimbursement for cleanup costs from potentially responsible parties (PRPs). There are four classes of PRPs—

(1) Current owners or operators of sites at which hazardous substances have been disposed of or abandoned.

(2) Previous owners or operators of sites at the time of disposal of hazardous substances.

(3) Parties that arranged for disposal of hazardous substances found at the sites.

(4) Parties that transported hazardous substances to a site, having selected the site for treatment or disposal.

b. *Resource Conservation and Recovery Act of 1976 (RCRA).* RCRA provides for comprehensive regulation of hazardous wastes from origination to final disposal. It imposes cleanup obligations on any party that has "contributed to" the disposal of waste that is causing an imminent and substantial endangerment.

Authoritative Literature. The following literature provides the primary guidance on accounting for environmental cleanup costs and liabilities:

- FASB ASC 450-20, *Loss Contingencies*, provides general guidance on accruing liabilities for loss contingencies.
- FASB ASC 410-20, *Asset Retirement Obligations*, provides accounting and reporting guidance that applies to environmental remediation obligations arising from the normal operation of a long-lived asset and that is associated with the retirement of that long-lived asset.
- FASB ASC 410-30, *Environmental Obligations*, provides specific guidance for recognizing, measuring, and disclosing environmental remediation liabilities. FASB ASC 410-30-25-16 through 25-19 provides guidance for determining whether environmental cleanup costs should be capitalized (partially discussed in the following paragraph).
- FASB ASC 360-10-55, *Property, Plant, and Equipment, Implementation Guidance and Illustrations*, addresses whether future cash flows for environmental exit costs associated with a long-lived asset should be included in the undiscounted expected future cash flows used to test property for recoverability.

Capitalization of Environmental Cleanup Costs. FASB ASC 410-30-25-18 provides the primary guidance on capitalization of environmental cleanup costs. According to that guidance environmental cleanup costs should be capitalized only if—

a. The costs are recoverable, and

b. At least one of the following conditions is met:

(1) The costs are incurred in preparing for sale property that is currently held for sale.

(2) The costs extend the life, increase the capacity, or improve the safety or efficiency of property owned by the company. Also, the costs improve the property as compared to its condition when originally built or acquired.

(3) The costs lessen or prevent environmental contamination that has not yet occurred but may otherwise result from future operations or activities. In addition, the costs improve the property as compared to its condition when originally built or acquired.

Special Considerations for Construction Contractors. The authoritative literature on accounting for environmental cleanup costs and liabilities focuses primarily on the owners of the contaminated property. Construction

contractors can incur environmental cleanup costs in three primary ways, and accounting could vary depending on the circumstances. The following guidance may apply:

a. *Cleanup Contract.* A contractor may enter into a contract to clean up existing contamination at a project site. In that case, the cleanup costs would generally be accounted for like costs under any other long-term contract.

b. *Property Owner.* The contractor might acquire property for its own use or speculative building, and that property might be contaminated for a variety of reasons. In that case, the environmental cleanup costs and liabilities should be capitalized as discussed in the previous paragraph.

c. *Project Contamination.* A contractor might become associated with a contaminated project site, for example, because of the actions of employees or subcontractors. In that case, environmental liabilities should be accrued in accordance with FASB ASC 450-20 and FASB ASC 410-30. However, it would be a best practice to charge the related costs to expense because the criteria for capitalization would not be met.

Accruing Environmental Remediation Liabilities

Accounting for environmental remediation liabilities can be challenging. First, it is difficult to determine when a liability has been incurred because it often cannot be easily associated with a single event. Second, the amount of the liability is often difficult to reasonably estimate until long after the problem has been identified. Engineers might be able to estimate some costs, but significant uncertainties surround the full cleanup cost. FASB ASC 410-30 provides more specific guidance for recognizing, measuring, and disclosing liabilities for legally required environmental remediation. In summary, environmental remediation liabilities should—

- Be accrued on a site-by-site basis when the criteria of FASB ASC 450-20-25-2 are met, using defined benchmarks for determining when those criteria are met.
- Include incremental direct costs, as well as compensation and benefit costs for employees who devote significant time to remediation activities.
- Include costs for the company's specific share of the liability for the site, as well as the company's share of costs that will not be paid by the government or other PRPs.
- Be estimated based on enacted laws and regulations.
- Be estimated based on expected improvements in remediation technology and productivity.
- Consider discounting when appropriate.

Determining When to Accrue a Liability. It is probable that an environmental remediation liability has been incurred when the following two elements are met on or before the date the financial statements are available to be issued:

a. It has been asserted or it is probable that it will be asserted (through litigation, claim, or regulatory assessment) that the contractor is responsible for participating in an environmental remediation process as a result of a past event (which occurred on or before the date of the financial statements).

b. It is probable that the result of the litigation, claim, or assessment will be unfavorable and the contractor will be held responsible.

If an assertion has been made or is probable of being made and if the contractor is associated with the site (as an owner, previous owner, operator, or was responsible for disposing of or transporting the hazardous substances at the site), there is a presumption that the outcome of the litigation, claim, or assessment will be unfavorable.

The fact that particular components of the overall environmental remediation liability may not be reasonably estimated during the early stages of the remediation process should not preclude recognizing a liability. In addition,

uncertainties regarding the contractor's share of an environmental remediation liability should not preclude the contractor from recognizing its best estimate of its share of the liability. Therefore, the following benchmarks are provided in FASB ASC 410–30–25–15 for determining when an environmental remediation liability meets the accrual criteria:

- *Identification and Verification of the Contractor as a PRP.* If the contractor determines that it is associated with a Superfund or RCRA site, it is probable that a liability has been incurred, and the liability should be accrued when all or a portion of it is reasonably estimable.

- *Receipt of Order or Mandates to Take Interim Corrective Measures.* For example, a company might receive a unilateral administrative order from the EPA requiring it to take a "response action" or risk substantial penalties. In these situations, the cost of performing the required work generally is estimable within a range, and the company should not delay accruing a liability for costs of removal actions beyond this point.

- *Participation as a PRP in a Remedial Investigation or Feasibility Study.* At this stage, the company generally has agreed to pay the costs of a study to investigate the environmental impact of the contamination and identify remediation alternatives for the site. The cost of the investigation generally can be estimated within a reasonable range. As the investigation proceeds, the company's estimate of its share of the total cost of the investigation can be refined.

- *Completion of Feasibility or Corrective Measures Study.* When the feasibility or corrective measures study is substantially complete, the company generally will be able to reasonably estimate both a minimum remediation liability and the company's allocated share of the liability.

- *Issuance of Record of Decision (ROD) or Approval of Corrective Measures Study.* At this stage, the EPA has issued its decision specifying a preferred remedy, and the company can refine its estimated liability based on the specified remedy and a preliminary allocation of total remediation costs.

- *Remedial Design and Implementation of Corrective Measures.* During the design phase of the remediation, engineers develop a better estimate of the work to be performed and can provide more precise estimates of the total remediation costs. The company should continue to refine and recognize its best estimate of its share of the liability as additional information becomes available throughout the operation and maintenance of the remedial action plan.

The preceding benchmarks should be considered when evaluating the probability that a loss has been incurred and the extent to which the loss is reasonably estimable. However, these benchmarks should not be applied in a way that would delay recognizing an environmental remediation liability beyond the point at which a liability would be recognized.

If the contractor cannot estimate a single loss amount, the guidance in FASB ASC 450-20-30-1 is cited, which allows companies to define a *range* of estimated losses and record the amount in the range that is the best estimate. (If no amount in the range is a better estimate than any other amount, the lowest amount in the range should be used.) Thus, in practice, the contractor generally should define the range of an estimated environmental remediation liability and refine the estimate as activities in the remediation process occur. Subsequent changes in estimates of the contractor's liability should be accounted for as changes in estimates. Consideration should also be given to the need for additional disclosures related to risks and uncertainties.

Estimating Environmental Remediation Costs. Environmental remediation liabilities should provide for the following costs as illustrated by FASB ASC 410-30-55-1 and 55-2:

a. Incremental direct costs, including—

   (1) Legal fees paid to outside law firms for work related to determining the extent of remedial actions required, the type of remedial actions to be used, and the allocation of costs among PRPs.

   (2) Costs related to the remedial investigation or feasibility study.

(3) Engineering and consulting fees paid to outside firms for site investigations and development of remedial action plans and designs.

(4) Other companies' costs for performing remedial actions (such as soil removal and disposal).

(5) Government oversight costs, such as fines.

(6) Costs of equipment that is dedicated to remedial actions and does not have an alternative use.

(7) PRP group assessments to cover costs incurred by the group in dealing with a contaminated site.

(8) Costs for operation and maintenance of the remedial action, including postremediation monitoring.

b. Compensation and benefits costs for employees who devote significant time directly to remediation activities, including—

(1) Internal legal staff involved with determining the extent of remedial actions required, the type of remedial actions to be used, and the allocation of costs among PRPs.

(2) Technical employees involved with remediation activities.

Costs of compensation and benefits should be allocated based on time spent on these activities.

Costs related to routine environmental compliance matters and legal costs associated with potential recoveries should not be included in remediation costs. However, GAAP does not provide guidance on whether the costs of defending against liability claims and assertions should be included in the measurement of the environmental remediation liability. It is a best practice for such costs to be included in the measurement of the liability to the extent they are probable and reasonably estimable.

Allocating Shared Costs among Responsible Parties. To record an environmental remediation liability, the company must determine its share of the total remediation liability. This is a subjective estimate based on many factors, including the following:

- *Who Are the PRPs for the Site?* Generally, the EPA will notify the company that it is a PRP, along with other PRPs identified by the EPA. However, depending on the available information, the EPA may not be aware of all PRPs. In that case, the company, along with other identified PRPs, should consider investigating to find other parties who may be liable for a portion of the remediation costs.

- *What Is the Percentage of the Total Liability That Will Be Allocated to the Company?* Several factors can be considered in allocating liability among PRPs, such as volumetric measures, the type of waste, whether the PRP was a site operator or owner, the degree of care exercised by the PRP, and any statutory or regulatory limitations on contributions from some PRPs. As a practical matter, the allocation often is determined by agreement among the parties, by hiring an allocation consultant, or by requesting that the EPA determine an allocation. The percentage for the entire remediation effort, not just a portion, should be used to determine the company's allocable share of the total remediation liability.

- *What Is the Likelihood the Other PRPs Will Pay Their Full Share of the Liability?* The company should assess the likelihood that the other PRPs will pay their allocable portion of the total remediation liability. That assessment generally is based on the financial condition of the other PRPs and must be monitored as the remediation progresses. Any amounts that will not be paid by other PRPs must be allocated among the remaining PRPs and included in the remaining PRPs' liabilities.

As mentioned previously, uncertainties in determining the company's share of the remediation liability should not preclude the company from recognizing its best estimate of its share of the liability, or at least the minimum estimate of its share of the liability if a best estimate cannot be made.

Effect of Changes in Laws and Regulations. According to FASB ASC 410-30-30-15, the accrual of environmental remediation liabilities should be based on enacted laws and adopted regulations, not on anticipated changes in

those laws and regulations. The company should recognize the impact of changes in laws and regulations when those changes are enacted or adopted.

Technology and Productivity Improvements. The accrual also should be based on remediation technology and methods expected to be approved to clean up the site. Therefore, when measuring its liability, the company should consider anticipated advances in technology only to the extent that the company has a reasonable basis to expect that a remediation technology will be approved. The uncertainty regarding the technology is removed when the regulatory agency issues its ROD or approved remediation order. At that point, the remediation technology to be used is considered to be defined.

FASB ASC 410-30-30-17 indicates that the accrual of the environmental remediation liability should be based on the estimated costs to perform each phase of the remediation effort at the time the phase is expected to be performed, considering such factors as inflation and productivity improvements due to experience with similar sites and similar remedial action plans.

Use of Discounting. Per FASB ASC 410-30-35-12, an environmental remediation liability, or a component of the liability, may be discounted to reflect the time value of money only if *both* of the following are fixed or reliably determinable:

a. The company's share of the aggregate liability amount, or component thereof.

b. The amount and timing of cash payments for the liability or component.

If the company can estimate only a range of possible loss from an environmental liability or other uncertainties exist about the timing of expenditures, discounting is not appropriate.

Claims for Recovery. Contractors may be able to pursue recoveries of amounts expended for environmental remediation from a variety of sources, including insurers, nonparticipating PRPs, the government, or other third parties. GAAP requires the amount of an environmental remediation liability to be determined independently from any potential claim for recovery. Furthermore, an asset related to a potential claim for recovery should be recognized only when realization of the claim is considered probable. (If a claim for recovery is being litigated, realization of the claim generally is not considered probable.) A potential claim for recovery should be measured at its fair value, considering both the costs related to the recovery and the time value of money. However, the time value of money should not be considered if the related liability is not discounted and timing of the recovery depends on the timing of paying the liability. In addition, the guidance from FASB ASC 210-20-45 is cited, which states that liabilities should not be presented net of related receivables unless there is a legal right of offset. FASB ASC 410-30-45-1 indicates that environmental remediation liabilities and related claims for recovery rarely, if ever, meet the requirements for offsetting. Thus, presentation of the gross liability and related claim for recovery in the balance sheet generally is appropriate.

Effect on Property Impairment. In addition to recognizing a liability for the costs of curing violations of environmental regulations, contractors should consider whether environmental regulations impose restrictions on the future use of the property, if they own the property in question. Significant restrictions on the property's future use could reduce the property's fair value or its ability to generate future cash flows. In that case, the property's carrying amount may not be recoverable and the contractor may need to recognize an impairment loss.

Impairment of Long-lived Assets

Occasionally, changes in operating conditions raise doubts about a contractor's ability to fully recover the carrying value of a particular asset. When it is determined that the carrying value will not be fully recovered, an asset is considered impaired. The Impairment or Disposal of Long-Lived Assets Subsections of FASB ASC 360-10 provide guidance on the recognition and measurement of an impairment loss. FASB ASC 360-10-35-21 provides examples of changes in circumstances that may indicate that the carrying amount may not be recoverable.

The guidance in the Impairment or Disposal of Long-Lived Assets Subsections applies to recognized long-lived assets, including capital leases of lessees, long-lived assets of lessors subject to operating leases, and long-term prepaid assets. It does not apply to goodwill; intangible assets not being amortized; financial

instruments, including investments in equity securities accounted for under the cost or equity method; deferred policy acquisition costs; or deferred tax assets (FASB ASC 360-10-15-4 and 15-5).

If a long-lived asset is part of a group of assets that may include other assets and liabilities not covered by FASB ASC 360-10, then that guidance applies to the group. An asset group is the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. The guidance in the following paragraphs applies to either an individual asset or to the asset group. Therefore, the term *long-lived asset* can generally be considered synonymous with *asset group*.

Classification of a Long-lived Asset. GAAP provides different accounting requirements depending on whether a long-lived asset is to be held and used, disposed of by sale, or disposed of other than by sale. However, the need to classify long-lived assets into these three categories depends on the facts and circumstances as follows:

- Disclosure of long-lived assets held for sale is required, regardless of whether they are impaired. Therefore, management should always identify the long-lived assets that the business intends to dispose of through a sale and value the assets accordingly.

- For long-lived assets that are not being held for sale, classifying them as to be disposed of other than by sale or held and used is not necessary unless there is an indication that the assets may be impaired. Indicators of potential impairment are discussed below.

Is an Impairment Assessment Necessary? Authoritative literature does not require an entity to routinely perform cash flow analyses on all of its long-lived assets to determine if they are fully realizable from future activities. A long-lived asset to be held and used should be tested for recoverability if events or changes in circumstances indicate that its carrying amount may not be fully recoverable. The following are examples of events or changes in circumstances that might indicate that an asset's carrying amount is not recoverable:

- A significant decline in the asset's market value.

- A significant adverse change in the extent or manner of the asset's use (for example, a significant decline in the use of a machine).

- A significant adverse physical change in an asset (for example, physical damage).

- Adverse changes in legal factors or the business climate that could affect the value of the asset (for example, a machine suddenly becomes obsolete, or changes in environmental regulations significantly restrict the use of a particular machine).

- Significant cost overruns beyond the amount originally expected to be needed to acquire or build the asset.

- A current period operating or cash flow loss combined with a history of operating or cash flow losses associated with a long-lived asset.

- A current expectation that it is more likely than not (greater than 50% likelihood) that an asset will be sold or disposed of before the end of its previously estimated useful life.

The preceding list is not all-inclusive. Other factors might raise doubts about the recoverability of an asset, and, if they do, the contractor should assess the asset for impairment.

During industry downturns, some contractors may find that more of their equipment is idle and for longer periods of time. Additionally, the market for used equipment may become oversaturated in the geographic areas most severely affected by the industry downturn. As a result, two of the events mentioned in the previous paragraph (a significant decline in the asset's market value and a significant adverse change in the extent of the asset's use) may occur indicating that the assets' carrying amounts may not be recoverable. In such a situation, company management and the practitioner should consider whether the value of the affected equipment has been impaired. If it is determined that impairment has occurred, the loss should be recognized and disclosure is required. Calculating an impairment loss is discussed in the following paragraphs.

Assets to Be Held and Used or Held for Disposal Other Than by Sale. An entity must be able to estimate both the expected cash flows and the fair value of a long-lived asset to calculate an impairment loss. Essentially, if the estimated undiscounted cash flows from a long-lived asset (whether held and used or held for disposal other than by sale) are at least equal to the asset's carrying amount, no adjustment is required and no impairment loss is recognized. However, if the carrying amount exceeds the estimated undiscounted cash flows, the entity should recognize an impairment loss through a charge to earnings and a reduction of the asset's carrying amount for any excess. GAAP does not address whether the reduction should be accomplished through a credit to the asset account or to a valuation allowance. As a practical matter, crediting a valuation allowance may be the best approach for most small and midsize entities. That will enable management to readily identify the temporary difference that arises because impairment losses are not deductible in computing taxable income until they are realized.

Upon recognizing an impairment loss, the adjusted carrying amount becomes the asset's new cost basis. It should not be adjusted for subsequent increases in fair value. However, it continues to be subject to the impairment requirements and future tests for recoverability should be based on comparisons with the new cost basis. Additionally, the new cost basis of a long-lived asset (whether classified as held and used or held for disposal other than by sale) should be depreciated over the estimated remaining useful life of the asset. As a practical matter, the events or changes in current circumstances that led to the impairment may have affected the remaining useful life. If the contractor plans to abandon the asset, the method used to depreciate it should result in a carrying amount at the date of abandonment equal to the expected salvage value, if any.

When an entity tests a group of assets for recoverability and an impairment loss is indicated for the group, the loss should be allocated to the individual long-lived assets in the group. The allocation should generally be in proportion to the carrying amounts of the individual long-lived assets. However, to the extent the fair value of individual long-lived assets can be determined without undue cost and effort, the allocation should not reduce the carrying amount of any long-lived asset below its fair value. The remaining useful life of the asset group should be based on the remaining useful life of the group's primary asset. The primary asset is the principal tangible long-lived asset being depreciated or intangible asset being amortized that is the most significant component asset from which the asset group derives its cash-flow-generating capacity.

Assets Held for Sale. A number of criteria must be met before a long-lived asset can be classified as held for sale. All of the following conditions are required for classification as held for sale:

a. Management with the proper authority has committed to a plan to sell the asset.

b. The asset, in its present condition, is immediately available for sale (subject only to the usual and customary sales terms for similar assets).

c. The entity has initiated an active program to find a buyer and the asset is being actively marketed at a reasonable price considering its current fair value.

d. Sale of the asset is probable and expected to be completed within one year. FASB ASC 360-10-45-11 permits an exception to this requirement when certain conditions beyond the entity's control exist.

e. It is unlikely that the plan of sale will significantly change or be abandoned prior to completion.

Long-lived assets that meet the held for sale criteria should be reported at the lower of the carrying amount of the long-lived asset or the fair value less selling costs. An impairment loss should be recognized for any initial or subsequent adjustment to the carrying amount of the long-lived asset to fair value less cost to sell. Once an asset has been classified as held for sale, it should no longer be depreciated.

S Corporations

S corporations are considered by many sureties to have a higher degree of risk than C corporations. Sureties have difficulty in assessing the timing and amount of stockholder withdrawals from S corporations. This difficulty is caused by the following:

- The removal of current and deferred income tax liabilities from the corporate financial statements does not mean the liability has gone away. While the taxes are paid at the personal level, it is likely that the funds will

come from the corporation. However, the ability of the surety to assess the timing and amount of these withdrawals is greatly reduced. Sureties often make their own calculations of what such withdrawals will be; however, their projections of amounts to be paid are usually greater than the actual amounts.

- In addition to withdrawals for income tax payments, stockholders seem more inclined to make distributions (dividends) from S corporations than C corporations. This is because taxable income that was previously passed through and was subject to tax at the stockholder level is generally not subject to additional tax when dividends are distributed.

- Because of the difficulties in projecting and controlling withdrawals, sureties are forced to place more emphasis on the personal net worth of the owners than is usually necessary for C corporations. Sureties often require reviewed or compiled personal financial statements from owners of S corporations.

What Information Should Be Provided a Surety? The following additional disclosures, while not required by GAAP, should be considered for S corporations:

a. A description of tax method(s) used to recognize income from construction contracts.

b. Retained earnings and changes in retained earnings segregated into the following components.

   (1) *Accumulated Adjustments Account.* The accumulated adjustments account essentially represents undistributed tax basis retained earnings as of the balance sheet date arising *after the date of conversion* to an S corporation. It excludes temporary differences that originate or reverse after the date of conversion and only includes permanent differences relating to nondeductible expenses incurred after the date of conversion.

   (2) *Tax Temporary Adjustments Account.* The tax temporary adjustments account represents cumulative temporary differences as of the balance sheet date. The account is adjusted for temporary differences that originate and reverse after the conversion.

   (3) *Accumulated Undistributed Non-taxable Income and Income Previously Taxed.* This amount represents undistributed tax basis earnings at the date of conversion plus other amounts that consist primarily of tax-exempt income since conversion.

c. A summary of the tax temporary adjustment account at the balance sheet date and changes for the current year.

d. The anticipated amount and timing of stockholder withdrawals after the financial statement date for payment of personal income tax liabilities.

PPC's Guide to Compilation and Review Engagements includes a comprehensive discussion of accounting procedures for S corporations. *PPC's Guide to Preparing Financial Statements* discusses the accounting for conversion from C to S corporation status.

Illustrated Disclosures. The disclosures discussed in the preceding paragraph are made in various ways. One method is to include all of the disclosures in supplementary information. (Inclusion in supplementary information is permissible since the disclosures are not required by GAAP.) Another method is to include Item b. in the statement of retained earnings and Items a., c., and d. in notes to financial statements. Some accountants include all of the disclosures in a note to the financial statements. Such a note (which also includes the GAAP requirement to disclose why no income tax expense is recorded) is presented in Exhibit 2-1.

Exhibit 2-1

Illustrated Income Tax Note to S Corporation Financial Statements

Income Taxes

Effective January 1, 20X1, the Company elected to be taxed as an S Corporation. Income for 20XX has accordingly been taxed to the stockholders as individuals and not to the corporation. The Company recognizes income on its construction contracts for income tax purposes using the percentage-of-completion method, which, as described in Note 1, is the same method used for financial statement purposes.

Retained earnings at December 31, 20XX, and changes for the year then ended, for income tax purposes are summarized as follows:

	Accumulated Adjustment Account	Tax Temporary Adjustments Account	Accumulated Undistributed Non-taxable Income and Income Previously Taxed	Total
Balance, beginning of year	$ 231,000	$ 21,000	$ 234,000	$ 486,000
Income taxed to stockholders	77,000	6,000	—	83,000
Nondeductible expenses	(2,000)	—	—	(2,000)
Non-taxable interest income	—	—	3,000	3,000
Dividends	(150,000)	—	—	(150,000)
Balance, end of year	$ 156,000	$ 27,000	$ 237,000	$ 420,000

The Tax Temporary Adjustments Account at December 31, 20XX, and changes for the year then ended, include the following:

	At December 31, 20XX	Year Ended December 31, 20XX
Excess of tax over financial statement depreciation	$ 6,000	$ 1,500
Allowance for doubtful accounts	13,500	3,500
Accrued employee benefits	7,000	1,000
Other	500	—
	$ 27,000	$ 6,000

The Company plans to pay dividends totaling $20,000 to stockholders in March 20XY for payment of personal income taxes arising from the Company's 20XX income.

* * *

Discontinued Operations and Costs to Exit an Activity

Construction companies are often involved in more than one construction-related activity such as the following:

- A general contractor might provide certain subcontractor services. For example, a residential general contractor might also complete the plumbing or concrete work for the project. A highway general contractor might complete the road painting aspects of the job.

- One company might perform the functions typically performed by two subcontractors such as providing both the plumbing and electrical work for a particular project.
- One contractor might perform the general contractor function for both single-family and multi-family construction projects.
- One company might construct both highways and single-family houses.

If a construction company decides to stop one of its activities, it has to evaluate whether that activity meets the requirements of a discontinued operation, and if so, report any related gain or loss appropriately.

Discontinued Operations. FASB ASC 205-20, *Discontinued Operations* defines discontinued operations as—

- a component or group of components of an entity, which is disposed of by sale or other means (such as abandonment) or is classified as held for sale, *and* represents a strategic shift having a major effect on operations and financial results of the entity, or
- a business that is classified as held for sale upon acquisition.

The disposal of a component or group of components of an entity would be reported as a discontinued operation only if the disposal represents a *strategic shift* that has or will have a major effect on the financial results or operations of the entity. FASB ASC 205-20-45-1C indicates that examples of a *strategic shift* include a disposal of a major geographical area, a major line of business, or a major equity method investment.

A component may be a reportable segment or an operating segment, as defined by FASB ASC 280-10-50-1; a reporting unit, as defined under FASB ASC 350-20-35-33 through 35-38; a subsidiary; or an asset group. (Asset groups are discussed earlier in this lesson.) Assets classified as held for sale should not be depreciated, and expected future losses associated with operations of long-lived assets to be sold should not be accrued before they occur; therefore, gains and losses on assets committed to a plan of disposal are no longer measured on a net realizable value basis. The provisions of the guidance relating to long-lived assets and impairment are discussed earlier in this lesson.

The discontinued operations guidance does not amend the costs to exit an activity guidance at FASB ASC 420-10, discussed later in this lesson.

Expanded disclosures to provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations are required.

FASB ASC 205-20 also provides guidance for the presentation and disclosure of discontinued operations. Generally, an entity is required to present the results of discontinued operations of a component, a group of components, or a business activity separate from continuing operations in the income statement. The assets and liabilities of a discontinued operation should be presented separately in the balance sheet in the current and prior periods presented. In addition, the financial statements should disclose the nature and amount of the adjustments.

Costs to Exit an Activity. When the activities do not represent a component of a business, any related gain or loss should be reported as a separate component of income from continuing operations in accordance with FASB ASC 420-10. GAAP for exit or disposal cost obligations at FASB ASC 420-10, *Exit or Disposal Cost Obligations*, applies to the following:

- Costs associated with disposal activities accounted for under FASB ASC 205-20.
- Costs associated with exit activities, such as restructurings, and exit activities not related to an entity recently acquired in a business combination.
- Costs related to the consolidation of facilities or the relocation of employees.
- Costs to terminate a contract, other than a lease.
- Costs associated with one-time employee termination benefits.

FASB ASC 420-10 does not apply to costs related to the retirement of long-lived assets. Such costs are accounted for according to GAAP for asset retirement obligations at FASB ASC 410-20, *Asset Retirement Obligations*.

The timing of the recognition and measurement of exit or disposal costs differ depending on the type of costs associated with the activity. However, costs are accrued only when the definition of a liability is met.

Presentation and Disclosure. Costs related to exit or disposal activities should be included in income from continuing operations unless the costs are associated with a discontinued operation. In that case, the costs should be included in the results of discontinued operations. If an entity's obligation for the liability is eliminated in a subsequent period, FASB ASC 420-10-40-1 indicates the liability should be removed from the entity's balance sheet. All previously-recognized costs should be reversed and presented in the same income statement line in which the costs were originally presented. Certain financial statement disclosures are required by GAAP. *PPC's Guide to Preparing Financial Statements* includes more information about discontinued operations and costs to exit an activity.

Risks and Uncertainties

In general terms, uncertainty stems from the inability to predict the future, and risks exist because uncertainty exists. FASB ASC 275, *Risks and Uncertainties*, requires entities to—

- Disclose risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the company.
- Communicate to financial statement users the inherent limitations in financial statements.

GAAP does not require disclosure of all risks and uncertainties, which would be an impossible task, but requires disclosure of certain risks and uncertainties that meet specified criteria. Specifically, disclosures should be considered in the following four areas:

- Nature of operation, including any activities that have not commenced in which the entity is currently engaged.
- Use of estimates when preparing the financial statements.
- Certain significant estimates.
- Vulnerability as a result of certain concentrations.

The first two disclosures, nature of operations and use of estimates, are required for all financial statements. The second two are required only for estimates and concentrations that meet specified criteria.

An extensive discussion of FASB ASC 275 is outside the scope of this course. However, the next several paragraphs provide an overview of the four areas where disclosure should be considered and discuss how those disclosures might be applied to construction contractors. The requirements are summarized in Exhibit 2-2. Additional information about risks and uncertainties is included in *PPC's Guide to Preparing Financial Statements*.

Exhibit 2-2

Disclosing Significant Risks and Uncertainties

	Nature of Operations	Use of Estimates	Certain Significant Estimates	Concentrations
When to Disclose?	Always.	Always.	• It is at least reasonably possible that the estimate of the effect on the financial statements of an existing condition will change in the near term due to future confirming events. AND • The change in estimate would have a material effect on the financial statements.	• A concentration exists at the financial statement date. AND • The concentration increases the company's vulnerability to the risk of a near term severe impact. AND • It is reasonably possible that the events able to cause the severe impact could occur in the near term.
Threshold for Disclosing?	N/A	N/A	Potential *material* effect on financial statements.	Potential *severe* impact to the company.
What to Disclose?	• Description of major products or services. • Relative importance of each business. • Basis used to determine relative importance of each business. • Principal markets and locations of the markets.	Explanation that management estimates are used in preparing financial statements.	• Nature of uncertainty. • An indication that it is at least reasonably possible that a change will occur in the near term.	• Description of the concentration. • Information about the general nature of the risk associated with the concentration. • Additional disclosures for concentrations of labor or foreign operations.

* * *

Nature of Operations. All financial statements should include a description of the major products or services the reporting entity sells or provides and the entity's principal markets, including the locations of those markets. If the entity operates in more than one business, disclosures must indicate the relative importance of each business and the basis for determining relative importance. Relative importance can be based on such things as assets, revenues, or net income, and does not have to be quantified. It can be communicated by using terms such as *predominantly, about equally*, or *major*. The following are examples of disclosures of a contractor's nature of operations:

> Do-It-Right Contractors, Inc. acts as the general contractor in constructing multi-family residential buildings in the Greater Chicago area. In addition, it provides property management services

throughout the Midwest United States. The two business units are about equal in size based on gross profit contributions to the Company.

*****

Southwest R&B, Inc. constructs roads and bridges principally for the states of Texas and Arkansas.

Use of Estimates. GAAP requires financial statement disclosures to include an explanation that preparation of financial statements requires the use of management's estimates. The disclosure will usually be standardized (that is, boilerplate). The disclosure normally should be included in the summary of significant accounting policies.

Certain Significant Estimates. GAAP requires additional disclosures for certain *significant* estimates. According to FASB ASC 275-10-50-8, disclosure regarding an estimate is required when known information available before the financial statements are available to be issued indicates that both of the following criteria are met:

- "It is at least reasonably possible that the estimate *of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements* will change in the near term *due to one or more future confirming events*. [Emphasis added.]

- The effect of the change would be material to the financial statements."

When applying the criteria it is important to only consider conditions, situations, or circumstances that *already exist. It is not appropriate or necessary to speculate about new events*. That helps to narrow the range of possibilities when disclosure might be appropriate. For example, assume that Hometown Construction Company is concerned about the possibility of Big City Construction Co. entering its markets and the effect of such an entrance on its financial statement estimates. If Big City has not made any indication that it will enter the market, Hometown is not required to consider disclosure. However, if Big City has formally announced an entrance or has already entered the market, the situation already exists and Hometown should consider whether the other criteria are met to require disclosure.

While the *existing condition* requirement helps to narrow the range of estimates that meets the criterion, the range is still very broad. That is primarily because of the use of the term *reasonably possible*, which has the same meaning in FASB ASC 275 as it does in FASB ASC 450, *Contingencies*. FASB ASC 450-20-20 provides the following definitions:

- *Probable.* The future event or events are likely to occur.

- *Reasonably Possible.* The chance of the future event or events occurring is more than remote but less than likely.

- *Remote.* The chance of the future event or events occurring is slight.

Deciding where to apply the threshold within that range is very subjective. Accountants must apply judgment based on the individual circumstances of each situation. Disclosure should generally be considered more closely when a condition, situation, or set of circumstances makes an estimate more susceptible to change than it ordinarily would be. In addition, the more critical an estimate is to the financial statements, the more likely it is that disclosure is needed. As a practical matter, the disclosure can be used to provide an early warning to financial statement users that certain estimates, based on the best information available, are still somewhat soft.

If an estimate meets the criteria for disclosure, the disclosure must—

- Describe the nature of the uncertainty, and

- Indicate that it is at least reasonably possible that a change in the estimate will occur in the near term (period of time not to exceed one year). However, specific use of the term *reasonably possible* is not required.

Using the example above, the following disclosure might be made:

> Recently, a large public construction company entered Hometown's primary market of Amarillo, Texas. Due to potential market loss, it is reasonably possible that the amount of the Company's deferred tax asset that it expects to realize might change in the near future.

It can be a good practice to document conclusions about significant estimates that could change in the near term. Such documentation can be informal and can be done, for example, on the relevant workpaper or in a separate memo.

Should Construction Companies Using the Percentage-of-completion Method Always Include a Significant Estimate Disclosure? The answer to that question is very subjective. Nowhere in GAAP does it suggest that certain industries have certain types of estimates that will *always* require disclosure under the "certain significant estimates" guidance. GAAP only requires that the *general* disclosure about estimates be made in every case. Additionally, FASB ASC 605-35-55-10 suggests that such a disclosure is not necessary if the contractor uses the percentage-of-completion method *and* has a history of making reasonably dependable estimates.

However, many accountants believe that in most cases it is *at least reasonably possible* that a material change in the estimates used in the percentage-of-completion method of accounting will occur in the near term. They believe that a significant estimates disclosure is *not needed* only where the effect would *clearly* not be material to the financial statements. They also believe the disclosure to be relatively simple and that it may provide some protection for the practitioner.

It is a good idea for contractors to include a significant estimates disclosure unless it can be clearly concluded that a material change in contract estimates is not at least reasonably possible. The following illustrates such a disclosure:

> The Company recognizes revenues from fixed-price construction contracts using the percentage-of-completion method, measured by the percentage of cost incurred to date to management's estimated total cost for each contract. That method is used because management considers total cost to be the best available measure of progress on the contracts. Because of the inherent uncertainties in estimating costs, it is at least reasonably possible that the estimates used will change within the near term. [In some instances, it may be appropriate to refer to "costs and revenues" in the preceding sentence.]

Even if this disclosure is used, it is still necessary to highlight other specific conditions, situations, or circumstances existing at the balance sheet date that could significantly change an estimate in the near term and have a material impact on the financial statements.

Vulnerability as a Result of Certain Concentrations. A company can subject itself to increased risks solely due to a lack of diversification, such as in operating markets, number of customers, or suppliers of raw materials. That lack of diversification is referred to as *concentrations*. FASB ASC 275-10-50 requires that concentrations be disclosed if certain criteria are met. According to FASB ASC 275-10-50-18, the types of concentrations that must be *considered* for disclosure include the following:

- Concentrations in the volume of business transacted with a particular customer, supplier, or lender.
- Concentrations in revenue from particular products or services.
- Concentrations in the available sources of materials, labor, or services; or of licenses or other rights used in the entity's operations.
- Concentrations in the market or geographic area in which an entity conducts its operations.

A concentration is of concern when it involves something that cannot be easily replaced. If, for example, a contractor purchases most of its lumber from a single supplier, that is not a concentration unless the supplier cannot be easily replaced. Disclosure of concentrations is only required when all of the following criteria are met:

- A concentration exists at the financial statement date.

- The concentration makes the company vulnerable to the risk of a near-term severe impact.

- It is at least reasonably possible that the events that could cause the severe impact will occur in the near term (within the next year).

The criteria are similar in some ways and use some of the same wording as the criteria for disclosing certain significant estimates. For example, the concentration must meet "existing condition" and "at least reasonably possible" criteria. Also, the criteria are to be considered using "information known to management before the financial statements are issued or are available to be issued."

For concentrations meeting the disclosure criteria, disclosures must include information that is adequate to inform financial statement users of the general nature of the risk associated with the concentration. Additional specific disclosures are required for concentrations of labor subject to collective bargaining agreements and for foreign operations if they meet the criteria listed above. The following are examples of disclosures that meet these requirements:

Concentration of Customers and Geographic Location

> Southwest R&B, Inc. constructs roads and bridges for states located in the southwestern United States. Approximately 70% of the Company's contracts are with the states of Texas and Arkansas.

Concentration of Source of Supply of Labor

> Eighty percent of Electrical Subcontractors, Inc.'s labor force are members of the United Electrical Workers Union. The Company's contract with the union is subject to renegotiation during 20XX. The Company's other workers are not represented by a union.

Identification and evaluation of concentrations can be documented on the relevant workpaper or by memo. *PPC's Guide to Preparing Financial Statements* provides more information about disclosing significant risks and uncertainties.

Changes In Estimates

Determining the percentage-of-completion for each uncompleted long-term contract at year-end involves estimation. FASB ASC 250-10, *Accounting Changes and Error Corrections*, requires disclosure of the change in accounting estimate if the effect is material to either revenue or cost. As contractors adjust the estimates related to uncompleted contracts, the cumulative effect of the revised estimates should be recognized in the period of change. Contractors and their auditors need to be aware of this required disclosure.

Comprehensive Income

FASB ASC 220-10, *Comprehensive Income*, establishes financial statement presentation and disclosure requirements relating to comprehensive income. The following paragraphs provide an overview of the requirements. Further guidance and illustrative financial statement presentations may be found in *PPC's Guide to Preparing Financial Statements*.

Definition of Comprehensive Income. Comprehensive income represents the change in a company's equity during a period from transactions and events other than those resulting from investments by or distributions to owners. Comprehensive income includes both net income and other comprehensive income (i.e., certain revenues, expenses, gains, and losses that are reported as separate components of stockholders' equity rather than in net income). Under FASB ASC 220-10-45-10A, other comprehensive income includes (not all-inclusive)—

- Unrealized gains and losses on debt and equity securities classified as available-for-sale.

- Amounts recognized in other comprehensive income for debt securities classified as available-for-sale and held-to-maturity related to an other-than-temporary impairment.

- Gains or losses related to pension or other postretirement benefits.
- Prior service costs or credits related to pension or other postretirement benefits.
- Transition assets or obligations related to pension or other postretirement benefits.
- Foreign currency translation adjustments and gains and losses from certain foreign currency transactions.
- The effective portion of the gain or loss on derivative instruments designated as cash flow hedging instruments (including qualifying foreign currency cash flow hedges).

Items other than net income that are included in comprehensive income are referred to collectively as *other comprehensive income*.

Financial Statement Presentation Requirements. All components of comprehensive income should be reported in a full set of financial statements in the period in which they are recognized. Companies that have no items of other comprehensive income in any period presented are not required to report comprehensive income. It is likely that many small to mid-sized contractors will not have comprehensive income.

Alternative Formats. Companies with items of other comprehensive income are required to report comprehensive income when a full set of financial statements that report financial position, results of operations, and cash flows is presented. FASB ASC 220-10-45-1 requires income to be reported in either a single continuous financial statement or in two separate but consecutive financial statements.

Single-statement Format. In a single-statement format (that is, a combined statement of income and comprehensive income), comprehensive income is reported in two primary sections corresponding to the two components of comprehensive income: net income and other comprehensive income. Additionally, FASB ASC 220-10-45-1A requires the following elements to be included in a statement of income and comprehensive income presented in the single-statement format, if applicable:

a. the components that make up net income,

b. a total for net income,

c. the components of other comprehensive income,

d. a total for other comprehensive income, and

e. a total for comprehensive income.

Two-statement Format. As previously mentioned, a reporting entity has the option of reporting comprehensive income in two separate but consecutive financial statements. When that reporting format is elected, the statement of comprehensive income should be presented immediately following the statement of income. The two statements are required to be presented consecutively.

According to FASB ASC 220-10-45-1B, when a reporting entity elects the two-statement approach, the statement of income (sometimes referred to as the "statement of net income") should include the components of net income and a total for net income. The statement of comprehensive income should begin with net income and present the following items:

a. the components of other comprehensive income,

b. a total for other comprehensive income, and

c. a total for comprehensive income.

Regardless of which approach is used, comprehensive income should be reported net of related tax effects. This can be done by presenting components of other comprehensive income net of taxes or by presenting pretax components with a total tax expense or benefit relating to other comprehensive income. In either case, the tax effects applicable to each component of other comprehensive income should be disclosed parenthetically on the face of, or in the notes to, the financial statements.

Reporting Accumulated Other Comprehensive Income in the Balance Sheet. The accumulated balance of other comprehensive income must be presented separately from retained earnings and additional paid-in capital in the equity section of the balance sheet and labeled with a descriptive title such as "accumulated other comprehensive income." In addition, companies are required to present on the face of the financial statements or disclose in the notes to the financial statements the changes in the accumulated balances for each component of other comprehensive income included in the balance of accumulated other comprehensive income.

Reclassification Adjustments. Reclassification adjustments may be necessary to avoid double counting items included in the current period's net income that previously were reported as other comprehensive income. For example, realized gains and losses on available-for-sale marketable securities reported in current year net income may have been reported previously in other comprehensive income as unrealized holding gains or losses. Reclassification adjustments should be calculated for each component of other comprehensive income, and current period reclassifications out of accumulated other comprehensive income should be reported separately from other amounts in other comprehensive income. Reclassification adjustments out of accumulated other comprehensive income must be presented by component and may either be presented on the face of the financial statement where the components of other comprehensive income are presented or disclosed in the notes to the financial statements. Additional reporting of the effect reclassification adjustments have on specific line items in the income statement is required.

Disclosure Requirements. Contractors must meet the disclosure requirements for comprehensive income. A detailed discussion of these requirements is beyond the scope of this course, but more information is available in *PPC's Guide to Construction Contractors*.

Going Concern

FASB ASC 205-40 addresses going concern and establishes that the evaluation of an entity's ability to continue as a going concern is *management's* responsibility. In addition, it establishes when management is required to disclose certain matters related to going concern. The requirements in FASB ASC 205-40 are effective for annual periods ending after December 15, 2016, and interim periods beginning after December 15, 2016.

For each reporting period, FASB ASC 205-40-50-1 requires management to evaluate whether conditions or events indicate there is substantial doubt about the entity's ability to continue as a going concern for the year subsequent to the date the *financial statements are issued* or the date the *financial statements are available to be issued*. Substantial doubt about an entity's ability to continue as a going concern exists when aggregate conditions and events indicate it is *probable* that the entity will not be able to meet its obligations as they are due during the year following the date the financial statements are available to be issued. Because the definition is one year from the date the financial statements are available to be issued, the GAAP definition prevents companies, auditors, and accountants from waiting long enough after the financial statement date for the substantial doubt to be cured before issuing the financial statements. In defining *substantial doubt*, the new GAAP guidance uses the term *probable*, which means likely to occur.

If conditions and events that raise doubt about an entity's ability to continue as a going concern exist, management would consider mitigating plans and whether those plans alleviate the substantial doubt. Management's plans may be considered to alleviate the substantial doubt if it is probable the plans (a) will be implemented effectively within one year of the date the financial statements are available to be issued *and* (b) mitigate the conditions and events

that raised substantial doubt. Certain disclosures are required depending on whether management's plans alleviate the substantial doubt.

a. If the plans are found to alleviate substantial doubt, management is required by FASB ASC 205-40-50-12 to disclose the following:

   (1) The principal conditions or events that raised the doubt.

   (2) Management's evaluation of the conditions and events relevant to the entity's obligations and ability to meet them.

   (3) Management's mitigating plans, which alleviate the substantial doubt.

b. If management's plans do not alleviate substantial doubt, management is required by FASB ASC 205-40-50-13 to disclose the following:

   (1) A statement that there is substantial doubt about the entity's ability to continue as a going concern for the year following the date the financial statements are available to be issued.

   (2) Principal conditions and events that raised substantial doubt.

   (3) Management's evaluation of those conditions and events relevant to the entity's obligations and ability to meet them.

   (4) Management's plans intended to mitigate the substantial doubt.

The disclosures are required for all periods that the substantial doubt about the entity's ability to continue as a going concern remains. The disclosures should provide further explanations as more information becomes available.

Subsequent Events

FASB ASC 855-10, *Subsequent Events*, includes accounting and disclosure standards on subsequent events. It does not apply to subsequent events specifically addressed in other applicable GAAP, including FASB ASC 740-10-25-15 (which addresses changes in judgment regarding tax positions previously taken) and FASB ASC 450-30-25-1 (which addresses contingencies that might result in gains).

FASB ASC 855-10-25 identifies two types of subsequent events. The first type is *recognized subsequent events* (called type I in prior standards) and the second type is *nonrecognized subsequent events* (called type II in prior standards). The key to proper treatment of subsequent events is identifying the event or condition and determining when the event or condition arose.

Recognized (Type I). *Recognized* subsequent events are those that *provide additional evidence* about conditions that existed at the balance sheet date, including the estimates inherent in preparing the financial statements. The proper accounting treatment for those events is to recognize the effects of the events in the financial statements. For example, a litigation accrual would be recognized at the settlement amount if the event that gave rise to the litigation took place before the balance sheet date and the litigation was settled after the balance sheet date but before the financial statements are available to be issued.

Nonrecognized (Type II). *Nonrecognized* subsequent events are events that provide evidence about conditions that did not exist at the balance sheet date but arose after that date but before the financial statements are available to be issued. Such events should not be recognized in the financial statements but should be disclosed if considered necessary to keep the financial statements from being misleading. If required, disclosures should include the nature of the event and an estimate of its financial effect, or disclosure that such an estimate cannot be made.

Nonpublic construction contractors should evaluate subsequent events through the date that the financial statements are available to be issued. (FASB ASC 855-10-25-1A). They should also disclose the date through which subsequent events were evaluated and whether that date is the date the financial statements were issued or were available to be issued.

When Financial Statements Are *Issued* and *Available to Be Issued*. According to the FASB ASC 855-10-20, financial statements are *issued* "when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP." Financial statements are *available to be issued* "when they are complete in a form and format that complies with GAAP and all approvals necessary for their issuance have been obtained, for example from management, the board of directors, and/or significant shareholders." Based on the guidance presented in the preceding paragraph, the date that should be used by nonpublic construction contractors is the date the financial statements are available to be issued.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. Current assets and liabilities are distinguished from other assets and liabilities for which of the following?

    a. A classified balance sheet.

    b. A financial instrument.

    c. The general ledger.

    d. A profit center.

12. Which of the following would a construction contractor consider a contract-related asset?

    a. General and administrative (G&A) costs.

    b. Accounts payable on contracts.

    c. Unbilled contract receivables.

    d. Deferred taxes from temporary differences in contract revenue.

13. Holbrooke Construction, based in California, enters into a financial instrument (not an insurance policy) that will help it mitigate the risk of an earthquake. This would be called which of the following?

    a. A derivative instrument.

    b. An embedded derivative.

    c. A guarantee.

    d. A weather derivative.

14. Which of the following statements best describes how environmental cleanup costs may affect construction contractors?

    a. Contractors are generally exempt from environmental cleanup costs.

    b. State laws exclusively control how contractors are affected by environmental cleanup costs.

    c. Contractors can face claims for materials they did not know were hazardous.

    d. The primary guidance on accounting for environmental cleanup is found in the federal laws.

15. Environmental remediation liabilities include which of the following?

    a. The cost of using the construction company's backhoe for cleanup efforts.

    b. Compensation of the administrative assistant who mans the home office while other employees perform the cleanup.

    c. Costs during the cleanup project, but none after the actual cleanup has been performed.

    d. Legal fees paid to outside law firms for work allocating remediation costs.

16. Which of the following statements best describes how a contractor should treat long-lived assets?

    a. Long-lived assets that are part of a group must be considered individually.

    b. Long-lived assets can be classified as held and used, disposed of by sale, or disposed of other than by sale.

    c. Contractors must perform annual cash flow analyses on long-lived assets.

    d. An impairment loss is based on the long-lived asset's fair value at the time of impairment.

17. Mega Construction incurs costs to consolidate two facilities and relocate employees to the new joint facility. These costs would be treated as which of the following?

    a. Risks and uncertainties under FASB ASC 275.

    b. Exit or disposal cost obligations under FASB ASC 420-10.

    c. Comprehensive income under FASB ASC 220-10.

18. When determining whether additional disclosures for significant estimates are needed, how likely must it be that the estimate of the effect on the financial statements will change soon due to future events?

    a. Definite.

    b. Probable.

    c. Reasonably possible.

    d. Remote.

19. Megan serves as Karma Construction's accountant. After the balance sheet date but before the company's financial statements are issued, Megan becomes aware of an event that provides evidence about a new condition that now affects Karma Construction. Karma Construction is a nonpublic company. How should Megan proceed?

    a. She should recognize the event in the financial statements.

    b. She should not recognize the event in the financial statements but consider disclosure.

    c. She elects not to disclose as of what date subsequent events were evaluated.

    d. Because the financial statements were not issued or available to be issued, she chooses to neither recognize nor disclose the event.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. Current assets and liabilities are distinguished from other assets and liabilities for which of the following? **(Page 175)**

    a. A classified balance sheet. [This answer is correct. Construction contractors are generally subject to the same reporting and disclosure requirements as other commercial entities. Chapter 6 of the AICPA Guide, includes information unique to construction contractors in the area of financial statement presentation. A classified balance sheet is one financial statement that contractors can present. This type of financial statement distinguishes current assets and current liabilities from other assets and liabilities.]

    b. A financial instrument. [This answer is incorrect. The definition of a financial instrument requires that there be an exchange of financial instruments. Since that is not a part of the definition above, it is not referring to a financial instrument.]

    c. The general ledger. [This answer is incorrect. There is a direct relationship between subsidiary records and the general ledger of a construction contractor. Information that is recorded on a contract-by-contract basis in the subsidiary records should also be recorded in the general ledger. However, the general ledger is not created solely to distinguish current assets and liabilities from other assets and liabilities; therefore, there is a better answer to this question.]

    d. A profit center. [This answer is incorrect. Authoritative guidance for construction contractors defines the profit center as the unit for the accumulation of revenues and costs and the measurement of income. This is a different portion of accounting than the one described above.]

12. Which of the following would a construction contractor consider a contract-related asset? **(Page 176)**

    a. General and administrative (G&A) costs. [This answer is incorrect. G&A costs typically are not related to specific contracts.]

    b. Accounts payable on contracts. [This answer is incorrect. Accounts payable on contracts are considered to be contract-related *liabilities.* This includes retentions, unless retentions will not be paid within the company's normal operating cycle, in which case they should be classified as noncurrent.]

    c. Unbilled contract receivables. [This answer is correct. Contract-related assets include (1) accounts receivable on contracts, including retentions; (2) unbilled contract receivables; (3) costs and estimated earnings in excess of billings; (4) other deferred contract costs; and (5) equipment and small tools specifically purchased for, or expected to be used solely on, an individual contract.]

    d. Deferred taxes from temporary differences in contract revenue. [This answer is incorrect. Deferred taxes caused by temporary differences in contract revenue and expense recognition methods are considered contract-related *liabilities.*]

13. Holbrooke Construction, based in California, enters into a financial instrument (not an insurance policy) that will help it mitigate the risk of an earthquake. This would be called which of the following? **(Page 178)**

    a. A derivative instrument. [This answer is incorrect. A financial instrument or other contract with all three of the following characteristics: (1) it has at least one underlying and at least one notional amount or payment provision or both, (2) it requires no initial net investment or an initial net investment less than required for other types of contracts expected to respond similarly to changes in market factors, and (3) the terms require or allow net settlement. Derivative instrument is a broad term, so it is not specific to the scenario described above. Therefore, there is a better answer to this question for Holbrooke's situation.]

b. An embedded derivative. [This answer is incorrect. This is an instrument with implicit or explicit terms that affects some of all of the cash flows or value of other exchanges required by its host contract, similar to a derivative instrument. Contracts that have embedded derivative instruments may include items such as bonds, insurance policies, and leases. However, embedded derivatives are not specific to Holbrooke's arrangement in this scenario, so there is a better answer to this question.]

c. A guarantee. [This answer is incorrect. Contractors may guarantee the debt or other obligations of an equipment company, subcontractor, real estate venture, or a joint venture that it does not control. However, this is a different type of financial consideration than the one described above. Therefore, there is a better answer to this question.]

d. A weather derivative. [This answer is correct. Weather derivatives are financial instruments often used to manage risk related to weather or geological variables. FASB ASC 815-45, *Weather Derivatives,* provides guidance on accounting for weather derivatives.]

14. Which of the following statements best describes how environmental cleanup costs may affect construction contractors? **(Page 182)**

a. Contractors are generally exempt from environmental cleanup costs. [This answer is incorrect. Environmental cleanup costs can significantly impact contractors in many different types of situations. One example is if fuel and chemical storage tanks leak hazardous substances into the soil and ground water at construction sites and on properties owned by the company.]

b. State laws exclusively control how contractors are affected by environmental cleanup costs. [This answer is incorrect. There are numerous federal, state, and local environmental laws and related regulations. Therefore, state laws are not the only ones a contractor will have to deal with.]

c. Contractors can face claims for materials they did not know were hazardous. [This answer is correct. The contractor need not be aware that the material is hazardous to be held liable for environmental cleanup costs. Many unsuspecting contractors find themselves facing claims for the cleanup of hazardous material left over from removed from a project site when they had no knowledge of the hazardous substance.]

d. The primary guidance on accounting for environmental cleanup is found in the federal laws. [This answer is incorrect. Many environmental cleanup obligations are based on federal laws; however, the primary guidance on accounting for environmental cleanup costs and liabilities is found in FASB ASC 450-20, 410-20, 410-30, and 360-10-55.]

15. Environmental remediation liabilities include which of the following? **(Page 185)**

a. The cost of using the construction company's backhoe for cleanup efforts. [This answer is incorrect. According to FASB ASC 410-30-55-1 and 55-2, only the costs of equipment that is dedicated to remedial actions and does not have an alternative use should be included. Therefore, because the company can use the backhoe for other construction projects, the full cost of this piece of equipment cannot be considered an environmental remediation liability.]

b. Compensation of the administrative assistant who mans the home office while other employees perform the cleanup. [This answer is incorrect. Per FASB ASC 410-30-55-1 and 55-2, compensation and benefits costs for employees who devote significant time directly to remediation activities are included in environmental remediation liabilities. This includes internal legal staff involved with determining the extent of remedial actions required, the type of remedial actions to be used, and the allocation of costs among potentially responsible parties (PRPs). This also includes technical employees involved with remediation activities. However, including the compensation and benefits of all employees at that time, whether or not they work on the cleanup, would be too much. Additionally, any compensation and benefits costs should be allocated based on time spent on these activities.]

c. Costs during the cleanup project, but none after the actual cleanup has been performed. [This answer is incorrect. The incremental costs included in environmental remediation liabilities include costs for operation and maintenance of the remedial action, including postremediation monitoring. Therefore, the contractor's job (and, therefore, the liabilities that can be included) do not automatically stop when the cleanup is done.]

d. Legal fees paid to outside law firms for work allocating remediation costs. [This answer is correct. According to FASB ASC 410-30-55-1 and 55-2, incremental direct costs included in environmental remediation liabilities will include legal fees paid to outside law firms for work related to determining the extent of remedial actions required, the type of remedial actions to be used, and the allocation of costs among PRPs.]

16. Which of the following statements best describes how a contractor should treat long-lived assets? **(Page 188)**

a. Long-lived assets that are part of a group must be considered individually. [This answer is incorrect. If a long-lived asset is part of a group of assets that may include other assets and liabilities not covered by FASB ASC 360-10, then that guidance applies to the group. Therefore, the term *long-lived asset* can generally be considered synonymous with *asset group.*]

b. Long-lived assets can be classified as held and used, disposed of by sale, or disposed of other than by sale. [This answer is correct. GAAP provides different accounting requirements depending on whether a long-lived asset is to be held and used, disposed of by sale, or disposed of other than by sale. However, the need to classify long-lived assets into these three categories depends on the facts and circumstances.]

c. Contractors must perform annual cash flow analyses on long-lived assets. [This answer is incorrect. Authoritative literature does not require a contractor to routinely perform cash flow analyses on all of its long-lived assets to determine if they are fully realizable from future activities. A long-lived asset to be held and used should be tested for recoverability if events or changes in circumstances indicate that its carrying amount may not be fully recoverable.]

d. An impairment loss is based on the long-lived asset's fair value at the time of impairment. [This answer is incorrect. An entity must be able to estimate both the expected cash flows *and* the fair value of a long-lived asset to calculate an impairment loss.]

17. Mega Construction incurs costs to consolidate two facilities and relocate employees to the new joint facility. These costs would be treated as which of the following? **(Page 192)**

a. Risks and uncertainties under FASB ASC 275. [This answer is incorrect. In general terms, uncertainty stems from the inability to predict the future, and risks exist because uncertainty exists. Disclosures should be considered for (1) nature of operations, (2) use of estimates in the preparation of financial statements, (3) certain significant estimates, and (4) vulnerability resulting from concentrations. The actions taken by Mega Construction in this scenario do not fall into these four areas, so FASB ASC 275 does not apply.]

b. Exit or disposal cost obligations under FASB ASC 420-10. [This answer is correct. When activities do not represent a component of a business, any related gain or loss should be reported as a separate component of income from continuing operations in accordance with FASB ASC 420-10. Examples of such costs include (1) costs associated with disposal activities accounted for under FASB ASC 205-20, (2) costs related to the consolidation of facilities or the relocation of employees, and (3) costs to terminate a contract that is not a lease. Therefore, FASB ASC 420-10 does apply to Mega Construction in this scenario.]

c. Comprehensive income under FASB ASC 220-10. [This answer is incorrect. Comprehensive income represents the change in a company's equity during a period from transactions and events other than those resulting from investments by or distributions to owners. Therefore, FASB ASC 220-10, which establishes the financial statement presentation and disclosure requirements relating to comprehensive income, does not apply to Mega Construction in this scenario.]

18. When determining whether additional disclosures for significant estimates are needed, how likely must it be that the estimate of the effect on the financial statements will change soon due to future events? **(Page 195)**

    a. Definite. [This answer is incorrect. The effect does not have to be confirmed as definite to require disclosure under GAAP.]

    b. Probable. [This answer is incorrect. To be considered probable, the future event or events are likely to occur; however, restricting disclosure to only probable events does not meet the requirements of FASB ASC 275.]

    c. Reasonably possible. [This answer is correct. GAAP requires additional disclosures for certain *significant* estimates. According to FASB ASC 275-10-50-8, disclosure regarding an estimate is required when known information available before the financial statements are available to be issued indicates that both of the following criteria are met: (1) it is at least *reasonably possible* that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events and (2) the effect of the change would be material to the financial statements. Reasonably possible means the chance of the future event or events occurring is more than remote but less than likely.]

    d. Remote. [This answer is incorrect. To be considered remote, the chance of the future event or events occurring is slight. However, including all remote events would be too much under GAAP.]

19. Megan serves as Karma Construction's accountant. After the balance sheet date but before the company's financial statements are issued, Megan becomes aware of an event that provides evidence about a new condition that now affects Karma Construction. Karma Construction is a nonpublic company. How should Megan proceed? **(Page 200)**

    a. She should recognize the event in the financial statements. [This answer is incorrect. *Recognized* subsequent events are those that *provide additional evidence* about conditions that existed at the balance sheet date, including estimates inherent in preparing the financial statements. The proper accounting treatment for those events is to recognize the effects of the events in the financial statements. However, since the condition that affects Karma Construction did not exist as of the balance sheet date, this would not be considered a recognized subsequent event, so Megan will not use this accounting treatment.]

    b. She should not recognize the event in the financial statements but consider disclosure. [This answer is correct. *Nonrecognized* subsequent events are events that provide evidence about conditions that did not exist at the balance sheet date but arose after that date but before the financial statements are available to be issued (FASB ASC 855-10-25-1A). Such events should not be recognized in the financial statements but should be disclosed if considered necessary to keep the financial statements from being misleading. Therefore, since Karma Construction has a nonrecognized event, according to this definition, this is the accounting treatment Megan should use.]

    c. She elects not to disclose as of what date subsequent events were evaluated. [This answer is incorrect. Nonpublic entities are required to disclose the date through which subsequent events were evaluated and whether that date is the date the financial statements were issued or were available to be issued. Therefore, Megan needs to include this disclosure in Karma Construction's financial statements.]

    d. Because the financial statements were not issued or available to be issued, she chooses to neither recognize nor disclose the event. [This answer is incorrect. Subsequent events have to be evaluated after the balance sheet date; therefore, Megan cannot ignore this event when preparing Karma Construction's financial statements.]

HOW TO TREAT INVESTMENTS IN VENTURES

Contractors frequently participate jointly with other entities to share risks, combine financial and other resources, or obtain financing or bonding. Ventures are generally organized in one of the following legal forms:

a. Corporation.

b. General or limited partnership.

c. Joint venture.

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

a. Consolidation.

b. Equity method, including the little-used expanded equity method.

c. Cost method.

d. Proportionate consolidation.

Consolidation

Consolidated financial statements present the financial position, results of operations, and cash flows of a contractor and its majority-owned venture as if the two were a single economic entity. The ownership by one entity of a controlling interest in another entity represents two separate legal entities but, in substance, a single economic or accounting entity. FASB ASC 810-10-10-1 states "There is a presumption that consolidated financial statements are more meaningful than separate financial statements and that they are usually necessary for a fair presentation when one of the entities in the consolidated group directly or indirectly has a *controlling financial interest* in the other entities ." and FASB ASC 810-10-15-8 states "For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation." The only exception to the requirement to consolidate majority-owned ventures is if control does not rest with the majority owners, for example, when a subsidiary is in legal reorganization or bankruptcy or operates under certain foreign exchange or governmental restrictions.

The power to control a partnership may exist even if the contractor owns less than 50% of the voting interest. If voting interest is not clearly indicated, ownership of a majority interest in profits or losses will generally indicate control. If the contractor has the ability to exercise control, for example, by contract, lease, agreement with other partners, or by court decree, the financial statements of the contractor and the partnership should be consolidated—even if the ownership percentage is 50% or less. On the other hand, a contractor who owns more than 50% of a partnership may not have the power to control if major decisions must be approved by one or more of the other partners. A noncontrolling investor in a partnership should not use the consolidation method even if the investor owns a majority of the partnership. Generally, an investor in a limited partnership is less likely to have a controlling interest or to exert significant influence than an investor in a general partnership. However, all facts and circumstances should be considered in each situation.

In consolidating two companies, the assets, liabilities, revenues, and expenses of the parent and the subsidiary are added together. Intra-entity balances and transactions, including intra-entity profits, should be eliminated. When reporting a noncontrolling interest in the consolidated balance sheet, FASB ASC 810-10-45-16 requires that the noncontrolling interest be treated as a component of consolidated equity, separate from the parent's equity. Additionally, when reporting a noncontrolling interest in the consolidated balance sheet, the consolidated net income attributable to both the parent and the noncontrolling interest should be presented, and the consolidated net income attributable to the parent and the noncontrolling interest should be disclosed on the face of the

consolidated income statement. (Some banks request that consolidating financial statements be included as supplemental schedules to show the entities as they originally existed prior to consolidation.)

Changes under ASUs 2015-02 and 2016-17. In certain situations, existing accounting standards may call for the consolidation of a legal entity when the reporting entity does not hold a majority of the voting rights of the legal entity. In other situations, consolidation might be required even though the reporting entity's contractual rights do not give it the ability to act primarily on its own behalf or the reporting entity is not exposed to the majority of the economic benefits or obligations of the legal entity. In February 2015, the FASB issued ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*, to address certain of those concerns. For entities other than public business entities, the amendments of ASU 2015-02 are effective for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017.

The amendments under the ASU affect any reporting entity that is required to evaluate whether it needs to consolidate certain legal entities. Specifically, the ASU—

- eliminates the presumption that a general partner should consolidate a limited partnership;
- modifies the evaluation of whether limited partnerships and similar legal entities are variable interest entities or voting interest entities;
- impacts the consolidation analysis for reporting entities that have involvement with variable interest entities, especially if they have fee arrangements and related-party relationships; and
- provides a scope exception to the consolidation standards for reporting entities with interests in legal entities that need to comply with certain rules for registered money market funds.

It seems likely that the amendments under ASU 2015-02 will not generally affect most contractor entities, but these amendments could have some impact. See further information below. Additionally, a discussion on the effects of the ASU and the interpretations on that guidance.

Limited Partnerships and Similar Legal Entities. The amendments in ASU 2015-02 affect limited partnerships and similar entities in a number of ways. First, there is no longer a presumption that a general partner has to consolidate a limited partnership. The ASU also adds a requirement that limited partnerships and similar entities must provide partners with either substantive kick-out rights or participating rights over the general partner in order to qualify as voting interest entities. (The FASB has amended the definitions of kick-out rights and participating rights under the ASU.) Lastly, for those entities that qualify as voting interest entities, the amendments indicate that a limited partner with a controlling financial interest is required to consolidate the limited partnership.

Evaluating Fees Paid for Variable Interest Determination. GAAP requires reporting entities to determine whether a variable interest exists in an entity when consolidation of that entity is being considered. If variable interests exist, the *reporting entity* is required to evaluate whether such interests are controlling financial interests that would result in consolidation of the entity. Current accounting rules provide specific criteria that need to be evaluated when assessing whether fees paid to a decision maker or service provider represent a variable interest in that entity. The ASU eliminates some of those criteria.

The Effect of Fee Arrangements and Related Parties on the Primary Beneficiary Determination. Under existing GAAP, when fee arrangements paid to a decision maker are considered to be variable interests, the decision maker includes the arrangement in its primary beneficiary determination. ASU 2014-15, however, excludes certain fees that are paid to a decision maker from that evaluation, making it less likely for the decision maker to satisfy the criterion based solely on the fee arrangement.

Under current GAAP, if no single party has a controlling financial interest in a variable interest entity, interests held by the reporting entity's related parties are considered to be those of the reporting entity when determining whether the related-party group has primary beneficiary characteristics. Under ASU 2015-02, when there is a single decision maker, related-party relationships would no longer be considered in their entirety, but are to be considered indirectly on a proportionate basis. However, in October 2016, the FASB altered that requirement by issuing ASU 2016-17, *Consolidation (Topic 810): Interests Held through Related Parties That Are under Common Control*, which

changes the manner in which a single decision maker evaluates indirect variable interests in a VIE. A single decision maker is no longer required to follow the provisions of ASU 2015-02 to consider indirect variable interests held through commonly-controlled related parties to be the equivalent of direct interests in their entirety. Instead, the single decision maker includes all of its indirect variable interests on a proportionate basis, which is consistent with indirect interests held through other related parties. The single decision maker is still required to consider whether it and one or more related parties under common control, as a group, have the characteristics of a primary beneficiary. For entities other than public business entities, ASU 2016-17 is effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. Entities that have not yet adopted ASU 2015-02 should adopt the amendments of ASU 2016-17 at the same time that the guidance in ASU 2015-02 is adopted. Entities that have already adopted the provisions of ASU 2015-02 should adopt the amendments of ASU 2016-17 retrospectively to all relevant prior periods beginning with the fiscal year in which the guidance in ASU 2015-02 was initially applied.

Certain Investment Funds. The amendments' effect in this area primarily applies to entities other than construction contractors, and, accordingly, is not further discussed in this course.

Income Tax Considerations. Consolidation rules for federal income tax purposes differ from GAAP requirements. IRS regulations require an 80% ownership for consolidated tax returns to be filed. Thus, in some cases, consolidated financial statements will be required by GAAP even though the companies do not qualify to file consolidated tax returns.

Variable Interest Entities (VIEs)

The following information provides guidance on considering the need to include in the financial statements of small and midsize construction contractors the consolidated financial results of entities considered to be variable interest entities. The guidance in this discussion is designed to provide an overview. *PPC's Guide to Related Parties (Including Variable Interest Entities)* provides detailed guidance.

The guidance on accounting for variable interests in variable interest entities is included with all of the authoritative consolidation accounting guidance in FASB ASC 810, *Consolidation*. Each section of consolidation accounting guidance in the Codification establishes the general principles, and then provides guidance on how to apply those principles to a variable interest in a variable interest entity. For example, FASB ASC 810-10-25, which provides guidance on recognition considerations, includes a General Subsection and a Variable Interest Entities Subsection, as does FASB ASC 810-10-50 on disclosures. The Codification often refers to a variable interest entity as a VIE.

Practitioners should carefully evaluate whether the accounting guidance for VIEs applies to any construction contractor business (or its owners) that has ownership, contractual, or other financial interest in another legal entity. Contractors have traditionally created separate companies for equipment rental, real estate leasing, materials purchasing, and land development or been involved in joint ventures for similar or other purposes. The contractor may be required to consolidate those entities in the construction company's financial statements.

Developing a conclusion about whether a variable interest exists and should be consolidated requires careful consideration. Many contractors may not want to consolidate their VIEs into their construction companies' financial statements because it may increase the debt reported by the construction company and negatively affect working capital. Some practitioners elect to not consolidate VIEs and instead, report the departure from GAAP in the financial statements. Also, some contractors have avoided consolidation by preparing income tax basis financial statements. However, when loan covenants require GAAP basis financial statements, such solutions do not provide a remedy. Additionally, if consolidation is required but not performed, a contractor may be in default not only on its loan covenants, but also its bonding agreement. Accordingly, it is a good idea for construction contractors to discuss and obtain approval from their lender and/or surety before pursuing an option of preparing financial statements with a GAAP departure or using a special purpose framework, such as the income tax basis of accounting.

An Accounting Alternative. FASB ASC 810-10 provides small and midsize private companies with a limited accounting alternative to the guidance in the Variable Interest Entities Subsections (VIE Subsections).

An Overview of the Accounting Alternative. The accounting alternative provides a narrow, optional exemption of a defined related party leasing arrangement from the scope of the VIE Subsections. The accounting alternative is available for a related party leasing arrangement with the following characteristics:

a. The reporting entity is a private company that leases property from an entity that is under common control with the reporting entity.

b. Substantially all activities between the reporting entity and the lessor entity relate to leasing activities, including activities that support the leasing activities, between the two entities.

c. If the reporting entity explicitly guarantees or provides collateral for any lessor obligation related to the asset being leased, the principal amount of the obligation does not exceed the value of the leased asset as of the inception date of the collateral arrangement or guarantee.

The VIE Subsections provide a list of relationships that generally indicate a variable interest entity relationship exists. If the relationships listed in that paragraph do not exist, consideration of the VIE guidance need not be considered. Additionally, under the accounting alternative discussed earlier, even if one or more of the relationships from FASB ASC 810-10-15-12 listed below do exist, the VIE guidance does not need to be considered for a relationship that has the characteristics listed in the previous paragraph. For example, if the lessor entity was formed by the reporting entity and its related parties (condition a. listed below), consideration of the VIE guidance is not required if the relationship between the reporting entity and the lessor entity has the characteristics listed in the previous paragraph.

If a reporting entity satisfies those characteristics and elects the accounting alternative, the reporting entity should apply the accounting alternative to all leasing arrangements that meet the conditions. If the reporting entity elects the accounting alternative, the required disclosures are also different. The accounting alternative should be applied retrospectively.

Deciding Whether to Elect the Accounting Alternative. Electing the accounting alternative eliminates the need to consider whether consolidation is required under the VIE Subsections. In addition, electing the accounting alternative requires only modest additional disclosures. It seems likely, then, that the accounting alternative will ordinarily be elected whenever the reporting entity has a relationship with the characteristics listed above and consolidation of the related entities does not provide useful information to financial statement users. However, the accounting alternative is available only for relationships with the specified characteristics and, therefore, does not eliminate the need for small and midsize private companies to consider whether the VIE Subsections apply in other situations. The remaining paragraphs discuss how to follow the guidance in the VIE Subsections for considering whether a VIE relationship exists.

When to Consider Whether the Reporting Entity Has a Variable Interest in a VIE. A small or midsize nonpublic construction contractor should consider whether it has a variable interest in a variable interest entity if it has one of the following relationships with another entity (FASB ASC 810-10-15-17d):

a. the reporting entity (the contractor), its related parties, or both participated significantly in the design or redesign of the entity (the potential VIE);

b. the entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties;

c. the reporting entity and its related parties provide more than half of the entity's subordinated financial support; or

d. the activities of the entity are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements.

Many small and midsize nonpublic construction contractors have the first type of relationship with another entity. Typically, an individual has the majority voting equity interest in both the reporting entity and the other entity.

However, the reporting entity may hold a majority or minority voting equity interest in the other entity. Examples of the first type of relationship with another small or midsize nonpublic construction contractor are—

a. The holder of a majority voting equity interest in an operating entity may form a separate entity to acquire real estate or equipment to lease to the operating entity.

b. The holder of a majority voting equity interest in a homebuilder may form a separate entity to acquire and develop residential lots for sale to the homebuilder.

c. A general contractor may form a limited liability company with a subcontractor to provide services almost exclusively to the general contractor.

A relationship that requires the reporting entity to consider whether it has a variable interest in a variable interest entity does *not* by itself mean that the reporting entity is required to include the consolidated financial results of the entity in its financial statements. A number of other considerations must be made before the reporting entity can decide whether consolidation is required.

Other Considerations. Although the authoritative consolidation accounting literature does not define *controlling financial interest*, it establishes the presumption that a majority voting equity interest in an entity gives the holder a controlling financial interest in the entity. It also specifically acknowledges the possibility that the presumption may be overcome.

Losses and Benefits. To provide a conceptual framework for the guidance, the FASB established the notion that the determination of who has a controlling financial interest in another entity depends partly on who bears the risk of things going worse than expected and who reaps the benefits of things going better than expected. The effect of things going worse than expected is generally referred to as either *losses* or *expected losses*. The effect of things going better than expected is generally referred to as either *benefits* or *expected residual returns*. The notion of losses and benefits is therefore not the same as measures of operating performance such as results of operations or cash flows from operating activities. Instead, the notions of losses and benefits look at who assumes the risks and receives the rewards of variability from expected results.

The VIE Subsections only specifically mentions *significance* of losses and benefits in the determination of whether a party holds a controlling financial interest in a variable interest entity. In that context, the guidance requires consideration of losses and benefits that could *potentially* be significant to the variable interest entity. Therefore, the determination is not made based on conditions that exist at the time the entity is formed but instead is made based on the assumption that future losses and benefits could be significant.

Sufficiency of Equity. The notion of the sufficiency of the equity investment looks at who bears the risk of losses.

a. If the equity investors alone bear the risk of things going worse than expected—the risk of losses—equity is sufficient.

b. If other parties share that risk, equity is not sufficient.

Whether equity is sufficient to finance the entity's activities *without additional subordinated financial support* depends on whether the equity investors alone bear the risk of loss or whether others share that risk. If other parties share that risk, they are considered to be providing *additional subordinated financial support*. Determination of whether financial support is subordinated looks at the substance of the financial support rather than its form. Whether equity is sufficient depends on the facts and circumstances. It is a best practice to address sufficiency qualitatively.

Qualitative assessments can take different forms. A forecast showing that cash flows from operating activities will be sufficient to cover debt service is an example of a qualitative assessment that equity that may be sufficient. Similarly, determinations that equity is at least equal to the amounts customarily required by lending institutions for similar entities or by industry guidelines, such as surety requirements for contractors, might also be sufficient.

The Power to Direct Significant Activities. FASB ASC 810-10-15-14b requires assessing whether the holders of the equity investment at risk as a group have the power to direct the activities of a variable interest entity that most significantly impact its economic performance. This notion requires identifying—

a. the goals in forming the entity,

b. the activities that are most important to ensuring that the entity meets those goals, and

c. the party that in substance controls those activities.

The guidance does not define *economic performance*. However, the way an entity's economic performance is viewed may depend on the reasons it was formed. The determination of economic performance therefore depends entirely on the facts and circumstances.

Determining Whether the Other Entity Is a VIE. Once the reporting entity determines that it has a relationship that requires it to consider the VIE Subsections, the next step is to consider whether the entity with which the reporting entity has the relationship is a variable interest entity. Generally, an entity is considered to be a variable interest entity if *either* of the following conditions is met:

a. Its equity is not sufficient to finance the entity's activities without additional subordinated financial support, *or*

b. Its equity investors do not have—

   (1) the power to direct the activities of the entity that most significantly impact its economic performance,

   (2) the obligation to absorb the entity's losses, or

   (3) the right to receive its benefits.

This definition effectively states that, for an entity to *not* be considered a variable interest entity, its equity investors must—

a. have enough equity investment at risk that the entity will be able to stand on its own,

b. have the power to direct the activities of the entity that most significantly impact its economic performance,

c. bear the risk of the entity's losses, *and*

d. have the right to receive the entity's benefits.

The determination of whether the entity is a variable interest entity is only relevant to determining whether the *reporting entity* should include the consolidated financial results of the entity in its financial statements, *even if* the reporting entity does not hold a majority voting equity interest in the entity. As a practical matter, however, even if the reporting entity has a relationship with an entity considered to be a variable interest entity, the reporting entity may not be required to include in its financial statements the consolidated financial results of the entity.

The remaining considerations required by the VIE Subsections may lead to the conclusion that the *reporting entity* does *not* have a controlling financial interest.

Determining Whether the Reporting Entity Has a Variable Interest in a VIE. If the reporting entity determines that the entity with which it has one of the prescribed relationships discussed earlier is a variable interest entity, it must determine whether it has a variable interest in that entity. The determination that the entity is a variable interest entity establishes the presumption that if there is a controlling financial interest in the entity, it will be established through a *variable interest*.

According to FASB ASC 810-10-20, a *variable interest* in a variable interest entity is a contractual, ownership, or other pecuniary interest in the entity that changes with fluctuations in the fair value of the entity's net assets.

Whether a financial instrument is considered to be a variable interest is only relevant to the variable interest entity considerations, not for consideration of other GAAP requirements.

The definition of a variable interest as a *pecuniary interest* means that a variable interest may be explicit or implicit. Generally, an explicit variable interest arises from a financial instrument, and an implicit variable interest arises from a relationship.

If the reporting entity has a majority voting equity interest in an entity, it may be required to consider both the General Subsections and the VIE Subsections. Holding an equity interest in an entity the reporting entity formed is one of the relationships that requires the reporting entity to consider the guidance in the VIE Subsections. Holding an equity interest also gives the reporting entity a variable interest in the other entity. The reporting entity must therefore determine whether the entity is a variable interest entity. Whether a majority voting equity interest in an entity that is not a variable interest entity gives its holder a controlling financial interest requires judgment.

Determining Whether Consolidation Is Required. If the reporting entity determines that it has a variable interest in a variable interest entity, it must then determine whether it is required to include the consolidated financial results of the entity in its financial statements. The party that has a controlling financial interest in a variable interest entity is considered to be its *primary beneficiary*; however—

a. An individual may be the primary beneficiary.

b. Not all variable interest entities have a primary beneficiary, just as not all entities that are not variable interest entities have a controlling financial interest. For example, all of the equity investment in an entity that is not a variable interest entity may be held by two individuals who have equal voting interests. Similarly, two holders of variable interests in a variable interest entity may share the obligation for the losses of the entity and the right to its benefits.

c. If a VIE does have a primary beneficiary, only one entity is expected to be identified as the primary beneficiary. In other words, a VIE would not be expected to have more than one primary beneficiary.

According to FASB ASC 810-10-25-38A, to be considered the primary beneficiary of a variable interest entity, an individual or entity must have a variable interest in the variable interest entity and have *both* of the following characteristics:

a. The power to direct the activities of the variable interest entity that most significantly impact the economic performance of the variable interest entity, *and*

b. *Either* the obligation to absorb losses of the variable interest entity that could potentially be significant *to the variable interest entity* or the right to receive benefits from the variable interest entity that could potentially be significant *to the variable interest entity*.

The determination of whether the reporting entity is the primary beneficiary of the variable interest entity may require the reporting entity to consider related-party relationships as well. The reporting entity should first determine whether it has both of the characteristics of a primary beneficiary. If it has both characteristics, the reporting entity should include the consolidated financial results of the variable interest entity in its financial statements.

If the reporting entity lacks one or both characteristics, it should determine whether one of its related parties has both characteristics. If a related party has both characteristics of a primary beneficiary, the reporting entity should not include the consolidated financial results of the variable interest entity in its financial statements.

If a related party does not have both characteristics of a primary beneficiary, the reporting entity should determine whether the reporting entity and its related parties as a group have both characteristics of a primary beneficiary. If the group does not have both of those characteristics, the reporting entity should not include the consolidated financial results of the variable interest entity in its financial statements.

However, if the group has both characteristics, the reporting entity should determine whether it is the member of the group most closely associated with the variable interest entity. If the reporting entity is the most closely associated

party, it should include the consolidated financial results of the variable interest entity in its financial statements. If it is not the most closely associated party, the reporting entity should not include the consolidated financial results of the variable interest entity in its financial statements.

The determination of whether the reporting entity is the party in the related-party group most closely associated with the variable interest entity should be made based on assessments of all relevant facts and circumstances, including—

a. whether there is a principal-agency relationship between members of the related-party group,

b. the relationship and significance of the activities of the variable interest entity to members of the related-party group,

c. the exposure of members to the variability associated with the anticipated economic performance of the variable interest entity, and

d. the design of the variable interest entity.

Rather than viewing the assessments as a scorecard, the results of the four assessments should be evaluated together. Depending on the facts and circumstances, one of the assessments may be viewed as providing more persuasive evidence of which party is most closely associated than the other assessments.

Disclosures. Certain disclosures must be made when consolidation is required and when consolidation is not required.

Applying the VIE Guidance. As the previous discussion indicates, the guidance in the VIE Subsections is complex and difficult to understand, even for seasoned accountants. *PPC's Guide to Construction Contractors* provides a worksheet accountants can use to apply the VIE guidance to financial statements of small and midsize nonpublic contractors.

If consolidation pursuant to FASB ASC 810-10 is required, contractors should consider whether the consolidation will cause negative affects to banking relationships, such as creating violations of loan covenants. Because the consolidation of certain entities may greatly affect the contractor's financial picture, bonding relationships may also be negatively impacted. Contractors and their accountants should also determine whether additional information will be needed for the consolidation because entities that will require consolidating may not have previously prepared financial statements using generally accepted accounting principles.

Construction Joint Ventures. A construction joint venture is a type of relationship that contractors are commonly involved in that often meets the qualifications of a VIE. Contractors frequently participate in construction joint ventures with other parties to share risks, combine financial and other resources, or obtain financing or bonding. A construction joint venture may be project specific or it may be a permanent arrangement. The legal form of these entities varies and can be C corporations, general partnerships, unincorporated joint ventures, limited partnerships, limited liability companies, and S corporations.

Other entities that often qualify as a VIE in the construction industry include—

- Highly leveraged entities.
- Land owner entities.
- Investment partnerships.
- Real estate partnerships and joint ventures.

Applicability to Income Tax Basis Financial Statements. As previously mentioned, some contractors have chosen to issue financial statements prepared on the income tax basis of accounting as an alternative to consolidation in accordance with GAAP for VIEs. However, consolidated income tax basis financial statements can be

presented only if the reporting entity presents consolidated income tax returns, and consolidation of income tax returns is an election that generally is available only in prescribed circumstances. Additionally, an entity that issues financial statements prepared in conformity with the income tax basis of accounting may be required by GAAP to make certain VIE-related disclosures. Essentially, if GAAP would require disclosures for certain matters, the statements should either provide the relevant disclosure or present information that communicates the substance of the disclosure. Related-party transactions, guarantees, and commitments are examples of items that may require disclosure.

PPC's Guide to Cash, Tax, and Other Bases of Accounting, includes a detailed discussion of special purpose framework financial statements, including the tax basis of accounting. That product may be purchased at **tax.thomsonreuters.com** or by calling (800) 431-9025.

Equity Method

Generally, the holder of a voting equity interest in an entity that does not give it a controlling financial interest, but gives it the ability to exercise *significant influence* over the operating and financial policies of the entity, should use the equity method to account for the investment. The equity method results in the reporting entity recognizing its share of the earnings reported by the other entity through an increase in the carrying amount of the reporting entity's investment in the other entity and an increase in earnings of the reporting entity. The equity method is commonly used by many contractors to account for their investments in construction ventures. The ability to exercise significant influence is sometimes difficult to measure. However, if a contractor owns 20% or more of a venture, the contractor is generally presumed to exert significant influence unless there is *predominant evidence to the contrary*.

Holding 20% or more of a venture does not create an absolute requirement to use the equity method for the investment. The 20% ownership level is usually a reasonable presumption for significant influence over a public company. However, for a nonpublic company, ownership of considerably more than 20% may be necessary, as a practical matter, to exercise significant influence. The following are two examples suggested in FASB ASC 323-10-15-10 as possible indicators of lack of significant influence that is not unusual for nonpublic companies:

a. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.

b. The investor needs or wants more financial information to apply the equity method than is available to the investee's other owners, and tires to obtain the information but fails.

Situations such as those described above are not conclusive indications of lack of significant influence. All of the attendant facts and circumstances must be evaluated including those discussed or referred to in the "Consolidation" discussion earlier in this section. If the ownership percentage exceeds 50%, the venture should generally be consolidated with the contractor.

FASB ASC 323-10, *Investments—Equity Method and Joint Ventures*, addresses applying the equity method to investments in voting common stock. FASB ASC 323-10-15-13 through 15-19 expands the application of the equity method to investments that are *in-substance* common stock. An investment may be considered in-substance common stock if it has risk and reward characteristics that are substantially similar to the entity's common stock. An investment is considered to be in-substance common stock if all of the following characteristics are substantially similar to the entity's common stock:

- Subordination features, such as liquidation preferences.
- Risks and rewards of ownership, such as participation in earnings, losses, and appreciation and depreciation in value.
- Obligation to transfer value, such as a mandatory redemption provision.
- Future changes in its fair value is expected to vary directly with changes in the common stock's fair value.

If any of these characteristics are not met, the investment is not considered in-substance common stock and should not be accounted for using the equity method.

Measurement Using the Equity Method. Under the equity method, the investment is initially recorded at cost following the requirements in FASB ASC 805-50-30 and is subsequently increased by the investor's proportionate share of the investee's net income and reduced by dividends and the investor's proportionate share of the investee's net loss. However, the investment is not reduced below zero unless the investor is committed to providing financial support to the investee. If there is a difference between the cost of the investment and the investor's proportionate equity in the investee's net assets at acquisition, the difference should first be related to specific assets of the investee based on their fair value. Any difference that cannot be related to specific assets is considered to be attributable to goodwill. The investor should adjust the investment account and investment earnings by an amount that represents the additional depreciation or amortization related to the difference as if it were actually recorded by the investee. (Unless the difference is material, it usually is accounted for as goodwill, instead of attempting to associate it with specific assets and recording the related depreciation.) The equity method is sometimes referred to as a *one-line consolidation* because stockholders' equity and the investor's net earnings generally should be the same whether the equity method is used or the two companies are consolidated. Thus, the amortization of the difference between cost and proportionate equity in net assets and other transactions and events follows essentially the same GAAP as consolidation, for example, intra-entity profits should be eliminated.

An Example of Equity Calculations. Assume the following facts for ABC Company (an equity investee):

			Net Book Value	
	Earnings	Dividends	100%	40%
Acquisition			$ 75,000	$ 30,000
End of Year:				
1	$ 25,000	$ —	100,000	40,000
2	30,000	10,000	120,000	48,000
3	35,000	15,000	140,000	56,000
4	30,000	5,000	165,000	66,000
5	15,000	—	180,000	72,000

If CAS, Incorporated buys 40% of the stock of ABC at book value, its statements would reflect the following:

	Increase for Earnings	Decrease for Dividends	Investment
Acquisition			$ 30,000
End of Year:			
1	$ 10,000	$ —	40,000
2	12,000	4,000	48,000
3	14,000	6,000	56,000
4	12,000	2,000	66,000
5	6,000	—	72,000

To illustrate the mechanics of applying the equity method, the following entries would be made by CAS for Year 2:

	DR	CR
Cash	$ 4,000	
Investment		$ 4,000
To record receipt of dividend.		

	DR	CR
Investment	$ 12,000	
Equity in earnings of ABC		$ 12,000
To record earnings on investment.		

Expanded Equity Method. This method can be used whenever the equity method is appropriate. Under this method, the contractor presents its proportionate share of the venture's assets, liabilities, revenues, and expenses in capsule form. The elements commonly presented include the contractor's share of net current assets, current liabilities, noncurrent assets, noncurrent liabilities, revenues, and expenses, using a caption such as "Contractor's share of net current assets of joint venture."

Income Tax Considerations. For income tax reporting, any investment of less than 80% ownership has to be accounted for using the cost method, and income is recognized as dividends are received. Thus, if an investment is carried on the equity basis for financial reporting, there may be a temporary difference between pretax accounting income and taxable income caused by the equity method.

Cost Method

The cost method should be used to account for any investment in a venture over which the contractor cannot exert significant influence. This method is generally appropriate for any investments of less than 20% ownership. Under the cost method, the investment is recorded by the contractor at cost, which generally remains unchanged unless a permanent impairment in value occurs. Earnings of the venture are recognized by the contractor only to the extent of dividends received. Losses are not recorded unless they indicate a permanent decline in value.

Proportionate Consolidation Method

Investments in unincorporated joint ventures are sometimes structured such that each venturer receives an *undivided interest* in the joint venture's assets and liabilities. In these arrangements, the venturer owns an undivided interest in each asset and is proportionately liable for its share of each liability. Use of the proportionate consolidation method to account for an investment of this type accurately reflects the substance of the ownership structure. Under this method, the investor records his share of the individual assets, liabilities, revenues, and expenses of the joint venture. The following example illustrates the assets, liabilities, revenues, and expenses that would be recorded by a contractor that uses the proportionate consolidation method to account for its 25% interest in a joint venture:

	Venture's Total	Investor's Share
Cash	$ 50,000	$ 12,500
Costs in excess of billings	500,000	125,000
Equipment	800,000	200,000
Payables	(200,000)	(50,000)
Debt	(750,000)	(187,500)
Beginning equity	(300,000)	(75,000)
Current year revenues	(900,000)	(225,000)
Current year expenses	800,000	200,000

In FASB ASC 810-10-45-14, contractors are also allowed to use the proportionate consolidation method for an investment in an *unincorporated legal entity* in the construction industry. However, as discussed earlier in this section, the equity method must be used if the contractor invests in the common stock of a corporate entity and has significant influence over that entity.

Summary of Accounting Methods for Investments in Ventures

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

a. *Less than 20%.* The cost method is normally used for these investments because of the presumption that the contractor will be unable to significantly influence the affairs of the venture. Cost is reduced for permanent declines in value, and dividends are treated as income when received.

b. *More than 50%.* A holding of more than 50% of the voting stock of another company generally constitutes control and requires presentation of consolidated financial statements.

c. *Between 20% and 50%.* There is a *presumption*, according to FASB ASC 323-10-15-8, that an investor that owns between 20% and 50% of a venture has the ability to exercise significant influence over the venture and should account for the investment using the equity method.

These considerations should be documented.

WHETHER TO APPLY CONSTRUCTION CONTRACTOR ACCOUNTING PRINCIPLES TO SIMILAR OPERATIONS

Construction contractor accounting principles can be applied to some similar business activities, but not to others. The environment and contractual arrangements of some businesses have characteristics similar to those of construction contractors, but the businesses do not operate directly in the construction industry. Common examples for which construction contractor accounting principles apply are as follows:

a. Architects.

b. Engineers.

c. Construction managers that enter into an agency contract with an owner to supervise and coordinate the construction activity on a project, including the negotiation of contracts with others for all construction work.

d. Companies that design, develop, manufacture, or modify complex equipment to a buyer's specifications.

This section addresses two common examples of similar operations for which the contractor accounting principles may be appropriate—

a. Homebuilders.

b. Certain manufacturing activities.

Accounting by Homebuilders

Homebuilders have many of the characteristics of construction contractors. However, they differ from construction contractors in that they often build on their own land. Their operations typically consist of the following activities:

a. Building homes under a contract with the customer:

   (1) on lots owned by the customer, or

   (2) on lots owned by the homebuilder; and

b. Building on a speculative basis, that is, without a sales contract.

Homebuilders often buy developed lots in several housing developments. Customers have the option of selecting one of those lots or providing their own lot. Similarly, the homebuilder usually has several basic plans, and customers have the option of selecting from those plans, either unmodified or modified, or supplying their own plans.

Homebuilders may have land and lot option purchase contracts with entities that could be considered variable interest entities. Typically, the homebuilder makes a deposit (often nonrefundable) with entities for the option to purchase land at a future date at a fixed price from an entity that is often structured as a limited liability company. If a deposit's refund is conditional, then the entity is probably a variable interest entity, and the homebuilder will need to determine if it is the primary beneficiary and is, thus, required to consolidate the entity. However, FASB ASC 810-10-25-55 and 25-56 exclude an interest in a specific asset when the asset's fair value is less than half of the entity's assets (and that interest is the homebuilder's only interest in the entity). For example, a homebuilder holds an interest in an entity that owns Land A with a fair value of $20,000 and no other interest in the entity, and the

entity's total fair value of assets is $80,000. Variable interest entities were discussed earlier in this lesson. Related disclosure requirements are beyond the scope of this course, but more information is available in *PPC's Guide to Construction Contractors*.

The mix of speculative and contract building changes from year to year depending on economic conditions. In addition, some houses are started on a speculative basis and placed under contract during construction. That happens at varying stages of construction—some are early enough in the construction period so the buyer can modify the plans, but some are close to closing.

If the homebuilder owns the lot, title typically does not pass until closing. In addition, down payment requirements often vary such as indicated below—

a. If a homebuilder uses a basic unmodified plan, a small down payment may be required because the homebuilder has little to lose if the house converts to speculative if the buyer defaults.

b. If the homebuilder's architectural plans are modified or the buyer supplies custom plans, a larger down payment often is required to lock in the buyer.

Houses are often built under contracts that contain contingencies such as obtaining suitable financing or selling a present home. Under those arrangements, the homebuilder will often include a clause requiring the contingency to be cured prior to the midpoint of construction so that, if not cured, the house may be converted to speculative.

Income Recognition. How income is recognized depends on whether the home is built on a lot owned by the homebuilder or on the buyer's lot, as summarized below:

a. If the homebuilder builds on the buyer's lot, the homebuilder is most likely functioning as a construction contractor and construction revenue recognition guidance, as previously discussed, would govern accounting for the contract. (Building on the buyer's lot without a contract would be rare for homebuilders.)

b. If the home is built on a lot owned by the homebuilder, the authoritative literature governing real estate applies both to building under contract and to speculative building.

It is clear that speculative building is not covered by the authoritative literature related to construction contractors since there is no contract. However, some have questioned whether contract building on homebuilders' lots is covered by the construction contractor literature or whether, since the contract involves the sale of a lot in addition to constructing the home, the transactions are covered by the real estate literature.

FASB ASC 605-35, *Revenue Recognition; Construction-Type and Production-Type Contracts*, basically excludes construction contracts for which authoritative accounting literature provides special methods of accounting. FASB ASC 970-360-55 concluded that the real estate literature of FASB ASC 360-20, *Property, Plant, and Equipment; Real Estate Sales*, and 970, *Real Estate—General*, applied. (Note that the construction contractor accounting literature still would apply to contract building on a lot already owned by the buyer.)

FASB ASC 360-20 and 970-605 provide guidance on income recognition. FASB ASC 970-10, 970-340, 970-360, 970-605, and 970-720-25 provide guidance on accounting for costs. It is likely that these accounting requirements will normally produce the same results concerning cost accumulation as described for construction contractors in Lesson 1. Unless a sale has been consummated, recognizing income under the deposit method, which defers all revenues and costs until closing, is required. FASB ASC 360-20-40-7 states all of the following conditions must be met before a sale is considered to be consummated:

a. the parties are obligated under terms of a contract,

b. all consideration has been exchanged,

c. any permanent financing for which the seller is responsible has been arranged, *and*

d. all conditions precedent to closing have been performed.

Homebuilders constructing on their own lots may not meet the preceding tests until closing because consideration has not been exchanged, and all conditions precedent to closing have not been performed. Accordingly, the deposit method generally would be used.

Although the deposit method is similar to the completed-contract method in many respects, it differs as follows:

Deposit Method	Completed-contract Method
1. Progress billings are recorded as a liability.	1. Progress billings are offset against contracts in progress.
2. Profit is recognized at closing.	2. Profit is recognized upon substantial completion.

The financial statements should refer to the deposit method, rather than the completed-contract method, in describing policies to account for the transactions.

If a homebuilder has some projects under contract for construction on the buyers' lots and others for construction on lots owned by the homebuilder, the percentage-of-completion or the completed-contract method would apply to the contracts using the buyers' lots, and the deposit method would apply to contracts using the homebuilder's lots and to speculative building. In that situation, separate policy notes might be provided for revenue and cost recognition. For example, one could be headed "Revenue and Cost Recognition on Contracts for Construction on the Buyers' Lots" and the other could be headed "Revenue and Cost Recognition on Speculative Building and Contracts for Construction on the Company's Lots."

Because homebuilders normally finance the construction of homes under lines of credit that must be repaid as the homes are sold, they rarely offer long-term mortgage financing to home buyers. However, if a homebuilder finances all or part of a sale involving a lot owned by the homebuilder, the accountant must consider whether the gross profit on the sale should be recognized in the year of sale or as the mortgage loan is collected. Real estate authoritative guidance prescribes tests to determine the profit recognition and resolves the issue based primarily on down payment and continuing investment requirements that must be met. If the requirements for use of the "full accrual" profit recognition method are met, then all profit on a sale financed by the homebuilder can be recognized upon the closing of the sale.

Construction Financing. Homebuilders often finance construction costs through construction loans payable to financial institutions. The loans are similar to equipment floor plans, and, as houses are sold, the related construction loans must be paid off. In many cases, substantially all of the construction costs are financed through such loans. The guidance provided in Lesson 1 for deciding whether to capitalize interest also applies to homebuilders. However, if a contractor charges all interest costs to earnings as they are incurred, and the volume and costs of jobs in progress are relatively constant, capitalizing interest often does not materially change the financial statements.

In many cases, the homebuilder's internal accounting policy for recording interest may produce results that are materially close to the GAAP requirements. Since interest is a significant cost to many homebuilders, it is common for them to charge interest on a project to construction costs using monthly statements provided by the financing institution. If construction loans have been obtained on individual projects, interest can be charged directly to the project. However, if a loan covers more than one project, the monthly interest statement would show interest for the loan rather than for the individual projects. Homebuilders often allocate the interest on those statements to individual lots based on their internal records of draws against those lots.

Typically, the homebuilder finances substantially all costs of the project through construction loans, and the results of the method described in the previous paragraph usually would be materially close to GAAP requirements. However, adjustments are sometimes needed for speculative houses that sit for long periods awaiting a buyer. In those circumstances, many homebuilders continue charging interest costs to the project until it is sold. Interest between substantial completion and sale should be expensed, and adjustment would be needed to the homebuilder's records for those houses.

Points, Commitment Fees, and Closing Costs. Homebuilders sometimes pay points to financial institutions to obtain more favorable mortgage rates for the buyer. For example, a mortgage banker will accept a lower interest

rate (and therefore lower future monthly payments) in exchange for a payment today. That payment, which is often referred to as a *buy-down point*, is an inducement for someone to buy when interest rates would otherwise make monthly payments so high that they would preclude the sale. Buy-down points usually are listed on the closing statement and should be charged to cost of sales.

Other closing costs incurred by the homebuilder that are shown on the closing statement (such as loan origination fees, other points paid by the homebuilder, and real estate taxes) also should be charged to cost of sales.

Homebuilders sometimes pay a fee to a financing institution to ensure the availability of construction financing. If the fee is material, fees can be amortized using the following guidance:

a. If the loan is payable on demand, the fees should be amortized using the straight-line method over a period consistent with the understanding between the borrower and lender. If no such understanding exists, the fees should be amortized over the borrower's estimate of the period that the loan will be outstanding. Any unamortized amount should be charged to interest expense when the loan is paid in full.

b. If the loan is a revolving line of credit or similar arrangement with no scheduled payments, the fees should be amortized using the straight-line method over the period the line is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract. Any unamortized amount should be charged to interest expense when the line is paid.

c. If a loan commitment expires unexercised, the fees should be charged to interest expense in the period of expiration.

d. Fees for all other arrangements should be charged to interest expense using the interest method. If the loan's stated interest rate varies based on future changes in an independent factor (for example, prime plus 1%), the calculation of the constant effective yield should be based either on the factor that is in effect at the inception of the loan or on the factor as it changes over the life of the loan.

Financial Statements. The financial statements of homebuilders are similar to those of construction contractors.

Deciding whether to present a classified balance sheet for construction contractors was discussed at the beginning of this lesson. Those comments generally also apply to homebuilders. It is common for homebuilders to present unclassified balance sheets.

Applying Construction Contractor Accounting to Manufacturing Operations

As mentioned previously, some manufacturing activities are similar to construction contracting and the same accounting rules should be applied. Instead of addressing the types of manufacturing operations that would be accounted for using construction contractor principles, FASB ASC 605-35-15-6 describes the types of manufacturing operations that *would not be subject* to those principles:

> Sales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels, if such sales are normally recognized as revenue in accordance with the realization principles for sales of products and if their costs are accounted for in accordance with generally accepted principles of inventory costing.

In other words, if a manufacturing operation meets all of the following criteria, construction contractor accounting principles *cannot* be applied to it, and *no profit* may be recognized prior to completion:

a. the product is produced in a standard manufacturing operation,

b. the product is sold in the ordinary course of business through regular marketing channels,

c. sales are normally recognized as revenue when realized, and

d. costs are accounted for in a manner similar to other inventory costs.

The preceding criteria should narrow the manufacturing operations to which construction contractor accounting may be applied.

For example, a manufacturer of custom saddles and bridles would probably only manufacture for specific customer orders, but the manufacturing process and the marketing for all saddles and bridles would probably be similar. As a result, GAAP would preclude contractor accounting, and all revenues would probably be recognized on shipment. A large order from a wholesaler might require delivery of all of the order at once and, if so, no revenue would be recognized prior to completion of the order. However, if the order permitted partial shipments, revenue would be recognized as those shipments are made.

The following are other examples of manufacturing operations for which construction contractor accounting probably would not be appropriate; instead, revenue probably would be recognized on completion:

a. A company manufactures boats under customer contracts in which it offers six basic designs and provides customers with several options for modifications.

b. A manufacturer of pallets receives a fixed-price contract to supply a trucking company with pallets.

c. A machine shop tools specialty parts under contracts with manufacturers.

It is a best practice to apply construction accounting principles to manufacturing activities that meet all of the following criteria:

a. *Business Environment.* FASB ASC 910-10-15-4 lists the following characteristics of a construction contractor's business environment, which should be present in order for a manufacturer to use the construction contractor accounting principles:

   (1) A contractor normally obtains its contracts by bidding or negotiating for specific projects.

   (2) A contractor bids or negotiates the initial contract price based on an estimate of the cost to complete the contract and the desired profit margin, although the initial price may be changed or renegotiated.

   (3) A contractor may be exposed to significant economic risks in the performance of a contract, particularly when the price is fixed.

   (4) Owners frequently require a contractor to post a performance and a payment bond as protection against the contractor's failure to meet performance requirements.

   (5) A contractor typically accumulates and accounts for costs and revenues by individual contracts or contract commitments extending beyond one accounting period.

b. *Contractual Arrangements.* A legally enforceable contract should exist which specifies the work to be performed, the basis of determining the amount, and terms of payment of the contract price. Generally, the contract requires total performance before the contractor's obligation is discharged.

c. *Product Characteristics.* The product must differ significantly from goods produced in the company's other manufacturing operations.

The following are examples of manufacturing operations for which construction contractor accounting would probably be appropriate:

a. A manufacturer of boat trailers receives a fixed-price contract with the U.S. Army to produce specially designed trailers to transport ammunition.

b. A manufacturer of standard tobacco processing machinery obtains a contract to design and build a special processing system for a new tobacco plant.

COMMON PROBLEMS THAT COULD ARISE WHEN APPLYING CONTRACT ACCOUNTING RULES

As the preceding discussions point out, it is generally more difficult to account for the operations of a construction contractor than for companies in most other industries. Because the GAAP accounting rules are complex and difficult to apply, the accountant must be constantly aware of the many traps or errors that are common to contract accounting. Some common problems associated with construction accounting are summarized in Exhibit 2-3.

Exhibit 2-3

Common Accounting Issues Associated with Contract Accounting

Issue	Type of Error	Correct Accounting
Accumulation of Contract Costs	The cash method is used to accumulate costs, and there may be significant unrecorded liabilities that affect cost records for contracts in progress.	Accrual accounting should be used to recognize all contract costs, and those costs must be allocated to the appropriate individual contract cost records.
	Costs recognized in the disbursement or voucher register are not properly allocated to individual contract cost records.	Contract costs must be recognized both in total in the general ledger accounts and individually for each profit center. The profit center is normally each individual contract. Amounts posted to general ledger control accounts (normally, expense accounts by major category, or in some cases a construction-in-progress account) should agree in total to amounts posted to subsidiary ledgers (the individual contract cost records).
	Certain categories of direct costs are not properly allocated to individual contract cost records.	All direct costs associated with the construction activity should be allocated to individual contract cost records.
	Indirect overhead costs are incorrectly allocated to contract costs.	All indirect costs associated with a construction contract should be allocated to individual contract cost records.
	Production period interest may need to be capitalized, but is not.	Both GAAP and tax rules require the capitalization of construction period interest. GAAP requires the capitalization of production period interest to the extent that cash receipts on a contract do not exceed production costs.
Revenue Recognition	Incorrect selection of the completed-contract method.	In most situations, the percentage-of-completion method should be used.

Issue	Type of Error	Correct Accounting
	Failure to exclude uninstalled material when performing a cost-to-cost percentage of completion evaluation.	In general, uninstalled materials charged to a contract (unless they were specifically fabricated for the contract) should be excluded from actual costs before computing cost-to-cost percentage of completion.
	Total estimated contract cost may not reflect adequate overhead costs, additional costs due to problems encountered on the contract, increased costs due to inflation, etc.	Total estimated cost of a contract must be adjusted to reflect management's best estimates of the actual cost to complete the contract. This adjustment must be made before a cost-to-cost percentage of completion calculation can be made.
Loss Contracts	Failure to accrue for loss contracts.	When the estimated total cost of a contract is projected to exceed the corresponding contract price, a loss accrual is required, regardless of which accounting method is used.
Unused Materials	Incorrectly transferring unused materials back to the warehouse or to the next job at cost, even if it exceeds market; or expensing the cost of unused materials to the completed job and therefore carrying the inventory at a zero cost.	Unused materials at the completion of a job should be transferred back to inventory or to the next job at the lower of cost or net realizable value.
Retentions	Failure to record retentions since they represent receivables that will not be collected until a project is complete.	Retentions should be recorded as billed. In addition, they should be reported separately in the accounting records from progress bills currently due so that agings will be correct.
Investments in Joint Ventures, Partnerships, or Other Entities	Using the cost method to account for such investments regardless of the appropriate method.	Investments which can be controlled by the contractor should generally be consolidated. Investments over which the contractor can exert significant influence should normally be accounted for using the equity method. The cost method is appropriate for all other investments.
Deferred Taxes	Failure to identify temporary differences between book and taxable income.	Tax law and GAAP rules for contractors may vary significantly, and deferred tax accounting is necessary for all temporary differences between book and taxable income.

* * *

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

20. Consolidated financial statements would have more meaning than individual financial statements under which of the following circumstances?

    a. Contractor A has a controlling interest in Venture B.

    b. Contractor C is makes quarterly income tax payments.

    c. Contractor D owns 10% of Venture E.

    d. Contractor F reports accumulated other comprehensive income on its balance sheet.

21. Which of the following statements most accurately describes an aspect of variable interest entities (VIEs)?

    a. Consolidating VIEs decreases a contractor's debt and increases working capital.

    b. If other parties share in the risk of losses, equity for the VIE is sufficient.

    c. Having a variable interest in a VIE is an interest that maintains a stable value.

    d. One of the most common VIEs for a contractor is a construction joint venture.

22. Which of the following statements best describes accounting for homebuilders?

    a. Because they typically own the land, accounting for homebuilders is significantly different from accounting for construction contractors.

    b. Homebuilders often have land purchase contracts with other entities that may be considered variable interest entities.

    c. If a homebuilder owns a lot, the title will pass when the buyer puts down earnest money on the property.

    d. Including contingencies in a homebuilding contract is prohibited by GAAP.

23. Layman's Construction runs a small manufacturing operation. Its products are produced using a standardized process and sold in the ordinary course of business through normal marketing avenues. The company recognizes sales of the manufactured product as revenue when realized, and accounts for costs like it does for other inventory costs. Which of the following applies in this scenario?

    a. The manufacturing operation is exempt from construction contractor accounting.

    b. Profit on the products manufactured by the company should be recognized based on percentage of completion.

    c. Because the company is a construction contractor, it must apply construction contractor accounting to all of its lines of business.

    d. The company can choose whether or not to use construction contractor accounting principles for the operation.

24. Which of the following construction contractors has correctly dealt with a common problem related to contract accounting?

    a. Sunrise Construction elects not to capitalize interest from a prior period.

    b. Sunset Construction includes uninstalled material in its evaluation of percentage of completion using the cost-to-cost method.

    c. Twilight Construction accrues loss contracts when it seems likely that total cost will exceed its price.

    d. Midnight Construction uses the cost method to account for controlling investments in joint ventures.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

20. Consolidated financial statements would have more meaning than individual financial statements under which of the following circumstances? **(Page 209)**

    a. **Contractor A has a controlling interest in Venture B. [This answer is correct. Consolidated financial statements present the financial position, results of operations, and cash flows of a contractor and its majority-owned venture as if the two were a single economic entity. The ownership by one entity of a controlling interest in another entity represents two separate legal entities but, in substance, a single economic or accounting entity. FASB ASC 810-10-10-1 states "There is a presumption that consolidated financial statements are more meaningful than separate financial statements and that they are usually necessary for a fair presentation when one of the entities in the consolidated group directly or indirectly has *controlling financial interest* in the other entities." Therefore, based on the guidance, it would be more meaningful for Contractor A to file consolidated financial statements that include Venture B.]**

    b. Contractor C is makes quarterly income tax payments. [This answer is incorrect. Consolidation rules for federal income tax purposes differ from GAAP requirements. IRS regulations require an 80% ownership for consolidated tax returns to be filed. Thus, in some cases, consolidated financial statements will be required by GAAP even though the companies do not qualify to file consolidated tax returns. Whether or not the contractor makes quarterly income tax payments is not a factor for determining whether or not to consolidate the financial statements, so Contractor C does not need to do so in this scenario.]

    c. Contractor D owns 10% of Venture E. [This answer is incorrect. The cost method should be used to account for any investment in a venture over which the contractor cannot exert significant influence. This method is generally appropriate for any investments of less than 20% ownership. Under these circumstances, Contractor D does not meet the qualifications for filing consolidated financial statements.]

    d. Contractor F reports accumulated other comprehensive income on its balance sheet. [This answer is incorrect. The accumulated balance of other comprehensive income must be presented separately from retained earnings and additional paid-in capital in the equity section of the balance sheet and labeled with a descriptive title such as "accumulated other comprehensive income." However, this type of income does not make it necessary for Contractor F to file consolidated financial statements.]

21. Which of the following statements most accurately describes an aspect of variable interest entities (VIEs)? **(Page 216)**

    a. Consolidating VIEs decreases a contractor's debt and increases working capital. [This answer is incorrect. Many contractors may not want to consolidate their VIEs into their construction companies' financial statements because it may *increase* the debt reported by the construction company and negatively affect working capital.]

    b. If other parties share in the risk of losses, equity for the VIE is sufficient. [This answer is incorrect. The notion of sufficiency of the equity investment looks at who bears the risk of losses. If the equity investors alone bear the risk of things going worse than expected—the risk of losses—equity is sufficient. If other parties share that risk, equity is not sufficient.]

    c. Having a variable interest in a VIE is an interest that maintains a stable value. [This answer is incorrect. According to FASB ASC 810-10-20, a *variable interest* in a variable interest entity is a contractual, ownership, or other pecuniary interest in that entity that changes with fluctuations in the fair value of the entity's net assets.]

d. One of the most common VIEs for a contractor is a construction joint venture. [This answer is correct. A construction joint venture is a type of relationship that contractors are commonly involved in that often meets the qualifications of a VIE. Contractors frequently participate in construction joint ventures with other parties to share risks, combine financial and other resources, or obtain financing or bonding.]

22. Which of the following statements best describes accounting for homebuilders? **(Page 220)**

a. Because they typically own the land, accounting for homebuilders is significantly different from accounting for construction contractors. [This answer is incorrect. Homebuilders have many of the characteristics of construction contractors, so construction contractor accounting principles can be applied. One difference is that they often are building on their own land, but this difference is not so significant that it excludes homebuilders from using these principles of accounting.]

b. Homebuilders often have land purchase contracts with other entities that may be considered variable interest entities. [This answer is correct. Homebuilders may have land and lot option purchase contracts with entities that could be considered variable interest entities. Typically, the homebuilder makes a deposit (often nonrefundable) with entities for the option to purchase land at a future date at a fixed price from an entity that is often structured as a limited liability company If a deposit's refund is conditional, then the entity is probably a variable interest entity, and the homebuilder will need to take this into account.]

c. If a homebuilder owns a lot, the title will pass when the buyer puts down earnest money on the property. [This answer is incorrect. If the homebuilder owns the lot, title typically does not pass until closing.]

d. Including contingencies in a homebuilding contract is prohibited by GAAP. [This answer is incorrect. Houses are often built under contracts that contain contingencies such as obtaining suitable financing or selling a present home. They are allowed by GAAP.]

23. Layman's Construction runs a small manufacturing operation. Its products are produced using a standardized process and sold in the ordinary course of business through normal marketing avenues. The company recognizes sales of the manufactured product as revenue when realized, and accounts for costs like it does for other inventory costs. Which of the following applies in this scenario? **(Page 223)**

a. The manufacturing operation is exempt from construction contractor accounting. [This answer is correct. If a manufacturing operation meets the following criteria, as discussed in FASB ASC 605-35-15-6, construction contractor accounting principles *cannot* be applied to it: (1) the product is produced in a standard manufacturing process, (2) the product is sold in the ordinary course of business through regular marketing channels, (3) sales are normally recognized as revenue when realized, and (4) costs are accounted for in a manner similar to other inventory costs. Therefore, because Layman's Construction meets all these criteria on its manufacturing operation, the operation will not be subject to the PC method or other types of construction contractor accounting principles.]

b. Profit on the products manufactured by the company should be recognized based on percentage of completion. [This answer is incorrect. According to FASB ASC 605-35-15-6, based on the criteria in this scenario, the manufacturing operation run by Layman's Construction *cannot* recognize profit prior to completion.]

c. Because the company is a construction contractor, it must apply construction contractor accounting to all of its lines of business. [This answer is incorrect. Based on the guidance in FASB ASC 605-35-15-6, if the appropriate conditions are met, Layman's Construction may be able to treat its manufacturing operation differently than other parts of its business.]

d. The company can choose whether or not to use construction contractor accounting principles for the operation. [This answer is incorrect. FASB ASC 605-35-15-6 includes specific guidance for how a manufacturing operation should be treated; therefore, Layman's Construction needs to follow that guidance when accounting for its manufacturing operation.]

24. Which of the following construction contractors has correctly dealt with a common problem related to contract accounting? **(Page 225)**

    a. Sunrise Construction elects not to capitalize interest from a prior period. [This answer is incorrect. Both GAAP and tax rules require the capitalization of construction period interest. GAAP requires the capitalization of production period interest to the extent that cash receipts on a contract do not exceed production costs. Therefore, Sunrise Construction needs to capitalize this interest for correct contract accounting.]

    b. Sunset Construction includes uninstalled material in its evaluation of percentage of completion using the cost-to-cost method. [This answer is incorrect. In general, uninstalled materials changed to a contract (unless they were specifically fabricated for the contract) should be excluded from actual costs before computing cost-to-cost percentage of completion. Therefore, Sunset Construction has committed a common error in its contract accounting.]

    c. Twilight Construction accrues loss contracts when it seems likely that total cost will exceed its price. [This answer is correct. One common error in contract accounting is failure to accrue for loss contracts. Twilight Construction has managed successfully avoid this error. When the estimated total cost of a contract is projected to exceed the corresponding contract price, a loss accrual is required, regardless of which accounting method is used.]

    d. Midnight Construction uses the cost method to account for controlling investments in joint ventures. [This answer is incorrect. A common error in contract accounting is to use the cost method to account for investments in joint ventures, partnerships, or other entities regardless of the appropriate method. However, under GAAP, the cost method is not appropriate for investments in which the contractor has control or can exert significant influence. Midnight Construction should consolidate these joint ventures instead.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Construction Contractors—Course 2—Accounting for Construction Contracts (CONTG172)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $89 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     CONTG172 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you

complete three courses, the price for grading all three is $254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked by **August 31, 2018**. CPE credit will be given for examination scores of 70% or higher.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Construction Contractors—Course 2—Accounting for Construction Contracts (CONTG172)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following statements best describes how construction contractors determine whether to recognize revenue on construction contracts using the percentage-of-completion (PC) method or the completed-contract (CC) method?

   a. Contractors can choose to use the method that gives them the best financial and tax results.

   b. Contractors must use the PC method unless specific conditions exist for using the CC method.

   c. Contractors must use the CC method unless specific conditions exist for using the PC method.

   d. Contractors must use the PC method if reasonably dependable estimates are not available.

2. Rockin' B Construction has a contract with Baker's Dozen to install new windows in the bakery by May 31 in exchange for $10,872. What is the correct term for the action that Rockin' B will perform?

   a. The contract.

   b. The job.

   c. The performance obligation.

   d. The commitment.

3. What is the normal profit center for a construction contractor?

   a. Individual contracts.

   b. Segments of individual contracts.

   c. Groups of combined contracts.

   d. The company as a whole.

4. What do contractors typically use to identify cost, revenue, gross profit, and billing information and accumulate that information on a contract-by-contract basis?

   a. Field reports.

   b. The general ledger.

   c. The profit center.

   d. Subsidiary records.

5. When recording construction contract activity to its general ledger, Fixer-Uppers debits costs to a construction-in-progress asset account as incurred or paid. The contractor does not expense the costs until the bill has been rendered. Fixer-Uppers uses which accounting approach?

   a. The construction-in-progress approach.

   b. The direct P&L approach.

   c. The income tax basis of accounting.

   d. Subsidiary records approach.

6. Carlos is a general contractor. When fulfilling a customer's contract to remodel a bathroom he pays for the following:

   i. Repairs on a piece of construction equipment.
   ii. A subcontract with an electrician.
   iii. Tiles for the floor.
   iv. Labor for the project.
   v. Liability insurance.

   Which of these costs would be considered direct costs and which would be considered indirect costs?

   a. Direct costs: iii. and iv.
   Indirect costs: i., ii., and v.

   b. Direct costs: ii., iii., and iv.
   Indirect costs: i. and v.

   c. Direct costs: i., iii., and iv.
   Indirect costs: ii. and v.

   d. Direct costs: i., ii., iii., and iv.
   Indirect costs: v.

7. When should all of an indirect cost be allocated to an overhead pool?

   a. When it does not relate to a construction activity.

   b. When only part of the cost relates directly to the construction activity.

   c. When the cost was incurred only for the benefit of the construction activity.

   d. When it will be the most beneficial to the construction contractor to do so.

8. Which of the following statements best describes an aspect of cost accumulation for a construction contractor?

   a. If a construction company constructs discrete projects to be sold or leased, interest costs should be expensed separately from the asset's cost.

   b. Costs that are reimbursed under a cost-plus contract must be capitalized under GAAP.

   c. Generally, costs that are not associated with the construction process are classified as selling, general, or administrative expenses.

   d. Back charges will be accrued whether or not the amount can be reasonably estimated.

9. Authoritative literature presumes which of the following related to making dependable estimates?

   a. That all construction contractors have the ability to make them in the normal course of business.

   b. That inherent hazards will not affect a construction contractor's ability to make dependable estimates.

   c. That computer software makes valid enough estimates that the contractor will be protected from inherent hazards.

   d. That inherent hazards are common and may recur repeatedly in a particular contractor's business.

10. Which of the following considerations applies if a job has a zero profit margin?

    a. Results from using the PC and the CC method will be the same.

    b. The contractor should use the PC method.

    c. Even if circumstances change, the contractor cannot recognize revenue for this job under this contract.

    d. If a change in estimate occurs, prior periods must be restated.

11. Which of the following contractors has correctly dealt with an issue related to estimating the costs to complete a contract?

    a. Alice identifies the quantities and prices of all the significant cost elements.

    b. Brian uses different elements of cost for the estimate than he does for the actual accumulated costs.

    c. Carol bases the cost estimate of a long-term contract on wage rates at the time of the estimate, not those that will apply at the end of the contract.

    d. Don keeps his estimates static so they are accurate records of the original plan.

12. Kauffman Construction submits an estimate for a remodeling job. The owner of the home then submits a change order. The price and the scope of the change order are not approved by the construction company and the owner. How should this change order be accounted for?

    a. The price of the change order should be included in the estimated contract revenues.

    b. The costs of the change order should be charged to contracts in progress.

    c. The costs of the change order should be charged to current operations.

    d. The change order must be evaluated as a claim instead.

13. Mac-2 contracts with a construction company to build a new retail location. After the contract begins, Mac-2 requests that a third story be added to the building. This change would most likely be accounted for as which of the following?

    a. A change order.

    b. A claim.

    c. A loss contract.

    d. An option or addition.

14. Which strategy will help a contractor deal with anticipated losses in accordance with GAAP?

    a. A loss should be recorded when contract revenue exceeds contract cost.

    b. Losses on a contract should be charged to a special loss account.

    c. Treatment of losses varies depending on whether the PC or CC method is used.

    d. A loss should not be recorded until the completion of the contract.

15. Comstat Construction has incurred $7,000 of costs on a contract that has an estimated total cost of $20,000. What is the contract's percentage of completion under the cost-to-cost method?

    a. 14%.

    b. 20%.

    c. 35%.

    d. 40%.

16. How does a contractor deal with uninstalled materials when using the PC method?

    a. They are included in actual costs incurred to date when the cost-to-cost method is applied.

    b. They are all omitted from the percentage-of-completion calculation since they were not used on the job.

    c. If specifically produced for the job, they are included in the percentage-of-completion calculation.

    d. If carried in the supplier's inventory, they are factored into the percentage-of-completion calculation.

17. Which of the methods for recognizing revenue is easier for a construction contractor to apply?

    a. The PC method.

    b. The CC method.

    c. The PC method is easier to use on larger contracts, and the CC method is easier to use on smaller contracts.

    d. The PC method is easier to use on combined contracts, and the CC method is easier to use on segmented contracts.

18. Which of the following statements best describes an aspect of the CC method?

    a. Determining the appropriate point of substantial completion determines when all profit from the contract will be recognized.

    b. The point of substantial completion is reached when all costs have been recouped and there are no more potential risks.

    c. Arbitrary acceleration or deferral of income is permissible if specific criteria are met and disclosed.

    d. General and administrative expenses should be dealt with independently from the individual contracts.

19. Lively Contractors, a small construction company, has a one-year operating cycle. What type of balance sheet should the company present?

    a. GAAP requires a contractor of this type to present an unclassified balance sheet.

    b. GAAP requires a contractor of this type to present a classified balance sheet.

    c. Lively Contractors can choose which type of balance sheet to present, but classified is preferable and would normally be presented.

    d. Lively Contractors can choose which type of balance sheet to present, but unclassified is typical due to its operating cycle.

20. When should a contractor net assets and liabilities against each other on its balance sheet?

    a. When it has overbillings.

    b. When it has underbillings.

    c. When billings exceed costs.

    d. When a legal right of setoff exists.

21. Assuming all other conditions are met, when could an embedded derivative be separated from its host contract?

    a. The economic characteristics are closely related to the host contract.

    b. The economic risks are clearly related to the host contract.

    c. The hybrid contract is remeasured at fair value, and changes are recognized as changes in financial position when they occur.

    d. If a separate instrument with the same terms would meet the definition of a derivative investment and the standalone contract is not a liability.

22. Paisley Construction needs to determine the fair value of one of its assets. Which of the following would be the most preferable input for this measurement?

    a. The quoted price of an identical asset in an active market.

    b. The quoted price of a similar asset in an active market.

    c. The quoted price of an identical asset in an inactive market.

    d. An assumption developed by the company based on available information.

23. Which of the following guarantees is exempt from the provisions of FASB ASC 460-10-25-1?

    a. Contractor 1 guarantees the obligations of a subcontractor.

    b. Contractor 2 guarantees a joint venture that it does not control.

    c. Contractor 3 guarantees the debt of a subsidiary.

    d. Contractor 4 guarantees the debt of a corporation it does not control.

24. Under which of the following circumstances would a construction contractor capitalize environmental cleanup costs under FASB ASC 410-30-25-18?

    a. The contractor enters into a cleanup contract for an existing contamination site.

    b. The contractor owns the property for speculative building.

    c. A subcontractor employed by the contractor contaminates the site.

    d. The contractor refuses to complete the cleanup project.

25. Which of the following statements best describes how construction contractors should deal with an environmental remediation liability?

    a. Such liabilities include direct and indirect costs, but do not include amounts paid in employee benefits.

    b. When faced with the possibility of such liabilities, the presumption is that the claim will be unfavorable.

    c. Such liabilities should not be recognized until after the early stages of the remediation process when they can be reasonably estimated.

    d. Contractors must estimate a single loss amount for such liabilities; a range is not acceptable.

26. Assuming all other conditions are met, under what circumstances can an environmental remediation liability be discounted to reflect the time value of money?

    a. The company's share of the aggregate liability amount is uncertain.

    b. A range of possible loss from the liability has been determined.

    c. The timing of cash payments for the liability is fixed.

    d. A claim for recovery has been filed.

27. According to the FASB ASC, a number of specific conditions must be met for a long-lived asset to be classified as held for sale. Assuming the construction companies below meet all the other required conditions, which one can classify a long-lived asset as held for sale?

    a. Red Construction plans to sell the asset within 18 months.

    b. Blue Construction is marketing the asset at a price well above market in hopes of profit.

    c. Yellow Construction is likely to change its mind prior to sale of the asset.

    d. Green Construction's management has committed to the plan for the asset's sale.

28. When an S corporation reports to a surety, the S corporation's accumulated adjustments account represents which of the following?

    a. Tax basis retained earnings that were undistributed as of the balance sheet date that arose after the S corporation's conversion date.

    b. Cumulative temporary difference that the S corporation has as of its balance sheet date.

    c. Tax basis earnings that were undistributed at the conversion date and other amounts consisting primarily of tax-exempt income since the conversion.

    d. Temporary differences that originated or reversed after the conversion and permanent differences related to deductible expenses incurred after the conversion.

29. Which of the following contractors should consider making a disclosure about concentrations?

    a. Northern Construction transacts business with a variety of customers and suppliers.

    b. Southern Construction provides several different types of services that provide similar amounts of revenue.

    c. Eastern Construction needs specific materials for the majority of its jobs, which are only available from one source.

    d. Western Construction has locations in several different geographic markets.

30. All of the following are included in *comprehensive income,* **except**:

    a. Realized gains and losses on debt and equity securities.

    b. Gains or losses related to postretirement benefits.

    c. Foreign currency translation adjustments.

    d. The effective portion of gain or loss from cash flow hedging instruments.

31. ConstructionCo presents a combined statement of income and comprehensive income. Which of the following elements does ConstructionCo need to present in this single statement format that it could exclude if it used a two-statement format?

    a. Components of other comprehensive income.

    b. Total comprehensive income.

    c. Total other comprehensive income.

    d. Total net income.

32. Under which of the following circumstances would a contractor most likely need to consolidate a venture into its financial statements?

    a. It owns a majority interest, but other partners have to approve decisions.

    b. It owns less than 40% of the interest, but exercises control under a contract.

    c. It is a noncontrolling investor in a partnership.

    d. It is a member of a limited partnership.

33. How could the accounting alternative provided by FASB ASC 810-10 affect a contractor with an interest in a variable interest entity (VIE)?

    a. If elected, only modest additional disclosures will be needed for the VIE.

    b. It eliminates the need for the contractor to consolidate the VIE's' financial statements.

    c. It replaces the VIE Subsections for small and midsized private contractors.

    d. It will need to be elected for each potential VIE or similar leasing arrangement.

34. What is the minimum percentage of a venture a contractor must own to be presumed to exert significant influence without predominant evidence to the contrary?

    a. 10%.

    b. 20%.

    c. 30%.

    d. 40%.

35. Milestone Contractors owns an investment in an unincorporated joint venture. The venture is structured so that each investor receives an undivided interest in the venture's assets and liabilities. What method should Milestone use to account for this interest?

    a. The cost method.

    b. The equity method.

    c. The expanded equity method.

    d. The proportionate consolidation method.

36. Which of the following construction contractors should use the equity method to account for an investment in a joint venture?

    a. Breaker Construction owns 10% of Venture A.

    b. Farthing Construction owns 35% of Venture B.

    c. Maverick Construction owns 51% of Venture C.

    d. Xanadu Construction owns 90% of Venture D.

37. When would the deposit method typically be used?

    a. When a contractor owns an interest in a construction joint venture.

    b. When a homebuilder finances construction using construction loans.

    c. When a homebuilder builds on lots that it owns.

    d. When a contractor has a manufacturing operation.

38. Purchasing a buy-down point will allow a homebuilder to do what?

    a. Get a lower mortgage interest rate.

    b. Sell a home for a higher price.

    c. Eliminate closing costs.

    d. Get a longer mortgage term.

39. Construction contractor accounting principles would be the most appropriate for which of the following manufacturing operations?

    a. Company 1 manufactures boats with six basic designs. The customer contracts provide several standard options for modifications.

    b. Company 2 manufactures pallets and receives a fixed-price contract from a trucking company to supply the trucking company with these pallets.

    c. Company 3 manufactures standard tobacco processing machinery and obtains a contract to design and build a special processing system for a new plant.

    d. Company 4 has a machine shop that tools specialty parts under contracts with various manufacturers.

40. Which of the following construction contractors has correctly dealt with an issue related to contract accounting?

    a. Alpha Construction uses the CC method to account for the majority of its contracts.

    b. Beta Construction transfers unused material that exceeds market value back to the warehouse at cost.

    c. Gamma Construction omits overhead costs from its total estimated contract costs since overhead is not related to the job at hand.

    d. Delta Construction uses accrual accounting to recognize contract costs and allocates the costs to individual contracts.

GLOSSARY

Back charges: Billings for work performed or costs incurred by one party that, in accordance with the agreement, should have been performed or incurred by the party to whom billed.

Buy-down point: Payments made to obtain more favorable mortgage rates for the buyer. An inducement for someone to buy when interest rates would otherwise make monthly payments so high they would preclude the sale.

Change orders: These modify provisions of the original contract but do not add new provisions. They can be initiated by the contractor or the customer and can affect any aspect of the contract, such as design, performance, site, or construction period.

Claims: These are made by the contractor against the owner in an attempt to collect additional revenues (revenues that exceed the contract price). Typically they arise because of unforeseen circumstances the contractor could not have avoided.

Construction-in-progress approach: A method for recording contract activity in which revenue is recognized when billings are rendered or collected. There is a two-step process for recording contract costs. First they are debited to a construction-in-progress asset account as incurred or paid. They are not expensed until a bill is rendered.

Contract: An agreement between two or more parties that creates enforceable rights and obligations.

Combined: When a group of contracts are aggregated into one profit center. This can be done under some limited circumstances.

Completed-contract (CC) method: A method for recognizing revenues on construction contracts in which income recognition is deferred until a contract is substantially complete.

Controlling financial interest: Ownership of a majority voting interest (generally over 50%).

Cost accumulation: The identification and accumulation of project costs on a contract-by-contract basis.

Cost-to-cost method: A widely used method to determine percentage of completion. Costs incurred to date are compared to the estimated total costs to be incurred.

Customer: A party that contracts with an entity to obtain goods or services in exchange for due consideration, where the goods or services are an output of the entity's normal activities.

Derivative instrument: A financial instrument or other contract that (1) has at least one underlying and at least one notional amount or payment provision or both, (2) requires no initial net investment or an initial net investment less than required for other types of contracts expected to respond similarly to changes in market factors, and (3) has terms that require or allow net settlement.

Direct costs: Costs unique to a specific contract, such as materials used in the construction of a project or the construction labor for that project.

Direct P&L approach: A method for recording contract activity in which revenue is recognized on each contract as billings are rendered, regardless of whether those billings correspond to the actual work completed on the contract. Contract costs are charged directly to expense accounts when they are incurred, and no attempt is made to capitalize any construction costs in an inventory or construction-in-progress asset account.

Embedded derivatives: Instruments that have implicit or explicit terms that affect some or all of the cash flows or value of other exchanges required by their host contract, similar to derivative instruments.

Fair value: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Indirect costs: Indirect job costs (such as rent, utilities, and repairs) that must be allocated either to contracts or the general operating expense of the contractor.

Input methods: One classification of methods for determining a contract's percentage of completion. These methods, which include contract costs, engineering estimates, and direct labor hours, base the percentage of completion on efforts devoted to the contract.

In-substance common stock: An investment with risk and reward characteristics that are substantially similar to the entity's common stock.

Nonrecognized subsequent events: Events that provide evidence about conditions that did not exist at the balance sheet date but arose after that date but before the financial statements are available to be issued. They are called Type II subsequent events.

Operating cycle: The time needed to convert cash first into materials and services, then into products, then by sale into receivables, and finally be collection back into cash.

Option: An option to a basic contract adds a provision to the original contract, such as adding a new wing onto the original structure. This can also be called an addition.

Output methods: One of the classification methods for determining a contract's percentage of completion. These methods, which include preestablished milestones, yards-of-concrete-poured, and units –produced, base the percentage of completion on results achieved.

Overbillings: Billings in excess of costs (and estimated earnings), which are shown as liabilities.

Percentage-of-completion (PC) method: A method for recognizing revenues on construction contracts in which the contractor recognizes income throughout the life of the contract. This method is used in most instances.

Performance obligation: A promise in a contract with the customer to transfer a good or service to the customer.

Profit center: For a construction company, this is typically each individual contract. For most other companies, this is the company as a whole.

Recognized subsequent events: Those that provide additional evidence about conditions that existed at the balance sheet date, including the estimates inherent in preparing the financial statements. They are also called Type I subsequent events.

Remediation: Steps taken to restore natural resources or to investigate, mitigate, or eliminate environmental contamination or the threat of contamination.

Retention receivables: Amounts contractors have withheld from payment on in-process contracts until the contract is completed successfully.

Segmented: When a single contract is broken into more than one profit center. This can be done under some limited circumstances.

Significant influence: When a contractor owns 20% to 50% of the venture.

Stand-alone selling price: The price for which an entity would sell a promised good or service separately to a customer.

Start-up activities: One-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with an entirely new class of customers or beneficiary, initiating a new process in an existing facility, or commencing some new operation.

Subcontractor: Other companies or individuals a contractor uses to perform a segment of the work required on a contract (e.g., electricians or painters).

Transaction price: The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.

Underbillings: Costs (and estimated earnings) in excess of billings on contracts in progress. They are recorded as assets.

Variable interest entity: An entity with either (1) equity that is not sufficient to financial its activities without additional subordinated financial support or (2) equity investors that do not have the power to direct the activities of the entity that most significantly impact its economic performance, the obligation to absorb the entity's losses, or the right to receive its benefits.

Weather derivatives: Financial instruments often used to manage risk related to weather or geological variables.

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COMPANION TO PPC'S GUIDE TO CONSTRUCTION CONTRACTORS

COURSE 3

RISK ASSESSMENT PROCEDURES AND AUDIT PLANNING (CONTG173)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses the basic approach to the audit of the financial statements of a construction contractor. It covers the process from the planning activities that start when the auditor considers whether to accept a new contractor client and extends through the preparation of a detailed audit plan. Also included in this course are the considerations that affect audit programs.

PUBLICATION/REVISION DATE: August 2017

RECOMMENDED FOR: Users of *PPC's Guide to Construction Contractors*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of auditing

CPE CREDIT: 7 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

FIELD OF STUDY: Auditing

EXPIRATION DATE: Postmark by **August 31, 2018**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Planning the Audit

Completion of this lesson will enable you to:

- Determine pre-engagement activities and audit planning and how they relate to audits of construction contractors.
- Identify how an auditor gains an understanding of a construction contractor under audit.
- Determine an auditor's consideration of fraud and illegal acts unique to contractors and the auditor's understanding of the contractor's internal control.

Lesson 2—Planning Decisions, Judgments, and the Timing of the Engagement

Completion of this lesson will enable you to:

- Determine the auditor's planning decisions and judgments, including the timing of the engagement.
- Identify special considerations for interim reviews.

TO COMPLETE THIS LEARNING PROCESS:

Submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
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Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Planning the Audit

INTRODUCTION

This lesson discusses the general approach to the audit of the financial statements of a construction contractor. It also covers the planning activities that begin when the auditor considers whether to accept a new contractor client and extend through the preparation of a detailed audit plan (audit programs). This course explains the planning considerations that affect audit programs.

The auditing information included in the course focuses on considerations that are unique to audits of construction contractors. Considerations that are relevant to all audits of financial statements are discussed in *PPC's Guide to Audits of Nonpublic Companies*.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine pre-engagement activities and audit planning and how they relate to audits of construction contractors.
- Identify how an auditor gains an understanding of a construction contractor under audit.
- Determine an auditor's consideration of fraud and illegal acts unique to contractors and the auditor's understanding of the contractor's internal control.

Authoritative Literature

Generally Accepted Accounting Principles. The objective of an audit is to express an opinion about whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework that is used by the entity. FASB ASC 105, *Generally Accepted Accounting Principles*, establishes the FASB Accounting Standards Codification (ASC) as the source of generally accepted accounting principles (GAAP) for nongovernmental entities.

Generally Accepted Auditing Standards (GAAS). Auditors of nonpublic entities should conduct their engagements in accordance with GAAS developed by the American Institute of Certified Public Accountants (AICPA). The AICPA *Code of Professional Conduct* (the Code) requires members to comply with SASs. This course is updated for changes in professional literature and includes guidance about how those changes might affect audits of construction contractors. Best practices suggest that firms have a system in place to ensure staff members are informed about current authoritative literature.

Defining Professional Responsibility. The auditor's degree of responsibility in complying with professional requirements is identified through two categories as follows (AU-C 200.25):

- *Unconditional Requirements.* Unconditional requirements are those that an auditor must follow in all cases if the circumstances apply to the requirement. Auditing standards use the word *must* to indicate an unconditional requirement.

- *Presumptively Mandatory Requirements.* An auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant except in rare circumstances when the auditor determines it necessary to depart from a relevant requirement. In that case, the auditor should perform alternative procedures to achieve the intent of the requirement (see AU-C 200.26). Auditing standards use the word *should* to indicate a presumptively mandatory requirement.

The auditor *must* document the justification for any necessary departure from a presumptively mandatory requirement of GAAS, along with how alternative procedures performed sufficiently achieve the intent of the requirement.

Use of the Terms *Must* and *Should*. Throughout this *course*, the terms *must* and *should* are used in accordance with AU-C 200.25. The term *required* is interchangeable with *should*.

Form and Structure of the Auditing Standards. Each auditing standard is divided into the following topics:

a. An ***introduction*** that explains its purpose and scope, subject matter, and effective date.

b. A brief list of ***objectives*** that outline what should be achieved.

c. A list of relevant ***definitions***.

d. The ***requirements*** the auditor is to follow to achieve the objectives.

e. Further guidance in an appendix of ***application and other explanatory material***.

Application and other explanatory material provides further guidance to the auditor in applying or understanding the requirements. While this material does not in itself impose a requirement, auditors should understand this guidance. How it is applied will depend on professional judgment in the circumstances considering the objectives of the standard. The requirements section references the related application and explanatory material. Also, when appropriate, considerations relating to smaller and less complex entities are included in this section.

Quality Control Standards. Statement on Quality Control Standard No. 8 (SQCS No. 8), *A Firm's System of Quality Control*, establishes standards and provides guidance for a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. SQCS No. 8 comprehensively addresses the quality control processes over a firm's accounting and auditing practice. The standard places an unconditional obligation on the firm to establish a QC system designed to provide reasonable assurance that the firm complies with professional standards and legal and regulatory requirements, and that it issues reports that are appropriate in the circumstances. *PPC's Guide to Quality Control* provides guidance and practice aids to assist firms in developing, implementing, and maintaining a system of quality control.

Interpretive and Other Auditing Publications. AU-C 200 identifies two other categories of auditing literature that are relevant to audits of financial statements as follows:

a. Interpretive publications as described in AU-C 200.27 and AU-C 200.A81.

b. Other auditing publications as described in AU-C 200.28 and AU-C 200.A82–.A84.

Interpretive Publications. Interpretive publications are not auditing standards but rather recommendations on applying GAAS. Interpretive publications include Auditing Interpretations, exhibits to the SASs, AICPA Audit and Accounting Guides, and AICPA Auditing Statements of Position. Auditors should consider applicable interpretive publications. If the auditor does not apply an interpretive publication, the auditor should be prepared to explain how he or she complied with the underlying SAS provisions. The unconditional requirements and presumptively mandatory requirements are not intended to apply to interpretive guidance issued by the AICPA. The AICPA Audit and Accounting Guide, *Construction Contractors* (the AICPA Guide) gives guidance on audits of financial statements of construction contractors.

Other Auditing Publications. Other auditing publications have no authoritative status but may help auditors understand and apply GAAS. Other auditing publications include AICPA publications other than auditing standards and interpretive publications, such as articles in professional journals, continuing professional education programs, textbooks, guide books, audit programs and checklists, and auditing literature published by state CPA societies and other organizations (for example, PPC guides). If auditors apply the guidance in other auditing publications, they should satisfy themselves that the guidance is both appropriate and relevant. Appropriateness refers to whether the guidance is technically sound. Relevance refers to whether the guidance is applicable to the circumstances of a particular audit engagement. Indicators of appropriateness include the extent to which the publication is recognized as being helpful and the professional qualifications of its author or issuer. There is a presumption that other auditing publications reviewed by the AICPA Audit and Attest Standards staff (such as auditing practice releases and AICPA risk alerts) are appropriate.

Organization of Course

This course is organized according to the following major sections:

a. Pre-engagement activities.

b. Audit planning and the risk assessment process.

c. Understanding of the contractor client and its environment.

d. Consideration of fraud and noncompliance with laws and regulations.

e. Understanding of internal control.

f. Audit planning decisions and judgments, including determining materiality.

g. Overall timing of engagement.

h. Audit sampling.

i. Estimate of audit time and budget.

j. Special considerations in an initial audit.

k. Special considerations for interim reviews.

Many of the aspects of audit planning are related and, in many cases, one aspect blends into another without a sharp distinction. For example, consideration of audit risk and obtaining an understanding of internal control are often done concurrently.

PRE-ENGAGEMENT ACTIVITIES

Pre-engagement activities take place (a) before an engagement is accepted and (b) in the early planning stages of an engagement. Pre-engagement activities include—

- Making the client acceptance and continuance decision, and
- Establishing the terms of the engagement.

For any client, it is important that these matters receive attention annually before the start of a continuing audit engagement. The higher risk nature of the construction industry makes it especially important to reassess these matters each year for continuing contractor clients. In addition to allowing the auditor to make the acceptance or continuance decision, pre-engagement activities also provide the auditor with important information that directly contributes to the assessment of risks and development of an audit strategy and detailed audit plan.

Deciding Whether to Accept or Continue a Client

Client acceptance and continuance polices and procedures provide reasonable assurance that:

- Engagements that are accepted can reasonably be expected to be completed with professional competence.
- The risks associated with providing professional services in the particular circumstances are appropriately considered.

Some of the unique factors commonly encountered in the construction contractor industry that may affect the auditor's ability to accept the engagement and the desirability of the engagement are discussed below.

Ability to Accept Engagement. The factors to be considered in deciding whether the auditor has the ability to accept the engagement are as follows:

a. independence from the potential contractor client;

b. auditor competence in the construction contracting industry;

c. auditability of the contractor's financial statements; and

d. ability to meet the time requirements, deadlines, or other requirements of the engagement imposed by the client or a significant user of the financial statements, such as a bonding company or lender.

Construction contract accounting and auditing involve unique and relatively complex aspects of GAAP and GAAS. The auditor should have the necessary competence in the industry or be able to obtain sufficient knowledge and understanding through continuing education courses, study of accounting literature, or discussion with knowledgeable persons.

AU-C 210, *Terms of Engagement*, defines *preconditions for an audit*. AU-C 210.06 indicates that the auditor should determine whether the financial reporting framework to be applied in the preparation of financial statements is acceptable. Also, the auditor should obtain the agreement of management and those charged with governance, as appropriate, that they acknowledge and understand their responsibilities. If the preconditions are not met, the auditor should discuss the matter with management and generally should not accept the proposed engagement. The only exceptions arise when the auditor is required by law or regulation to accept, which would be extremely rare for a contractor. The auditor needs to carefully consider whether the contractor's financial reporting system can account for costs by contract and whether it appears to include all direct and indirect costs of construction in contract costs. In the initial audit of a contractor, there may be serious auditability constraints. For example, testing the percentage-of-completion and allocation of costs to the opening balances for contracts in progress at the beginning of the year can be extremely difficult. If the contractor's prior period financial statements were audited by another auditor, substantiating opening balances may be easier, but a more detailed review than normal of the predecessor's workpapers may be necessary.

Auditability is also affected by difficult-to-audit transactions and the existence of contentious accounting issues. Certain construction contractors are more complex to audit than others because of the nature of their accounting transactions. For example, estimated costs to complete that include environmental remediation costs have more difficult assumptions and estimates than contracts that include only standard subcontractor costs. Additionally, the accounting for contractors involved in one or more joint ventures is normally more complex than the accounting of contractors with no investments in other entities. Inquiring about what revenue recognition methods are used for GAAP and tax purposes; the types and average duration of contracts; the existence of activities carried on through joint ventures; the steps taken to ensure compliance with applicable laws, regulations, and agreements such as immigration laws, labor union contracts, and payroll tax reporting; the existence of lawsuits, contract disputes, or other serious contingencies; and the applicability of complex accounting pronouncements will help provide the auditor with a preliminary understanding of the auditability of the entity.

In addition to inquiry of the client, the auditor's consideration of auditability issues normally includes review of prior periods' financial statements and tax returns. If possible, the auditor would make a review of individual contract records at an early interim date to evaluate the number and location of sites to be visited and the existence of obvious cost omissions that might be corrected before the accounting records are closed at year-end. An interim review of contract records requires the client to post individual contract records at an early date. The issues considered in evaluating auditability are also relevant to obtaining an understanding of the entity and its environment.

Another important consideration in determining the ability to accept an engagement is the ability to meet the time or other requirements of the engagement imposed by the client, a lender, or a bonding company. In the construction industry, surety companies provide various contract-related bonds. A bonding company may impose audit requirements for supplemental schedules that add to the time and difficulty of performing the audit.

Desirability of Engagement. If an auditor concludes that he or she can meet the professional and other requirements related to a potential new engagement, an equally important consideration is the desirability of accepting the engagement. Factors that affect the desirability of proposing for or accepting the engagement include the client's reputation, degree of competition, adequacy of fee, long-term viability of the contractor, and opportunity for practice development.

Consideration of the reputation and integrity of a prospective or continuing client and its management is always important, but it is especially significant for a contractor client. The construction industry is more susceptible to illegal activities, such as bribery, kickbacks, and fraud, than many other industries. This characteristic means that a more thorough investigation of a prospective client is advisable, as well as monitoring existing client publicity. One way to consider a client's reputation is to evaluate who its key relationships are with, such as its surety, banker, prior accountant, or attorney. Another way is to consider the methods the contractor uses to win new contracts.

Yet another way to consider a client's reputation is to have discussions with the predecessor auditor. AU-C 210.11 requires the successor auditor to request permission from the prospective client to inquire of the predecessor auditor prior to final acceptance of the engagement. The auditor is to inquire about matters that would assist in making the acceptance decision. The term *predecessor auditor* refers to an auditor from a different audit firm who reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of the financial statements. In the latter circumstance, there may be two predecessor auditors—the one who performed the most recent audit and the one who was initially engaged, but did not complete the audit. The communication about management integrity and other matters is required to be made of all predecessor auditors. When a predecessor did not complete the audit, it is less likely the auditor will consider it appropriate to review the predecessor's workpapers. A written communication is not required and, whether or not a written communication is used, the auditor may find that oral inquiries concerning management integrity, possible noncompliance with laws and regulations, or disagreements on accounting or auditing matters promotes candor by the predecessor.

The degree of competition for the engagement and the adequacy of the fee are related. The more competition for the engagement, the greater the fee pressure is likely to be. In considering the adequacy of the fee, the auditor needs to consider that a construction contractor client often requires more accounting/bookkeeping assistance than a typical commercial business of comparable size. Many contractors keep their accounting records on a cash basis and only post direct labor and materials to contract costs. The auditor will often be expected to develop and propose those adjustments necessary to put the records on an accrual basis and otherwise conform with GAAP. Also, the financial reports contractors must provide to bonding agencies and lenders often contain extensive detailed schedules.

Another consideration in deciding to accept a client is the long-term viability of the contractor. In other words, does the contractor have the necessary resources to continue to operate in the long-term? Because there are usually significant start-up costs associated with beginning to provide services to a contractor, the auditor needs to consider whether the contractor will continue to use the CPA firm's services long enough to recoup those costs. Considerations include whether the contractor has the ability to attract new customers; has competent, reliable subcontractors; and has the ability to obtain adequate surety bonds.

An auditor might consider a potential contractor client worth pursuing in spite of uncertainty about fee adequacy if the auditor wants to develop experience, expertise, and a reputation in the area as a basis for securing other contractor clients. Generally, the amount of knowledge of the industry and its accounting, tax, and business practices that is required for an audit of a contractor makes it desirable for the auditor to have a broader contractor client base.

Deciding Whether to Retain an Existing Client. An auditor should reassess its continuing association with an existing contractor client each year. This decision is usually much easier than the initial acceptance decision because the auditor has experience with the contractor's financial reporting system and its ability to estimate costs, percentage of completion, and loss contracts. However, the auditor also needs to be aware of financial or operational changes that increase the risk of material misstatement of the financial statements or that adversely change the profitability of the engagement. As part of the auditors' process of updating knowledge of the entity and its environment, the auditor considers changes in the following:

- overall gross profit amounts and percentages for completed contracts and contracts in progress;
- types of projects;
- general geographic area of projects;
- status of significant claims;
- profit fade/gain on contracts in progress last year and this year;
- backlog;
- ability to obtain commercial general liability insurance; and/or
- surety bonding.

Most construction contractors were hit hard by the economic crisis that began in 2008. While many contractors have returned to a normal operating environment, that has not been the case for all segments and geographic

regions of the construction industry. Especially for those contractors, the auditor needs to carefully consider whether going concern is an issue.

Establishing the Terms of the Engagement

After a new or continuing engagement has been accepted, AU-C 210.09–.10 states that the auditor should agree on the terms of the engagement with management (or those charged with governance) and document that agreement in an audit engagement letter or another form of written communication. The documentation should include the following:

- The objective and scope of the engagement.
- Management's responsibilities.
- The auditor's responsibilities.
- A statement that due to the inherent limitations of an audit, combined with the inherent limitations of internal control, there is a risk that a material misstatement may not be detected.
- Identification of the applicable financial reporting framework.
- Reference to the expected form and content of reports to be issued by the auditor and a statement that circumstances may occur in which a report may differ from its expected form and content.

Generally, an engagement letter for a contractor client is not any different from one for other audit clients. However, matters of particular importance for a contractor client are the services to be provided, the timing of the engagement, and the client assistance to be provided in preparing schedules and assembling information on a timely basis.

The services to be provided to contractor clients should be listed because they are often more extensive than for other business clients. Generally, the auditor will be expected to provide accounting/bookkeeping assistance, prepare tax returns, and report on schedules prepared for bonding agencies, as well as audit and report on the financial statements. Construction contractors often include additional information with audited financial statements, generally at the request of bonding agencies or other lenders. AU-C 720, *Other Information in Documents Containing Audited Financial Statements*, and AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, address information accompanying the basic financial statements. The basic requirements of AU-C 725 applicable when a construction contractor engages the auditor to report on additional information, such as schedules prepared for bonding agencies. Auditors ought to cover these additional services in the engagement letter. (The provisions of ET 1.295, *Nonattest Services,* apply to nonattest services performed for attest clients.)

Also, in many states, the auditor will be expected to prepare prequalification and/or contractor license application filings. While the auditor is not required to bill separately for these services, many auditors find that doing so lowers client fee resistance. The client can see the fee for bookkeeping and tax services that could be eliminated by expanding its own staff. Also, many auditors who have not segregated their charges have lost audit clients to successor auditors who agreed to perform the "audit" for less. The successor then charges extra fees for the bookkeeping services.

Because interim work such as site visits and preliminary review of contracts is more common for contractor clients, it is worthwhile to indicate the dates of this work as well as the dates for beginning and completing final fieldwork. The client-prepared schedules that will be provided and their due dates are also often specified. Client management needs to be informed that delayed receipt of this information is likely to result in increased audit fees and a delayed audit report.

AUDIT PLANNING

Nature of Audit Planning

AU-C 300, *Planning an Audit*, establishes requirements for audit planning, including development of an overall strategy and audit plan, involvement of the engagement partner and team members, and consideration of whether

specialized skills are needed. Audit strategy is the auditor's operational approach to achieving the objectives of the audit. It is a high-level description of the audit scope, timing, and direction. It includes matters such as identifying material locations, contracts, and account balances, identifying audit areas and contracts with a higher risk of material misstatement, the overall responses to those higher risks, and the planned audit approach by area (for example, substantive procedures or a combined approach of substantive procedures and tests of controls).

Auditors generally establish a preliminary audit strategy before performing extensive risk assessment procedures based on knowledge from past experience with the client and the results of preliminary engagement activities. As auditors gather additional information through the performance of risk assessment procedures, they complete the overall audit strategy, including overall responses at the financial statement level.

Obtaining an understanding of the entity and its environment, including its internal control, is an essential part of planning the audit. An effectively planned audit is responsive to the assessment of the risk of material misstatement based on the auditors' understanding of the entity and its environment, including its internal control.

Audit planning also includes developing an audit plan (also called an audit program). The audit plan is more detailed than the audit strategy and documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence.

The Risk Assessment Process

The risk assessment process involves performing procedures, obtaining an understanding of various matters about the entity and its environment, and making decisions and judgments about assessed risks and other matters based on the understanding. Best practices indicate that it is useful to classify the audit planning requirements related to planning in the following categories:

- Procedures performed.
- Understanding obtained.
- Decisions and judgments made.

Procedures Performed. Risk assessment procedures include inquiry, analytical procedures, inspection, and observation as well as related planning activities and procedures, including preliminary engagement activities related to client acceptance and continuance, and holding a discussion among the engagement team. The auditor's consideration of fraud required by AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, is not separate from the consideration of audit risk but is integrated into the overall risk assessment process. That is, the assessment of risks due to error occurs simultaneously with the assessment of risks due to fraud. The key requirements of AU-C 240 are addressed at relevant points throughout this course.

Understanding Obtained. Risk assessment procedures are performed to obtain an understanding of the entity and its environment, including its internal control. The auditor obtains information about the following:

a. Industry, regulatory, and other external factors.

b. Nature of the entity.

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.

d. Measurement and review of the entity's financial performance.

e. Internal control, which includes the selection and application of accounting policies.

f. Fraud risk factors.

Decisions and Judgments Made. The information obtained by applying risk assessment procedures is used to make the important decisions and judgments that are part of audit planning. These decisions and judgments include determining materiality levels and assessing risks of material misstatement at the financial statement and relevant assertion levels.

Summary of Risk Assessment Process. Exhibit 1-1 summarizes the various elements in the risk assessment process in the categories of procedures performed, understanding obtained, and decisions and judgments made.

Exhibit 1-1

The Risk Assessment Process

Procedures Performed	Understanding Obtained	Decisions and Judgments Made
• Preliminary engagement activities. • Inquiries of management and others. • Preliminary analytical procedures. • Observation and inspection. • Discussion among the engagement team.	• Industry, regulatory, and other external factors. • Nature of the entity. • Objectives, strategies, and related business risks. • Measurement and review of the entity's financial performance. • Internal control. • Selection and application of accounting policies. • Fraud risk factors.	Decisions at the Financial Statement Level: • Materiality at the financial statement level. • Materiality for particular items of lesser amounts. • Risks of material misstatement at the financial statement level. • Overall audit strategy. Decisions at the Account Balance, Transaction Class, and Relevant Assertion Level: • Performance materiality. • Risks of material misstatement at the relevant assertion level, including identification of significant risks. • Nature, timing, and extent of further audit procedures (including tests of controls and substantive procedures).

* * *

The Sequence of Audit Planning

Because an audit of financial statements is an iterative process, audit planning is not a discrete phase of the audit. Audit planning continues throughout the audit even though many of the planning steps and procedures necessarily are performed at the beginning of the audit process. Audit planning begins with engagement acceptance and continues throughout the remainder of the audit. Also, many of the audit planning steps and procedures can be performed simultaneously and tend to blend together. Nevertheless, having a logical sequence of steps and procedures provides a useful framework. This approach is presented in Exhibit 1-2.

Exhibit 1-2

Steps in the Audit Process Related to Planning

Preliminary Engagement Activities

1. Perform procedures regarding acceptance or continuance of the client relationship and the specific audit engagement.

2. Evaluate compliance with ethical requirements, including independence.

3. Establish an understanding with the client and communicate in an engagement letter.

General Audit Planning at the Financial Statement Level

4. Establish preliminary audit strategy.

5. Determine the nature, timing, and extent of risk assessment procedures and perform the procedures.

6. Determine the materiality level for the financial statements taken as a whole (preliminary planning materiality) and materiality for particular items of lesser amounts.

7. Perform preliminary analytical procedures (a risk assessment procedure).

8. Hold a discussion among the engagement team.

9. Identify fraud risk factors, areas where special audit consideration may be necessary, and other areas where there may be higher risks for material misstatement.

10. Assess audit risk at the overall financial statement level.

11. Complete the overall audit strategy, including overall responses at the financial statement level.

Detailed Audit Planning at the Relevant Assertion Level for Account Balances, Transaction Classes, and Disclosures

12. Determine performance materiality (often in conjunction with Step 6).

13. Assess audit risk in relation to relevant assertions for transaction classes, account balances, and disclosures.

14. Develop a detailed audit plan for the nature, timing, and extent of further audit procedures.

* * *

Depending on the auditor's knowledge and past experience with the client, as well as other factors, certain planning steps might be performed at differing stages or sequences from one engagement to the next. For example, the sixth step, determine the materiality level for the financial statements taken as a whole, and the twelfth step, determine performance materiality, are often performed concurrently. Also, some auditors might choose to determine materiality (step 6) before performing risk assessment procedures (step 5) to help determine the areas of focus. For the eighth step, the discussion among the engagement team, the precise timing of this meeting can vary with the circumstances, and while it is usually more efficient and effective if it occurs relatively early in planning, it need not occur in any particular sequence. Although planning steps may occur in a slightly different sequence than illustrated in Exhibit 1-2, it is important that the auditor revisit judgments made earlier in planning as new information becomes available throughout the audit to determine the effect on risk identification, risk assessment, materiality, and further audit procedures.

Risk Assessment and Other Planning Procedures

AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, at AU-C 315.05, explains that the auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at both the financial statement and relevant assertion levels. Risk assessment procedures are focused toward gathering and evaluating information about the client and are not specifically designed as tests of controls or substantive procedures. Risk assessment procedures alone do not provide sufficient appropriate audit evidence on which to base an opinion. In all circumstances, further audit procedures are necessary to support an opinion.

Obtaining an understanding of the contractor and its environment, including its internal control, is an essential aspect of the consideration of risk. Thus, audit procedures performed to obtain that understanding are referred to

as *risk assessment procedures* because the information obtained by performing those procedures is used to support the auditor's assessment of the risk of material misstatement. Auditors normally consider the effectiveness of various types of risk assessment procedures in identifying risks during the planning process. A variety of risk assessment procedures are used when obtaining an understanding of the entity and its environment. For example, an auditor cannot limit his or her risk assessment procedures to only inquiry.

In addition to providing information about the contractor and its environment, including its internal control, the performance of risk assessment procedures may provide audit evidence about relevant assertions related to account balances, transaction classes, or disclosures, or about the operating effectiveness of controls. Therefore, risk assessment procedures may also serve as tests of controls or substantive procedures, or may be performed concurrently with those procedures. However, risk assessment procedures by themselves do not provide sufficient appropriate audit evidence to express an opinion on financial statements.

Types of Risk Assessment Procedures

AU-C 300 and AU-C 315, specifically identify the following audit procedures and related activities as necessary risk assessment and other planning procedures:

a. Preliminary engagement activities, including establishing an understanding with the client.

b. Inquiries of management, internal audit (if applicable), and others within the entity and those charged with governance.

c. Analytical procedures.

d. Observation and inspection, such as visits to the contractor's premises or job sites and tracing transactions through the information system (that is, walkthroughs).

e. Discussion among the engagement team.

All of the risk assessment procedures are performed when obtaining an understanding of the entity and its environment, but each of those procedures need not be performed for every component of the required understanding. The standards are explicit, however, in indicating that inquiry alone is not sufficient to evaluate the design and implementation of internal control. Therefore, observation and inspection will most likely be coupled with inquiry procedures when obtaining the understanding of internal control. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement is required by AU-C 315.11, and AU-C 240.15 expands on the discussion as it relates to brainstorming about susceptibility to material misstatement due to fraud.

Nature, Timing, and Extent—General Considerations. The nature, timing, and extent of some risk assessment procedures may be relatively consistent across audit engagements, but some procedures will need tailoring in response to the information gathered. For example, in all audits the auditor will make inquiries of management responsible for financial reporting about accounting policies and other aspects of the financial reporting process. However, determining others within the entity to whom related questions may be directed will depend on the circumstances and the specific information gathered about the entity. For example, if initial inquiries reveal that certain key control activities are performed at some job sites, the auditor will likely make further inquiries of job site personnel about the activities that take place at the job sites. Because of the relative consistency across contractor engagements, performance of some risk assessment procedures can begin without extended consideration of their nature, timing, and extent, but other aspects of the risk assessment procedures can only be determined after information is gathered about the particular contractor and its environment.

Gathering Information Needed to Identify Fraud Risks. In connection with obtaining an understanding of the contractor's business and the construction industry, auditors may become aware of information that is relevant to identifying fraud risks. In addition, auditors should perform the following procedures to obtain information that is used to identify fraud risks:

- Inquire of management and others in the company about the risks of fraud and how they are addressed.

- Consider the results of analytical procedures.

- Consider the existence of fraud risk factors.
- Consider certain other information.

Using the Results of Risk Assessment Procedures Performed in Prior Periods. Professional standards require the performance of risk assessment procedures to obtain an understanding of the entity and provide a basis for the assessment of risks. Can the auditor use information gathered from procedures performed in a prior period and limit the extent of current year procedures? Similarly, can information obtained from the auditor's previous experience with the client (for example, a review engagement performed in the previous year) be used in identifying risks of material misstatement? The answer to both questions is a qualified "yes."

The process of understanding the client's business and specific construction industry is continual. For a new engagement, a basic level of knowledge is needed to begin preliminary planning. However, a significant amount of knowledge is gained during the audit. The auditor's previous experience with the contractor also contributes to the understanding of the entity and its environment. Audit procedures performed in previous audits ordinarily provide useful audit evidence about the following:

- The contractor's organizational structure, business, and controls.
- Past misstatements and whether they were corrected on a timely basis.
- Significant changes from the prior period.

Information about past misstatements assists the auditor in assessing risks of material misstatement in the current audit. Before using information obtained in prior periods, however, AU-C 315.10 requires auditors to ascertain whether changes have occurred since the last audit that may be relevant in the current audit. The auditor is interested in identifying changes in personnel; procedures; processes; contracts; products or services; contingencies; facilities; nature of the business; ownership; management; financial condition; earnings pressures; conditions and events or operating results that are relevant to the going concern assumption; loan covenant compliance; litigation status; bonding status; control environment or activities; fraud risks; management attitude toward, or pressures on, the auditors; scope of the engagement; and any other internal or external conditions that might be of audit significance. These changes may change the client's business risk or the auditor's assessment of risks of material misstatement. The auditor performs risk assessment procedures in the current audit to determine whether changes have occurred that affect the relevance of information gathered in previous audits. For example, auditors might perform inquiries of client management and key client personnel, including accounting personnel outside the accounting department or other parties, supplemented by observation and inspection (for example, review of interim financial reports and job costs summaries and performing walkthroughs) to determine if changes have occurred. The nature, timing, and extent of procedures performed to update the understanding of the contractor's business and the construction industry may be affected by the significance of changes in certain matters from the prior period, the significance of the risks of material misstatement affected by the changes, and the availability of relevant and reliable evidence to support conclusions about any changes from the prior period.

The nature of the auditor's procedures always includes inquiries, observation, and inspection, but best practice indicate that the extent of risk assessment procedures will often be considerably less in continuing audit engagements than in initial engagements, consisting primarily of sufficient procedures to identify and evaluate changes. The extent of current period risk assessment procedures may need to be increased, however, in response to the following:

- The information relates directly to a past misstatement or risk of material misstatement identified in the prior year.
- Other information obtained through risk assessment procedures indicates a possible significant change in the current year.
- There is a greater likelihood that significant changes will occur given the nature of the information.

The following paragraphs address the risk assessment procedures listed earlier in this lesson and their role in identifying and assessing risk.

Inquiries of Management and Others

Inquiry of management and others is used extensively throughout the audit planning process. AU-C 315.06 specifically requires the auditor to make inquiries of management, internal audit (if such a function exists), and others within the entity who may have information that is likely to help in the identification of risks of material misstatement whether due to error or fraud. In many cases, inquiry serves as a foundation for the performance of other risk assessment procedures in that the responses obtained drive the need for additional or corroborating procedures. Inquiry consists of several elements—posing a question or requesting information on a matter, evaluating the response, and following up to obtain additional information as needed. As such, inquiry can be an extremely effective procedure in identifying risks. For example, an auditor might ask management about any changes in the contractor's construction processes or suppliers. The auditor would then evaluate the response obtained and determine if a potential risk exists. In this case, the auditor is concerned about potential warranty claims and, if so, a possible reserve. If the auditor deems that there is an indication of this risk, additional inquiries might be posed to further identify the risk and determine whether other risk assessment procedures are necessary.

Inquiry is a critical risk assessment procedure, but inquiry cannot be used alone when identifying and assessing risks. Auditors use a combination of inquiry, analytical procedures, and observation and inspection during the risk assessment process. Furthermore, auditors are prohibited from only using inquiry when evaluating the design and implementation of internal control.

Matters and Parties of Inquiry. The auditor should inquire of management and others in the entity about the following matters:

a. The contractor and its environment as enumerated in AU-C 315.

b. Fraud-related matters as enumerated in AU-C 240.

c. Related parties and related party transactions as enumerated in AU-C 550.

d. Accounting estimates as enumerated in AU-C 540.

e. Compliance with laws and regulations as enumerated in AU-C 250.

f. Communications from service organizations about fraud, noncompliance with laws or regulations, or uncorrected misstatements at the service organization that affect the entity's financial statements, as enumerated in AU-C 402.19.

g. The contractor management's preliminary evaluation of whether conditions or events exist that raise substantial doubt about the contractor's ability to continue as a going concern for a reasonable period of time.

Examples of the members of management that auditors may consider interviewing include:

- The owner/manager of a contractor.
- The president or chief executive officer.
- The controller.
- The chief financial officer.
- Component management, if applicable.

Inquiries of others within and outside the construction contractor entity, in addition to management and those charged with governance, are either required or can provide useful information. Examples of inquiries of others include the following:

a. *Those Charged with Governance.* Their involvement in the financial reporting process and how financial statements are used. AU-C 240.21 requires the auditor to inquire directly of those charged with governance (or the audit committee or at least its chair) about the risks of fraud and knowledge of actual, suspected, or alleged fraud.

b. *Internal Audit.* Activities concerning the design and effectiveness of internal control and management's responses to any findings by the internal audit function. AU-C 315.06 requires inquiry of appropriate internal audit personnel who may have information on risks of material misstatement due to fraud or error, or who can assist in identifying such risks. In addition, AU-C 240.19 requires inquiry of internal audit personnel about risks of fraud, knowledge of actual, suspected, or alleged, and activities concerning fraud detection, and whether management has satisfactorily responded to any findings.

c. *Other Employees.* Their role in the financial reporting process and additional or corroborating information to support management's responses. AU-C 240.A18–.A19 and AU-C 315.A7 include discussions of the benefits of inquiry and provide examples of others within the entity to whom the auditor might direct inquiries about the existence or suspicion of fraud. Auditors may consider obtaining the perspective of employees from different functional areas and at varying levels of authority when identifying risks of material misstatement. For construction contractors, project managers often are the operating personnel that can provide invaluable information to auditors about specific contracts and the client's business in general. It may also be useful to meet with personnel who report to the project manager. If a job site visit is not performed, the auditor may need to call the project manager or arrange a time to meet.

d. *Parties outside the Entity.* Inquiries of parties outside the entity are not required but are procedures that might be helpful. For example, the auditor might find it useful to make inquiries of external legal counsel or of valuation experts that management has engaged. The auditor might also find it useful to make inquiries of customers, suppliers, sureties, or regulators to better understand the nature of the entity and its operations.

Fraud-related Inquiries. The consideration of fraud in a financial statement audit is an integral part of obtaining an understanding of the entity and its environment and assessing the risks of material misstatement. AU-C 315.09 explains that during planning the auditor should consider the results of the fraud risk assessment along with the other information obtained as part of identifying the risks of material misstatements. AU-C 240.15 notes that the discussion among the engagement team required by AU-C 315 should include fraud brainstorming, and AU-C 315.29 also notes that the auditor should consider fraud risks in identifying significant risks. The inquiries of management made in audit planning, according to AU-C 240.17–.18, should include the following specific areas of inquiry:

- Whether they have knowledge of any actual, suspected, or alleged fraud.
- Management's process for identifying, responding to, and monitoring the risks of fraud in the entity.
- The nature, extent, and frequency of management's assessment of fraud risk and the results of those assessments.
- Any specific risks of fraud that management has identified or that have been brought to its attention.
- The classes of transactions, account balances, or disclosures for which a fraud risk is likely to exist.
- Management's communications, if any, to:
  - Those charged with governance on its process for identifying and responding to fraud risks.
  - Employees on its views on appropriate business practices and ethical behavior.

The areas of inquiry required by AU-C 240 include management's processes and assessment methods, as well as knowledge of identified risks or actual, suspected, or alleged fraud. Naturally, auditors give more weight to information about risks and knowledge of fraud if management has effective processes and assessment methods. As AU-C 240.A20 also notes, management is often best situated to perpetrate fraud. Thus, the responses of members of senior management concerning the likelihood of perpetration of fraud by them are far less meaningful than responses with respect to perpetration by lower levels within the entity.

In addition to inquiries of management, those charged with governance, and internal auditors, the auditor should direct inquiries to other employees to determine whether they are aware of fraud that is occurring or have

suspicions of fraudulent activity. Deciding which employees to make inquiries of and the extent of those inquiries is a matter of professional judgment that depends primarily on whether the auditor believes those employees may provide information that is relevant to identifying fraud risks. Making inquiries of employees outside the accounting department or those at varying levels of authority may be useful in providing a different perspective about the risks of fraud. Their responses may corroborate responses received from management or the owner/manager, or may provide information about the possibility of management override of controls.

Because management or the owner/manager is often in the best position to perpetrate and conceal fraud, the need for professional skepticism in making the auditor's inquiries of management cannot be overemphasized. Generally, it is necessary to corroborate responses, especially those of management or the owner/manager. Additional audit evidence may be necessary to resolve any inconsistencies among responses.

Related Party Inquiries. Although many related party transactions occur in the ordinary course of business, some related party relationships and transactions may give rise to higher risks of material misstatement than transactions with unrelated parties. As a result, AU-C 550, *Related Parties* at AU-C 550.14 requires the auditor to make specific inquiries of management and others regarding related parties. In addition, auditors are required by AU-C 550.15 to inquire of management and others within the entity and perform other risk assessment procedures as needed to understand the controls over related party relationships and transactions.

Inquiries about Accounting Estimates. Because of the nature of accounting estimates, there can be a high degree of estimation uncertainty. As a result, AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*, at AU-C 540.08 indicates that when obtaining an understanding of how management identifies transactions, events, and conditions requiring accounting estimates, the auditor should make inquiries of management about whether any changes in circumstances have occurred that may give rise to new accounting estimates or the need to revise existing estimates.

Inquiries about Compliance with Laws and Regulations. AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, at AU-C 250.14, requires the auditor to inquire of management and those charged with governance about whether the entity is in compliance with laws and regulations that may have a material indirect effect on the financial statements and to inspect relevant correspondence with licensing and regulatory authorities. The focus of the auditor's inquiries is on laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements. Compliance with those laws and regulations may be fundamental to the operating aspects of the entity, fundamental to an entity's ability to continue as a going concern, or necessary for the entity to avoid material penalties. Examples relevant to construction contractors include compliance with an entity's operating license and with laws or regulations related to occupational safety and health (OSHA), labor relations (DOL, USDA), environmental protection (EPA), employee relations (Department of Health and Human Services, Department of Homeland Security, EEOC), and others. The auditor may also inquire about the entity's policies and procedures regarding compliance with laws and regulations (including the prevention of noncompliance); the policies or procedures adopted for identifying, evaluating, and accounting for litigation claims; and the use of directives and periodic representations obtained from management at appropriate levels of authority concerning compliance with laws and regulations.

Inquiries Related to Service Organizations. AU-C 402.19 requires the auditor to inquire of management about whether a service organization has reported to them, or whether they are otherwise aware of, any fraud, noncompliance with laws and regulations, or uncorrected misstatements at the service organization that affect the financial statements of the user entity. The auditor should evaluate how such matters, if any, affect the nature, timing, and extent of further audit procedures. If the auditor needs additional information to perform this evaluation, it may be necessary to ask the user entity to contact the service organization to obtain the necessary information.

Documentation. There are no specific documentation requirements for inquiries made as risk assessment procedures, but AU-C 230, *Audit Documentation*, provides pertinent guidance. AU-C 230.09 indicates that in documenting the nature, timing, and extent of audit procedures, the auditor should record the identifying characteristics of the items or matters tested. Additionally, AU-C 230.09 indicates that auditors should record who performed the audit procedures and when the work was completed, as well as who reviewed the audit work performed and the date and extent of such review. AU-C 230.A14 suggests that, for a procedure involving inquiries of entity personnel, the auditor records the inquiries made, the dates of inquiries, and the names and job designations of the personnel. Best practices suggest documenting such matters when performing risk assessment inquiry procedures.

Analytical Procedures

AU-C 315.06 specifies that risk assessment procedures should include analytical procedures, and AU-C 315.A14 notes that analytical procedures performed as risk assessment procedures may encompass both financial and nonfinancial information. AU-C 315.A15–.A16 explains that unusual or unexpected relationships identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud, but when analytical procedures use data aggregated at a high level, the results provide only a broad initial indication about whether a material misstatement may exist.

Knowledge of the client and its environment is interrelated with the use of analytical procedures in audit planning. Performing effective preliminary analytical procedures requires the auditor to understand the contractor's business and the construction industry to know what relationships would be expected to exist, what relationships would be considered unusual or unlikely, and what plausible explanations might exist for observed relationships. That knowledge is also important in assessing the significance of differences from expected relationships. For that reason, the auditor generally needs an understanding of the construction industry and the company's operations before performing preliminary analytical procedures. The auditor's knowledge and understanding of the client can also be improved by applying preliminary analytical procedures in audit planning. The use of any particular analytical procedures is not required. The sophistication, extent, and timing of analytical procedures may vary widely, depending on the size and complexity of the client. Analytical procedures might include analysis of ratios or trends related to profitability, liquidity, solvency, and contract activity combined with inquiries of financial and operating management.

When the results of preliminary analytical procedures indicate the existence of unusual or unexpected relationships, the auditor considers those results in identifying risks of material misstatement of the financial statements due to fraud. The imaginative use of analytical procedures can be useful in refining the risk assessment for detecting a misstatement. If the auditor focuses on trends that are difficult or impossible to manipulate by the perpetrator, analytical procedures will generally be more effective. Volume data trends need to exhibit a logical relationship to reported amounts. For example, for a highway contractor, the auditor could analyze the average material cost per square foot. The same type of analysis could be performed for the following:

- The number of employees and direct labor costs.
- The number of major pieces of equipment and the equipment overhead costs.
- The ratio of materials cost to total contract costs for similar contracts.

Financial statement accounts are often linked in an operating cycle that should result in plausible, persistent relationships. For example, if direct labor and materials costs are increasing but the gross profit percentages on fixed fee contracts are also increasing, the auditor needs to question why and regard the client's response skeptically. Management may explain that the number of competitors has decreased allowing the contractor to make bids with a higher profit percentage and still be awarded the contracts. The auditor could validate the client's response, for example, by reviewing the bid spreads and bids on comparable projects from prior years. Additionally, the auditor could compare the list of competitors from prior years to a current listing to verify the decline in competitors.

Very few contractors actually keep their books on a GAAP basis. Many small contractors maintain their general ledgers in accordance with methods used to file their tax returns, which might be the cash basis, accrual basis, or completed-contract basis of accounting. Regardless of size, very few contractors actually use a pure percentage-of-completion basis of accounting throughout the year. Thus, performing a preliminary analytical review by comparing the prior year's audited financial statements to the current year's general ledger may have no meaning. Before performing such an analysis, the auditor may need to estimate the adjustments needed to prepare GAAP-based financial statements.

Industry statistics may be helpful for comparison purposes. Many construction contractors report to an industry-specific national organization (such as the Associated General Contractors of America or the American Subcontractors Association) that can provide relevant statistical information. The auditor can ask the contractor which industry data would be most comparable to its business.

Performing preliminary analytical review for a construction contractor generally involves calculation of some unique ratios such as the following:

- Contract revenues to working capital $\frac{\text{Contract Revenues}}{\text{(Current Assets – Current Liabilities)}}$
- Overbillings to underbillings $\frac{\text{Overbillings}}{\text{Underbillings}}$
- Months in backlog $\frac{\text{Total Contract Backlog}}{\text{(Annual Revenue} \div 12)}$
- Revenues to net worth $\frac{\text{Contract Revenues}}{\text{Stockholders' Equity}}$
- Net fixed assets to net worth $\frac{\text{Net Fixed Assets}}{\text{Stockholders' Equity}}$
- Cash to overbillings $\frac{\text{Cash}}{\text{Overbillings}}$

In addition to analysis of ratios, the auditor needs to be alert for unexpected changes in key financial/nonfinancial relationships. For example, is there a corresponding change in direct labor costs based on the change in the number of employees? Is there a significant difference between gross profit on completed contracts and gross profit on contracts in progress? Has the change in purchasing versus leasing construction equipment affected the percentage of direct and indirect costs charged to contracts?

Analytical Procedures Related to Revenue. AU-C 240.22 requires auditors to perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. The auditor also needs to consider the absence of expected changes. For example, the client's financial statements do not reflect downward trends of gross profit experienced by other contractors in the client's peer group. Ordinarily, comparison of current and prior-period account balances for revenue accounts are not sufficient to achieve that objective, and other types of analytical procedures are used. Analytical procedures related to revenue that may be useful in identifying unusual or unexpected relationships include:

- *Trend Analysis.* Auditors may analyze trends in the components of revenue accounts or transaction types. It may be helpful to look at several trends or relationships to identify inconsistencies or unusual patterns. For example, the gain/fade analysis discussed later in this lesson reveals unusual trends during the contract's life or overall trends in gross profit may indicate fraudulent financial activity.

- *Ratio Analysis.* Ratio analysis is the analysis of relationships between financial statement items by computing the ratio of one financial statement amount to another. The ratio may be compared to the same ratio for a prior period (or several prior periods) to identify unusual or significant variations. Ratios that use information management generally is unable to manipulate, such as cash flows may be most effective in revealing indications of fraudulent financial reporting.

- *Analysis of Relationships between Financial and Nonfinancial Amounts.* When comparing financial and nonfinancial amounts, it may be most effective to use a base that (a) would be expected to have a reasonable relationship to revenue and (b) could not easily be manipulated by management or the owner/manager. For example, auditors may compare contracts in progress or revenue per project manager (or full-time equivalents). In addition, components, such as equipment or labor may be used to measure capacity.

- *Budgetary Comparison.* Comparison of actual amounts with budgets or contract estimates may also indicate unusual variations. For example, revenue might significantly exceed budget because of improper revenue recognition.

Analytical procedures related to revenue should be updated in the final review stage of the audit.

In the audit of a construction contractor, the focus is on individual contracts, and the most useful analytical procedures are those that improve the auditor's understanding of the relative risks associated with contracts. A useful starting point is to consider the aggregate gross profit amounts and percentages for completed contracts and contracts in progress. By comparing the contractor's total gross profit for the period with the portion of gross profit from completed contracts and the portion of gross profit from contracts in progress, the auditor can make an overall assessment of the portion of gross profit subject to the risks and uncertainties of the estimating process.

Generally, the greater the percentage of gross profit from contracts in progress, the higher the risk of material misstatement and the more extensive the audit scope required. The comparison of gross profit on completed contracts versus gross profit on contracts in progress also allows the auditor to assess the consistency of gross profit earned and trends in gross profit.

Profit Gain/Fade Analysis and Bid Spread Analysis. The auditor needs to analyze the contractor's estimating abilities by scanning the details of contracts completed during the year and contracts in progress. The contractor's estimating ability is always important and is especially critical when a relatively large portion of gross profit is from contracts in progress. The auditor considers the contractor's estimating abilities in two areas: (a) the initial estimate of contract costs used in bidding and (b) the estimates of contract progress and costs to complete during the construction process.

The analysis of the estimating process is generally an important part of the audit of a construction contractor. One common analytical procedure used to assess the accuracy of estimates is the profit gain/fade analysis. This analysis involves reviewing the trends in contract gross profit during annual or interim periods throughout each contract's life. (See Exhibit 1-3 for an example of a profit gain/fade worksheet.) The auditor looks for unusual variations or trends during the contract's life, as well as the overall trends in contract gross profit. If the contract gross profit tends to fade significantly (for example, 10% or more) for many of the contracts, that may suggest that the client is overly optimistic in estimating costs and profits on its contracts. Alternatively, unusual patterns noted during the review of the contractor's profit gain/fade analysis could be indicative of material misstatements.

Analyzing the profit gain/fade on contracts may also reveal information regarding the contractor's bidding habits. Bidding on contracts is a competitive process. When a majority of completed contracts result in profit gain, it might be an indication that the contractor is bidding too conservatively. Contractors that bid too conservatively could be losing bids. Alternatively, when a majority of completed contracts result in profit fade, it might indicate that the contractor is bidding too aggressively. A consistently aggressive bidding strategy could impact the ability of the contractor to remain in business.

When there is a significant or unusual gain or fade on a contract, the auditor needs to investigate the cause. For example, a review of the profit gain/fade analysis at Exhibit 1-3 should consider the following (not intended to be all-inclusive):

- What is the cause of the large increase in the gross profit amount and percentage on Contract 202?
- Why did Contract 523 have the significant profit margin decline in Year 20X3?
- Why has the incidence of contracts with a profit fade increased in Year 20X3?

Exhibit 1-3

Example Profit Gain/Fade Analysis

Contract	Estimated/actual Gross Profit—20X0		Estimated/actual Gross Profit—20X1		Estimated/actual Gross Profit—20X2		Estimated/actual Gross Profit—20X3		Contract-to-date Profit Gain (Fade)		Gain (Fade) 20X1	Gain (Fade) 20X2	Gain (Fade) 20X3
	$	%	$	%	$	%	$	%	$	%	$	$	$
101	$ 13,198	8.2%	$ 20,511	15.4%	—	—	—	—	$ 7,313	55.4%	$ 7,313		
102	26,910	4.1%	50,920	3.8%	47,110	3.5%	—	—	20,200	75.1%	24,010	(3,810)	
202	177,970	3.4%	187,002	3.1%	216,320	3.4%	227,086	3.7%	49,116	27.6%	9,032	29,318	10,766
203	35,534	8.7%	32,852	7.0%	—	—	—	—	(2,682)	(7.5%)	(2,682)		
307			68,313	5.6%	71,711	6.1%	—	—	3,398	5.0%		3,398	
308			175,399	11.9%	183,128	12.7%	—	—	7,729	4.4%		7,729	
409			100,576	5.4%	129,968	7.3%	119,252	6.6%	18,676	18.6%		29,392	(10,716)
410					112,475	5.6%	115,759	5.6%	3,284	2.9%			3,284
523					283,749	3.9%	218,250	2.0%	(65,499)	(23.1%)			(65,499)
536					137,168	5.5%	131,345	5.1%	(5,823)	(4.2%)			(5,823)
606					107,200	17.0%	124,376	19.6%	17,176	16.0%			17,176
607					257,074	6.2%	251,248	3.7%	(5,826)	(2.3%)			(5,826)
745					101,806	3.7%	145,801	3.8%	43,995	43.2%			43,995
780							145,018	5.6%					
833							102,312	4.8%					
834							216,206	4.4%					
	$ 253,612		$ 635,573		$ 1,647,709		$ 1,796,653		$ 91,057		$ 37,673	$ 66,027	$ (12,643)

* * *

The auditor needs to be alert for contracts in a profit position at the end of the preceding period that deteriorate to a loss or break even position at the end of the current period. If this type of deterioration occurs with any consistency, the client's estimating process is probably unreliable. In these circumstances, there is a high risk of material misstatement, and the auditor will need to expand the detailed testing of estimates of costs to complete. Conversely, if the profit fade/gain analysis indicates the client's estimating process is highly reliable, the auditor may assess the risk of material misstatement as low and reduce the extent of detailed testing of estimates of costs to complete.

For contractors with more than a few contracts, it is often useful to analyze contracts by project manager, owner, type of contract, etc., when looking for trends. For example, if a large contractor with several project managers is experiencing significant profit fade on some of its contracts, further analysis may reveal that significant fade is occurring only on the contracts supervised by a particular project manager. In this instance, testing may need to be expanded only on the contracts supervised by that project manager.

Another analytical procedure that is directed primarily at the bidding process is the bid spread analysis, which involves the following steps:

a. Review the contracts the client has been awarded during the audit period.

b. For each of those contracts, determine the bid submitted by the next lowest bidder. Other parties' bids can be obtained through public records (for government contracts), industry contacts, sureties, or the client (although client-supplied information should be supported by copies of bid documents or other evidence).

c. Compare the client's bid to the next lowest bidder.

d. Inquire about significant bid spreads (that is, instances in which the client's bid was significantly lower than the next lowest bidder).

A large bid spread does not always lead to financial statement misstatement. However, it may suggest that the client failed to consider certain required costs in preparing the bid or that the client may have difficulty achieving its estimated profit on that contract.

Cash Flow Analysis by Contract. The auditor may gain a better understanding of the contractor by analyzing its cash flow on each contract on a quarterly or annual basis. An example of a cash flow analysis by contract is presented in Exhibit 1-4. Depending on the size of the contractor, it may be helpful to group contracts by type of construction, project manager, or size of contract. This analysis highlights a contractor's strength or weakness in negotiating the timing and frequency of billings on its contracts. However, for those contractors that are only able to bill when the work is completed, such as smaller subcontractors, this analysis may not be as beneficial because those contractors normally experience a negative cash flow on each project.

Documentation. Documentation of preliminary analytical procedures can be limited, but it needs to be sufficient to provide support for the auditor's risk assessment. The results of the preliminary analytical review ordinarily are documented using a narrative memorandum, comparative carryforward schedule, or other form of workpaper. Documentation may also include the effect on the audit plan or indicate that the results should be considered when identifying fraud risks.

Exhibit 1-4

Example Cash Flow Analysis by Contract

Contract	Total Contract Amount	Total Estimated Cost	Estimated Gross Profit	Billings to Date	Contract Receivables[a]	Cash Collected to Date	Costs to Date	Accounts Payable	Cash Paid to Date	Net Cash Flow	Cash Flow to Contract Amount	Cash Flow to Gross Profit
500	$ 500,000	$ 450,000	$ 50,000	$ 500,000	$ 50,000	$ 450,000	$ 446,700	$ 85,350	$ 361,350	$ 88,650	17.7%	177.3%
501	275,000	210,000	65,000	275,000	30,000	245,000	222,100	45,600	176,500	68,500	24.9%	105.4%
602	350,000	310,000	40,000	225,000	45,000	180,000	240,000	25,000	215,000	(35,000)	−10.0%	−87.5%
603	115,000	85,000	30,000	65,000	0	65,000	70,000	15,000	55,000	10,000	8.7%	33.3%
605	180,000	160,000	20,000	100,000	20,000	80,000	110,000	32,500	77,500	2,500	1.4%	12.5%
608	750,000	625,000	125,000	300,000	45,000	255,000	260,000	35,400	224,600	30,400	4.1%	24.3%
609	425,000	380,000	45,000	320,000	40,000	280,000	311,300	25,900	285,400	(5,400)	−1.3%	−12.0%
610	300,000	230,000	70,000	125,000	25,000	100,000	122,600	15,800	106,800	(6,800)	−2.3%	−9.7%
623	160,000	135,000	25,000	60,000	12,500	47,500	92,500	18,600	73,900	(26,400)	−16.5%	−105.6%
636	245,000	215,000	30,000	175,000	25,000	150,000	110,000	18,900	91,100	58,900	24.0%	196.3%
	$ 3,300,000	$ 2,800,000	$ 500,000	$ 2,145,000	$ 292,500	$ 1,852,500	$ 1,985,200	$ 318,050	$ 1,667,150	$ 185,350		

Note:

[a] Retainage is also included in this amount.

* * *

Observation and Inspection

According to AU-C 315.06, risk assessment procedures should include observation and inspection. There are a number of ways to use observation and inspection when assessing risk. When obtaining an understanding of the contractor and its environment, observation or inspection might be the key procedure that enables the auditor to fully obtain pertinent information and identify related risks. For example, to gain an understanding of the client's financing arrangements and underlying covenants, the auditor might decide to review the client's loan agreements and other related documents. That procedure, coupled with a review of the client's financial statements, might be the key procedure that helps the auditor identify risks related to potential noncompliance with loan covenants.

More frequently, observation and inspection are used to corroborate or follow-up on the results of inquiries made of management and others. For example, when evaluating the design and implementation of the entity's system of internal control, members of management might tell the auditor that they communicate the importance of ethical values to employees through a written code of conduct and by example. The auditor might wish to corroborate this response by examining the written code. In addition, the auditor may determine that a risk exists based on observation of management's current and past interactions with employees that contradict the behavior standards in the written code.

Other than the requirement to perform some observation and inspection procedures related to internal control, however, determining when to use observation and inspection, as opposed to other risk assessment procedures, is generally a matter that is left to the auditor's judgment. Ordinarily, best practices indicate that observation and inspection procedures are effective in the following situations when obtaining an understanding of the contractor:

- To understand the design of controls related to the audit.
- To verify that controls have been implemented, for example, as part of a walkthrough.
- When responses to inquiries indicate a potential risk for a significant account.
- When responses to inquiries are inconclusive, conflicting, or prove to be incorrect.
- In combination with inquiry to fully understand a matter.
- When necessary information can only or best be obtained through observation or inspection (for example, understanding the client's construction processes might best be done through observation.)
- When the evidence gathered through observation and inspection can also be used for a substantive procedure.
- In recurring engagements, to determine whether changes have occurred that affect the continued relevance of the information gathered in a prior period.

Documentation. AU-C 230.09 requires documentation of the identifying characteristics of specific items tested, and AU-C 230.A14 provides examples of how this might be accomplished. Based on that guidance, best practices suggest documenting the following:

- For an inspection of documents, identify the item inspected, for example, by indicating the title and date of the report or the document name and number. (To facilitate inquiring about or requesting copies of the report or document at a later time, best practices suggest referring to the report or document by the same name that the client uses to refer to it.)
- For an observation procedure, document the process or subject matter observed, individuals involved and their titles, and where and when the observation was carried out.

Discussion among the Engagement Team

AU-C 315.11 requires the key members of the audit team (including the engagement partner) to discuss the susceptibility of the contractor's financial statements to material misstatements and the application of GAAP to the

entity's facts and circumstances. AU-C 240.15 requires an open exchange of ideas, or *brainstorming* among audit team members about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. These discussions can be held concurrently, that is, one meeting can cover the susceptibility of the financial statements to material misstatements from both error and fraud. However, it is important that the auditor consider the susceptibility to fraud as a distinct part of this combined discussion to avoid the potential dilution of this critical consideration.

The focus of the audit team discussion is on the individual members gaining a better understanding of the potential for material misstatements resulting from error or fraud in the specific areas assigned to them, and understanding how the results of audit procedures they perform affect other aspects of the audit. In this discussion, the more experienced members of the audit team can share their insights based on their cumulative knowledge of the contractor, the construction industry, and its environment.

Matters to be Discussed. The engagement team discussion is aimed at the susceptibility of the financial statements to material misstatement (including the application of GAAP), that is, the areas of vulnerability. The discussion is one of the sources of information used to assess the risks of material misstatement. Thus, the discussion ought to open the minds of members of the audit team to potential material misstatements from error and, particularly, from fraud. Any high risk areas that have already been identified, however, also need to be communicated to the team members.

The following matters are specifically required to be discussed during the engagement team discussion:

- The susceptibility of the entity's financial statements to material misstatement.
- The application of GAAP to the entity's facts and circumstances in light of its accounting policies.
- The susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions.
- Fraud-related matters.

In addition, focusing on the areas of vulnerability, the engagement team discussion might include the following topics:

a. Critical issues and areas of significant audit risk.

b. Areas susceptible to management override of controls.

c. Unusual accounting practices used by the client.

d. Important control systems.

e. Significant IT applications and how the use of IT may affect the audit.

f. Materiality levels and how materiality will be used to determine the extent of testing.

g. The need to exercise professional skepticism throughout the engagement, to be alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred, and to be rigorous in following up on such indications.

Best practices indicate that the discussion also needs to address how the business risks facing the client could result in a material misstatement of the financial statements, focusing especially on changes from the prior year and new developments. During the discussion, the audit team focuses on how knowledge of the client's business risk would affect audit procedures by identifying the accounts that would be affected and the nature of procedures that could be performed to address the risks. Considering business risks enhances the auditor's ability to identify risks of material misstatement. However, the auditor need not identify or assess all business risks facing the client.

Although most business risks will eventually have financial consequences that affect the financial statements, not all business risks give rise to risks of material misstatement.

The auditor of a construction contractor ought to give focused attention to whether management is under significant pressure, for example, to maintain a certain amount of working capital because of bonding requirements by the contractor's surety; to transfer costs from one contract to another to avoid showing a loss on a contract; or to improperly inflate the estimated gross profit on contracts in progress.

Examples of other factors the engagement team might discuss that affect the likelihood of material misstatements caused by error include the following:

- Past experience with the client (including areas with audit difficulty and misstatements encountered).
- Changes in the client's organization (for example, changes in personnel or accounting systems).
- The nature and complexity of transactions.
- Known accounting and auditing issues.

In addition to discussing important control systems, it may be appropriate to discuss potential risks that may exist due to limitations in the client's personnel and assignment of responsibilities. For some smaller entities, the engagement team might consider issues regarding the background and competence of individuals in key processing and financial decision-making roles especially if concerns had been noted in previous audits.

Related Parties. AU-C 550.13 specifically requires auditors, as part of the engagement team discussion, to consider how related party relationships and transactions could affect the susceptibility of the financial statements to material misstatement. AU-C 550.A7–.A8 indicates that the team discussion might include the following related party matters:

- Nature and extent of the entity's relationships and transactions with related parties.
- Importance of maintaining professional skepticism regarding related parties throughout the audit.
- Circumstances or conditions that may indicate the existence of unidentified related party relationships or transactions.
- Types of records or documents that might indicate the existence of related party relationships or transactions.
- Importance that management and those charged with governance attach to the identification of, accounting for, and disclosure of related party relationships and transactions and the related risk of management override.
- How related parties might be involved in fraud.

Best practices suggest that the discussion include reminding the engagement team that if related parties or significant related party transactions are identified by the auditor that were not previously identified and disclosed by management, the engagement team is required by AU-C 550.23 to promptly communicate such information to other team members. Also, AU-C 550.23 requires that the auditor inquire of management as to why applicable controls over related party relationships and transactions failed to identify and disclose such information.

Fraud-related Matters. AU-C 240.15 indicates that the discussion should also include the following fraud-related matters:

- How and where the entity's financial statements (for example, which accounts or transaction classes) might be susceptible to material misstatement due to fraud.

- How the entity's assets could be stolen.
- External and internal factors that might create incentives/pressures, provide opportunities, or enable rationalization of fraud.
- Risk of management override of controls.
- Circumstances that might be indicative of earnings management or manipulation of other financial measures.
- Practices management might use to manage earnings or other financial measures that could lead to fraudulent financial reporting.
- How the auditor might respond to the susceptibility of the financial statements to material misstatement due to fraud.
- Importance of maintaining professional skepticism regarding potential for material misstatement due to fraud.

The fraud aspect of the discussion ought to give appropriate consideration to financial statement misstatement from both fraudulent financial reporting (i.e., "cooking the books") and stealing. A key consideration when assessing fraud risk is what motivations may exist for management to intentionally misstate the financial statements or what controls may be lacking that could result in theft. By identifying the motives and opportunities for fraud, the auditor should be able to assess the direction of the risk. For example, if the auditor identifies an unusual motivation for management to maximize earnings and show a consistent growth trend because the entity intends to offer shares to the public in the near future, the auditor may determine that the risk is overstatement of assets and earnings. Also, a high level of outside interest in the financial statements increases the incentive for fraudulent financial reporting. When considering fraud risk factors for a construction contractor, one or more of the following situations may be present that increase such risk:

- Sureties or bonding agents determine the contractor's bonding capabilities.
- The entity is a joint venture between two or more entities.
- The entity is involved in high-profile construction projects.

AU-C 240.15 requires that the discussion also include the appropriate audit response to the areas identified as susceptible to material misstatement due to error or fraud (for example, by identifying the accounts that would be affected and the nature of procedures that could be performed to address the risks).

The discussion should include an open exchange of ideas (that is, *brainstorming*). AU-C 240.15 indicates that participants should set aside their beliefs that management and others are honest and have integrity, and maintain an attitude of professional skepticism throughout the discussion. Both AU-C 315 and AU-C 240 refer to a discussion; therefore, one-sided communication, such as a memo from the engagement partner, is not appropriate. (However, when the entire engagement is performed by a single auditor, the auditor might simply consider and document the susceptibility of the entity's financial statements to material misstatements.) The medium for discussion (for example, a meeting or a conference call) ought to encourage interaction and an appropriate exchange of ideas. AU-C 240.15 indicates that communication about the risks of material misstatement is not limited to that discussion, but should occur throughout the audit.

AU-C 240.12 indicates that, in accordance with AU-C 200, throughout the audit, the auditor should exercise professional skepticism and recognize the possibility of a material misstatement due to fraud regardless of any beliefs about the honesty and integrity of management and those charged with governance gained from past experience. AU-C 200.14 defines *professional skepticism* as "an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence." Thus, auditors ought to actively consider how management could perpetrate and conceal fraudulent financial reporting. For example, auditors may use "what if" scenarios that focus on the financial statement areas

vulnerable to fraud with the presumption that management or employees are inclined (either because of incentives/pressures or attitudes/rationalizations) to perpetrate fraud. According to AU-C 200.A26, the auditor's belief that management and those charged with governance are honest and have integrity does not mean that the auditor is allowed to be satisfied with less than persuasive audit evidence.

Effect on Significant Audit Areas. After discussing the risks that could result in a material misstatement of the financial statements and determining how those risks affect specific audit areas, best practices suggest that the engagement team then discuss each significant audit area. The team ought to focus on the real risks affecting each area and determine the most effective and efficient audit procedures that address those risks. Members of the audit team need to avoid relying on what procedures were performed during the prior year audit when discussing what procedures to perform in the current year. In fact, it may be best to ignore the prior year workpapers when initially discussing each significant area. That way, the audit team starts with a clean slate when developing the audit approach and avoids the temptation to just rely on "what we did last year." The result is usually a more effective and efficient audit approach. However, after the team has discussed each significant area, the prior year workpapers can be reviewed to make sure there are not any issues that were overlooked.

Who Attends the Discussion? Key members of the engagement team need to participate in a single discussion, and the engagement partner determines what matters will be communicated to other team members. In addition, it may be appropriate to include specialists, such as IT specialists, assigned to the engagement team. Executive level team members generally are aware of significant accounting and auditing issues that could affect the audit, while staff members or specialists may be more familiar with the client's accounting systems and controls. Both perspectives are important in considering the susceptibility of the financial statement to material misstatements from error or fraud. Best practices suggest that all members of the engagement team, including specialists with an ongoing role in the engagement, participate in the discussion. Also, the discussion may include component auditors and consideration of how matters discussed apply to components. The engagement team, however, does not include external specialists engaged by the auditor or individuals within the internal audit function who provide direct assistance to the auditor on the audit engagement.

When Does the Discussion Occur? Before holding the discussion with the engagement team, best practices suggest the engagement partner have preliminary planning discussions with the client. Issues to discuss with the client include the services to be provided, scheduling, and other administrative matters. In addition, the auditor can discuss the client's business environment (particularly changes from the prior year), the client's view of the business risks that the client is addressing, the status of significant contracts, and other specific issues facing the client. The auditor can also obtain additional information to be used in the planning process prior to meeting with the engagement team. Specific information to obtain includes the following:

a. Interim financial information.

b. Client budgets and any related operating and strategic planning documents.

c. Minutes of board of directors meetings.

d. Copies of new debt or other significant agreements or contracts.

e. Significant internal audit reports.

f. Schedule of contracts completed during the year and currently in progress.

Also, if an engagement summary memo was prepared for the prior year audit, it can be reviewed before the engagement team discussion to identify risk areas identified in the prior audit.

The schedule of contracts completed during the year and currently in progress is an important source of information in a construction contractor audit. The schedule will allow the audit engagement team to discuss the timing and location of any job site visits. In scrutinizing this information, the engagement team should focus on the risks, including the risk of fraud, associated with each contract, the classification of each contract, and the audit procedures that will be performed to address each risk.

Within the context of AU-C 240 and AU-C 315, it is clear that the discussion among the engagement team is expected to occur during the performance of risk assessment procedures as part of audit planning, but the exact timing is not specified. Best practices suggest holding the discussion prior to performing the information-gathering procedures discussed later in this lesson. It is important to set the proper tone of professional skepticism and to inform less experienced staff members about the risks of material misstatement before performing those procedures. However, nothing prevents the firm from holding discussions both before and during the information-gathering process. These decisions are normally made by the engagement partner, and firms exercise professional judgment to determine what works best in their particular audit process. In any case, engagement team members communicate and share information obtained throughout the audit about the risks of material misstatement due to error or fraud.

Other Matters That May Be Discussed. While not a requirement of AU-C 240 or AU-C 315, the auditor might also use the engagement team discussion as an opportunity to consider other planning matters related to the audit. Those items could include, but are not to limited to, the following:

a. Critical dates and other timing considerations.

b. Engagement budgets.

c. Key client contacts for assigned areas.

d. Other engagement administrative matters.

e. Other services that will be provided.

AU-C 220.17 requires the engagement partner to take responsibility for the direction, supervision, and performance of the audit engagement, while AU-C 220.A12 further clarifies that *direction* of the engagement team involves informing team members of certain matters. The engagement partner typically informs the engagement team of matters such as the following:

- Their responsibilities, including complying with relevant ethical requirements and applying professional skepticism when planning and performing the audit.
- If more than one partner is involved with the engagement, each of their responsibilities.
- Objectives of the work to be performed.
- Nature of the entity's business.
- Risk-related issues.
- Problems that could arise.
- Detailed audit approach to performing the engagement.

The engagement team discussion also provides an opportunity for the engagement partner to remind the audit team members of the audit documentation requirements of AU-C 230. Among the matters that might be covered are the following:

a. Inclusion of abstracts or copies of significant contracts or agreements examined to evaluate the accounting for significant transactions.

b. Identification of items tested in tests of operating effectiveness of controls.

c. Identification of documents inspected or items confirmed in substantive tests of details.

d. Documentation relating to substantive analytical procedures.

e. Documentation relating to consideration of the entity's ability to continue as a going concern.

f. Documentation of the nature and effect of aggregated misstatements and the conclusion as to whether they cause material misstatement of the financial statements.

g. Documentation of who performed and reviewed the audit work and the date the work was performed and reviewed.

Documentation. AU-C 315.33 requires that the following items be documented regarding the discussion among the audit team:

- How and when the discussion occurred.
- Participating audit team members.
- Significant decisions reached concerning planned responses at the financial statement and relevant assertion levels.

AU-C 240 imposes similar documentation requirements related to fraud aspects of the discussion.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following statements regarding the desirability of the audit engagement for a new contractor client is **incorrect**?

   a. A more thorough investigation is necessary of a construction contractor client because the construction industry is more susceptible to illegal activities.

   b. A discussion with the predecessor auditor should not be used to determine a client's reputation.

   c. The level of competition for the engagement is closely related to the adequacy of the fees.

   d. An auditor might consider a possible contractor client despite uncertainty about fee adequacy.

2. Which of the following statements regarding the nature of audit planning is correct?

   a. Audit strategy is a theoretical approach to achieving audit objectives.

   b. Risk assessment is a component of audit planning.

   c. Preliminary audit strategy is established after risk assessment.

   d. The audit strategy is also referred to as the audit plan.

3. Which of the following is included in the decisions made at the financial statement level through the risk assessment process?

   a. Overall strategy.

   b. Objectives and related operating risks.

   c. Selection of accounting policies.

   d. Risks of material misstatement at the relevant assertion level.

4. Which of the following statements regarding how auditors use inquiries through the audit process is correct?

   a. Auditors rarely use management inquiry during the audit planning process.

   b. Auditors can use inquiry as the sole method of assessing the risk after they have determined that a potential risk exists.

   c. Auditors can make inquiries of others outside the entity when identifying and assessing risk.

   d. Auditors often use inquiry as the sole method when evaluating the design and implementation of internal control.

5. Regarding preliminary analytical procedures, which of the following is **not** generally effective?

   a. Comparing prior year audited financial statements to the current year general ledger.

   b. Focusing on trends that are difficult for a perpetrator to manipulate.

   c. Looking for unexpected changes in key financial/nonfinancial relationships.

   d. Expecting certain financial statement accounts to exhibit plausible relationships in an operating cycle.

6. Which of the following additional items should be used in the planning process when planning an audit of a contractor?

   a. Documentation of the nature and effect of aggregated misstatements.

   b. List of items inspected or items confirmed in substantive tests of details.

   c. Going concern consideration documentation.

   d. Schedule of contracts completed and/or currently in progress.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following statements regarding the desirability of the audit engagement for a new contractor client is **incorrect**? **(Page 257)**

   a. A more thorough investigation is necessary of a construction contractor client because the construction industry is more susceptible to illegal activities. [This answer is incorrect. Consideration of the reputation and integrity of a prospective or continuing client and its management is always important, but it is especially significant for a contractor client. The construction industry is more susceptible to illegal activities, such as bribery, kickbacks, and fraud, than many other industries. This characteristic means that a more thorough investigation of a prospective client is advisable, as well as monitoring existing client publicity.]

   b. A discussion with the predecessor auditor should not be used to determine a client's reputation. [This answer is correct. Another way to consider a client's reputation is to have discussions with the predecessor auditor. According to AU-C 210.11, an auditor is required to communicate with the predecessor auditor regarding management integrity and other matters before accepting an engagement.]

   c. The level of competition for the engagement is closely related to the adequacy of the fees. [This answer is incorrect. The degree of competition for the engagement and the adequacy of the fee are related. The more competition for the engagement, the greater the fee pressure is likely to be. In considering the adequacy of the fee, the auditor needs to consider that a construction contractor client often requires more accounting/bookkeeping assistance than a typical commercial business of comparable size.]

   d. An auditor might consider a possible contractor client despite uncertainty about fee adequacy. [This answer is incorrect. An auditor might consider a potential contractor client worth pursuing, in spite of uncertainty about fee adequacy, if the auditor wants to develop experience, expertise, and a reputation in the area as a basis for securing other contractor clients.]

2. Which of the following statements regarding the nature of audit planning is correct? **(Page 259)**

   a. Audit strategy is a theoretical approach to achieving audit objectives. [This answer is incorrect. Audit strategy is an auditor's operational approach to achieving audit objectives of the audit. AU-C, *Planning an Audit*, establishes requirements for audit planning, including development of an overall strategy and audit plan, involvement of the engagement partner and team members, and consideration of whether specialized skills are needed.]

   b. Risk assessment is a component of audit planning. [This answer is correct. Obtaining an understanding of the entity and its environment, including its internal control, is an essential part of planning the audit. An effectively planned audit is responsive to the assessment of the risk of material misstatement based on the auditors' understanding of the entity and its environment, including its internal control.]

   c. Preliminary audit strategy is established after risk assessment. [This answer is incorrect. Preliminary audit strategy is generally established before risk assessment procedures are performed.]

   d. The audit strategy is also referred to as the audit plan. [This answer is incorrect. The audit plan is more detailed than the audit strategy, documenting the procedures necessary to obtain sufficient audit evidence.]

3. Which of the following is included in the decisions made at the financial statement level through the risk assessment process? **(Page 260)**

   a. Overall strategy. [This answer is correct. According to AU-C 300, developing the overall audit strategy is one of the decisions made at the financial statement level via the risk assessment process. It is a high-level description of the audit scope.]

   b. Objectives and related operating risks. [This answer is incorrect. Objectives, strategies, and related business risks are part of the understanding obtained through the risk assessment process.]

   c. Selection of accounting policies. [This answer is incorrect. Selection and application of accounting policies is an element of the understanding obtained through the risk assessment process.]

   d. Risks of material misstatement at the relevant assertion level. [This answer is incorrect. At this level, the auditor is concerned with performance materiality; and the nature, timing, and extent of further audit procedures.]

4. Which of the following statements regarding how auditors use inquiries through the audit process is correct? **(Page 264)**

   a. Auditors rarely use management inquiry during the audit planning process. [This answer is incorrect. Inquiry of management and others is used extensively throughout the audit planning process. AU-C 315.06 specifically requires the auditor to make inquiries of management, internal audit (if such a function exists), and others within the entity who may have information that is likely to help in the identification of risks of material misstatement whether due to error or fraud.]

   b. Auditors can use inquiry as the sole method of assessing the risk after they have determined that a potential risk exists. [This answer is incorrect. Inquiry is a critical risk assessment procedure, but inquiry cannot be used alone when identifying and assessing risks. Auditors use a combination of inquiry, analytical procedures, and observation and inspection during the risk assessment process.]

   c. Auditors can make inquiries of others outside the entity when identifying and assessing risk. [This answer is correct. The auditor might decide that inquiries of others outside the entity would be useful. For example, the auditor might find it useful to make inquiries of external legal counsel or of valuation experts that management has engaged.]

   d. Auditors often use inquiry as the sole method when evaluating the design and implementation of internal control. [This answer is incorrect. Auditors are prohibited from only using inquiry when evaluating the design and implementation of internal control.]

5. Regarding preliminary analytical procedures, which of the following is **not** generally effective? **(Page 267)**

   a. Comparing prior year audited financial statements to the current year general ledger. [This answer is correct. Since very few contractors keep their books on a GAAP basis, performing a preliminary analytical review by comparing the prior year's audited financial statements to the current year's general ledger may have no meaning unless the auditor first estimates the adjustments needed to prepare GAAP-based financial statements.]

   b. Focusing on trends that are difficult for a perpetrator to manipulate. [This answer is incorrect. Analytical procedures are generally more effective if the auditor focuses on trends that are difficult or impossible to manipulate by the perpetrator. Volume data trends need to exhibit a logical relationship to reported amounts. For example, the number of employees and direct labor costs.]

   c. Looking for unexpected changes in key financial/nonfinancial relationships. [This answer is incorrect. For example, direct labor costs should decrease if there is a decrease in the number of employees.]

   d. Expecting certain financial statement accounts to exhibit plausible relationships in an operating cycle. [This answer is incorrect. For example, if direct labor and materials costs are increasing but the gross profit percentages on fixed fee contracts are also increasing, the auditor needs to question why.]

6. Which of the following additional items should be used in the planning process when planning an audit of a contractor? **(Page 277)**

   a. Documentation of the nature and effect of aggregated misstatements. [This answer is incorrect. Misstatements are usually not known until the field work part of the audit has been completed and would not be part of the planning process.]

   b. List of items inspected or items confirmed in substantive tests of details. [This answer is incorrect. Substantive tests of details are part of the audit field work, not the initial planning process.]

   c. Going concern consideration documentation. [This answer is incorrect. Documentation relating to consideration of the entity's ability to continue as a going concern occurs at the completion of the audit, not in the planning process.]

   d. Schedule of contracts completed and/or currently in progress. [This answer is correct. To properly plan the audit, the audit team should consider contracts that have been completed during the year and those that are still in process. The schedule will allow the audit engagement team to discuss the timing and location of any job site visits.]

UNDERSTANDING THE CONTRACTOR AND ITS ENVIRONMENT

Introduction

The auditor, according to AU-C 315.05, should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion level. AU-C 315.03 explains that the objective of the auditor is to make this assessment through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks. The auditor's focus in obtaining the understanding is on attaining a knowledge level sufficient to identify the risks of material misstatement of the financial statements and to design the nature, timing and extent of further audit procedures. However, the understanding is a purpose-driven audit focus and not a general knowledge level that might be appropriate for some other purpose such as managing the entity.

Obtaining a solid in-depth understanding of the client's business and how it operates is fundamental to both audit efficiency and effectiveness. Understanding the business is the key to knowing what the risks are and where to look to see if the risks have resulted in a material misstatement of the financial statements. Understanding the client's business includes not only understanding the risks the client faces in doing business, but ideally, understanding what management's response is to those risks, and, consequently, what residual risk of material misstatement of the financial statements remains. The auditor's process in obtaining this understanding is focused on those matters that could cause material misstatements in the financial statements, including potential going-concern problems, fraud risk factors, undisclosed related-party transactions, violations of laws and regulations, or uncertainties.

Components of the Understanding

AU-C 315.12 indicates that the auditor's understanding of the entity and its environment consists of an understanding of the following items:

a. Industry, regulatory, and other external factors.

b. Nature of the entity.

c. Objectives, strategies, and related business risks.

d. Measurement and review of the entity's financial performance.

e. Selection and application of accounting policies.

In addition, the consideration of fraud risk factors is an important objective of performing risk assessment procedures. Although considering the presence of fraud risk factors occurs simultaneously with obtaining information about the entity and its environment, it merits focused attention.

Construction Entity, Industry, and Related Internal and External Factors

Types of Construction Projects. The auditor considers the types of construction projects engaged in by the contractor. Contractors can be classified as highway, heavy construction, or general building. General building can be subdivided between housing and nonresidential construction. Housing construction includes building of single family residences and apartment buildings, including cooperative and condominium apartments. This type of construction involves relatively unstable market demand and great sensitivity to key economic indicators, such as interest rates, personal income, and unemployment levels. Nonresidential construction includes all types of commercial or other nonhousing buildings, such as office buildings, schools, and factories. The stability and sensitivity to economic indicators for this part of the industry is in between housing and highway and heavy construction. Highways, bridges, and power plants tend to be publicly financed, longer term, and less sensitive to short-term fluctuations in economic indicators.

Industry Economic Factors. The auditor relates the type of construction projects of the contractor to key economic factors for the construction industry in his or her geographic area. These factors generally include interest

rates, government tax and fiscal policies, and local demographics, such as population and personal income. The contractor's geographic area may also include foreign economies. For example, the contractor may enter into contracts with foreign companies, purchase goods or services from foreign companies, or have a domestic customer that relies on foreign sales for much of its revenues. In any case, the economic factors need to be evaluated, regardless of the specific economy. Review of appropriate trade publications can provide information about industry economic factors.

Current Economic Situation. The financial and economic crisis that began nearly a decade ago has reversed for many sectors of the construction industry. However, changes that took place in the industry during the economic crisis continue to affect some contractors negatively. During periods of longer-lasting economic downturn, such as what much of the construction industry experienced, audit risks identified previously may become more significant, and new risks may develop.

The following economic factors need to be considered in audit planning and risk assessment:

- *Decreased Margins.* If economic difficulties are still affecting the contractor's ability to obtain new work at prerecession margin levels or the contractor is continuing to perform work that was bid earlier at below normal margins, gross profit may continue to remain low.

- *Joint Venture and Subcontractor Concerns.* A general contractor may continue to be affected by problems that subcontractors are experiencing. Subcontractor problems include going out of business or an inability to obtain surety bonding. Also, the failure of subcontractors or contractors involved in joint ventures may cause issues for a contractor that depends on their work.

- *Supervision, Staffing, and Financing of New Work.* If the contractor significantly downsized during the economic downturn and had to dismiss skilled and experienced operations and accounting personnel, there may be an inability to maintain robust internal controls as a result of the workforce reduction and an increased risk of accounting misstatements.

- *Going Concern.* One implication of the previously discussed factors is that evaluation of going concern issues of contractors continues to be an important audit consideration. Contractors may continue to have difficulty funding projects and cash-flow problems.

Contract Documents and Provisions. The auditor also needs to consider the types of contracts used by the contractor and be familiar with the contract documents. Since the risks to the contractor can vary significantly depending on the type of contract, it is important for the auditor to understand the possible variations in contracts and their accounting and auditing significance. For example, a fixed-price contract, the riskiest type of construction contract, requires accurate cost estimates, and estimating errors can easily result in loss contracts that should be identified and accrued for currently. In addition, depending on the type of construction project and/or the stage of the project, the weather can significantly impact construction contractors. Bad weather can lead to delays, cost overruns, and scheduling difficulties. If contracts do not include appropriate provisions for weather delays, this could potentially lead to contractor penalties for not completing the affected projects timely.

The auditor also needs to be familiar with the accounting and auditing significance of various contract agreement provisions. The auditor needs to understand the business and accounting risk associated with noncompliance with contract provisions. Among the significant contract provisions are those for change orders and billing procedures. Since change orders affect both contract price and cost estimates, they can have a material effect on revenue recognition. The auditor needs to identify when contract changes have been made and assess their effect on costs and revenue.

Billing procedures can vary widely among contractors. Billings may be closely tied to contract performance or may be intentionally accelerated in relation to contract performance. Billing and collection ahead of disbursements for costs incurred on a project is called *front-end loading*. Under this type of billing arrangement, cash receipts are greater in the early stages of a project. Front-end loading is fairly common in the construction industry, and it is one reason that a well-managed contractor will tend to have a relatively small balance sheet in relation to the level of operations.

Contract Disputes, Litigation, and Claims. Because of the nature of construction activities, disputes, litigation, and claims tend to be relatively common and much more significant than for the average commercial business. The auditor needs to be aware of the potential for contract disputes, litigation, and claims and plan the audit to provide reasonable assurance that those matters will be identified. In the initial planning of the audit, the auditor needs to inquire about any new contract types or new provisions providing for significant liquidating damages or other features that could increase the risk of disputes, litigation, and claims.

Other Factors. Other factors may also impact the construction industry, and trends may occur on a national level that have ramifications to the contractor client. Accordingly, it is important for the auditor to be alert for any other factors that may affect construction contractor clients, such as:

- Building materials costs.
- Insurance losses.
- A tightening of credit.
- Surety industry trends.
- New legislation.
- Overhead costs, such as labor or equipment rental.
- Revised or new accounting and reporting requirements.
- Changing trends in construction, such as the recent increase in socially responsible *green* building.

Client Response to External Factors. The response of the particular construction contractor to external forces may vary considerably depending on the internal administrative and operating characteristics. Some contractors may reduce their workforce to cut costs and limit any unnecessary expenditures. Others may attempt to aggressively pursue contracts to gain market share at the expense of competitors. These responses can affect the audit areas considered to be key areas as well as the risk of particular types of misstatements. The need to economize may lead to the elimination or weakening of existing controls that will increase the risk of material misstatement. The auditor needs to discuss with management external forces and other conditions that could impact the audit.

Industry Accounting Policies and Practices

During initial audit planning, the auditor needs to consider whether the contractor is using the correct method and, in broad terms, whether the method is being applied appropriately in the circumstances. The auditor's consideration includes the methods used for both GAAP and tax purposes.

Consideration of the correctness of the revenue recognition method used is an integral part of obtaining an understanding of the client because the criteria for the appropriate method relate to matters such as contract documents, financial reporting systems, and estimating procedures that are part of a knowledge of the client and its business. The choice between the two generally accepted methods of revenue recognition depends on a careful evaluation of the circumstances. The two methods are not interchangeable; that is, the contractor does not have a free choice in selecting between them. FASB ASC 605-35-25-57 specifies the conditions for use of the percentage-of-completion method. Those conditions concern the following matters:

a. *Written Contracts.* Construction work is performed based on written contracts executed by the buyer and contractor that clearly specify the goods or services to be provided and received, the consideration to be exchanged, and the terms of settlement.

b. *Buyer Performance.* The buyer has the ability to satisfy its obligations under the contract.

c. *Contractor Performance.* The contractor has the ability to satisfy its contractual obligations.

d. *Estimating Process.* The contractor has an adequate estimating process and the ability to estimate reliably both the costs to complete and the percentage of contract performance completed.

Implicit in the condition of the ability to make reasonably dependable estimates is the condition that the contractor's financial reporting system is adequate to accumulate and allocate construction costs in a manner consistent with the estimates produced. Best practices indicate that when these conditions exist, the percentage-of-completion method must be used. If these conditions do not exist, the completed-contract method must be used. Also, the authoritative literature assumes that the ability to make reasonably dependable estimates in the normal course of business is essential to a contractor's ability to continue as a going concern.

The accounting method used by the contractor has an effect on the audit objectives and assertions. For example, when the completed-contract method is used, the auditor is concerned with obtaining evidence of whether contracts are complete or substantially complete. In contrast, when percentage-of-completion is used, the auditor is concerned with obtaining evidence that an evaluation of contract performance has been measured properly. Under both methods, the auditor is concerned with evaluating whether the contractor's estimates indicate that total costs will exceed total revenues and that a loss on the contract should be recognized.

Preliminary Review of Contracts Completed and in Progress

The auditor obtains schedules of contracts in progress and contracts completed during the year for use during initial audit planning. Preferably, these schedules ought to be obtained and analyzed at an interim date because of the audit planning decisions ordinarily based on this analysis. Among other things, these schedules are used by the auditor to do the following:

a. Identify significant loss contracts.

b. Make a preliminary assessment of the contractor's estimating abilities.

c. Identify job sites to be visited.

d. Identify obvious mistakes or omissions in the financial reporting system for accumulating and allocating contract costs that can be corrected by the client before the accounting records are closed.

e. Assess the status of backlog conditions. (The AICPA Guide defines *backlog* as "the amount of revenue that a contractor expects to be realized from work to be performed on uncompleted contracts, including new contractual agreements on which work has not begun.")

f. Identify unusual contract terms or conditions, or contracts that have been combined or segmented for additional attention.

g. Assess any other factors that may affect the risk of material misstatement of the financial statements.

Knowledge of the contracts completed and in progress during the period is part of the auditor's understanding of the client's contract estimation, billing, and cost accounting system.

The auditor needs to relate the information on specific contracts to his or her general understanding of the types of construction projects and typical contract documents and provisions of the contractor. Changes in significant contract terms or movement into new types of contracts may increase the risk of material misstatement of the financial statements. The AICPA Guide, at Paragraph 9.44, identifies the following information that can be used in the preliminary review of contracts as well as other stages of the audit:

- Job number.

- Type of contract.

- Contract price.
- Original cost estimate and related gross profit.
- Billing and retention terms.
- Provisions for changes in contract prices and terms.
- Penalty or bonus features related to performance criteria, such as completion dates.
- Bonding and insurance requirements.
- Location and description of project.

The preliminary review of contracts ought to also include contracts with subcontractors.

Fraud Risk Factors

Fraud risk factors are events or conditions that indicate an incentive or pressure to perpetrate fraud, provide an opportunity to commit fraud, or indicate attitudes or rationalizations to justify a fraudulent action. AU-C 240.24 states that the auditor should evaluate whether the information obtained from risk assessment procedures indicates that one or more fraud risk factors are present.

The identification of fraud risk factors is a natural by-product of performing risk assessment procedures. Along with the other information obtained about the contractor and its environment, the fraud risk factors are an important component in identifying the risks of material misstatement at the financial statement and relevant assertion levels. The auditor's primary concern in considering fraud risk factors is to identify whether a risk factor is present and needs to be considered in identifying and assessing risks of material misstatement due to fraud. The presence of a particular fraud risk factor does not necessarily indicate the existence of fraud. Whether a risk factor is present and needs to be considered in identifying and assessing the risks of material misstatement due to fraud is a matter of professional judgment.

Examples of Fraud Risk Factors. AU-C 240.A75 provides examples of fraud risk factors that may be considered when identifying and assessing the risks of material misstatement due to fraud. The risk factors are classified into factors related to fraudulent financial reporting and factors related to misappropriation of assets. Because it may be helpful to consider fraud risk factors in the context of the conditions generally present when fraud occurs, the standard further classifies the illustrative risk factors into conditions relating to incentives/pressures, opportunities, and attitudes/rationalizations. It is important to note that these are only examples and the auditor also may consider other risk factors not specifically listed in the standard.

Auditor's Considerations of Fraud Risk Factors. For misappropriation of assets, the consideration of fraud risk factors is influenced by the degree to which assets susceptible to misappropriation are present. However, some consideration is given to risk factors related to incentives/pressures, opportunities arising from control deficiencies, and attitudes/rationalizations for misappropriation, even if assets susceptible to misappropriation are not material. One of the primary fraud risks for a small contractor is fraudulent cash disbursements, in which case there is always an asset subject to misappropriation. Therefore, there always ought to be some consideration of fraud risk factors related to misappropriation. In addition, when considering risk factors for misappropriation, the auditor may identify risk factors related to inadequate monitoring and weaknesses in internal control that could also be present when fraudulent financial reporting occurs.

The presence of risk factors related to financial stress or dissatisfaction among employees is particularly important when considering the risk of misappropriation of assets because those conditions often provide both incentive and rationalization for theft. The auditor, during the course of the audit, may become aware of information that indicates potential financial stress or dissatisfaction of employees with access to assets susceptible to misappropriation. Examples include:

- Anticipated layoffs that are known to employees.
- Unfavorable changes in employee compensation or benefit plans.

- Failure to receive promotions or other expected rewards.
- Known unusual changes in behavior or lifestyle.
- Employees that are known to be experiencing significant personal financial obligations.
- Behavior indicating dissatisfaction with the company, including disregard for company policies and procedures.

If the auditor becomes aware of the presence of these or similar risk factors, he or she considers them when identifying the risks of material misstatement due to fraud.

Best practices indicate that domination of management by a single individual does not, in and of itself, indicate a failure by management or the owner/manager to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In fact, in many small businesses, strong owner/manager involvement actually can be a control strength in that there is a great deal of oversight of employees throughout the process. However, AU-C 550.20 indicates that a fraud risk factor may exist when an entity has related parties who have the ability to exert control over, or significantly influence, management or the entity.

Auditors need to focus on the choice of modifying words in the risk factors (such as *inappropriate* means, *unduly* aggressive, etc.). For example, a fraud risk factor might be, "There is an interest by management or the owner/manager in employing *inappropriate means* to minimize reported earnings for tax-motivated reasons." Many businesses have an interest in minimizing reported earnings to reduce income taxes. The primary consideration, however, is whether the owner/manager has shown an interest in minimizing income through inappropriate means. The auditor may have knowledge from prior audits of the owner/manager attempting to run personal expenses through the business in an effort to reduce income taxes. This situation would likely be considered a fraud risk factor. However, if the owner/manager is interested in minimizing taxes through legitimate means, such as sophisticated tax planning, then the auditor would not consider this to be a fraud risk factor.

If fraud risks are present, in accordance with AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating Evidence Obtained*, AU-C 240.28, and AU-C 240.30, the auditor considers whether the assessment of the risk of material misstatement due to fraud calls for an overall response, one that is specific to a particular account balance, class of transaction, or disclosure at the relevant assertion level, or both. An overall response is considered in establishing the overall audit strategy and a specific response is considered in developing the detailed audit plan.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. The AICPA Audit Risk Alert, *Real Estate and Construction Industry Developments,* lists specific examples of external factors related to the economic crisis that may affect the contractor. Which of the following is one of those factors?

   a. Costs of building materials.

   b. Decreased margins.

   c. New legislation.

   d. Litigation.

8. Which of the following contract types is considered the riskiest type for a contractor?

   a. Fixed-price.

   b. Cost-plus.

   c. Shorter-term.

9. Which of the following statements is correct regarding fraud risk factors?

   a. Identification of fraud risk factors is a natural by-product of performing risk assessment procedures.

   b. Auditors must look for fraud risk factors during planning.

   c. If a particular fraud risk factor is present then fraud must exist.

   d. All events, opportunities, and attitudes must be present to form a fraud risk factor.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

7. The AICPA Audit Risk Alert, *Real Estate and Construction Industry Developments,* lists specific examples of external factors related to the economic crisis that may affect the contractor. Which of the following is one of those factors? **(Page 287)**

    a. Costs of building materials. [This answer is incorrect. Costs of building materials are a factor that can impact the construction industry, but not a specific risk mentioned in the AICPA Audit Risk Alert.]

    b. Decreased margins. [This answer is correct. If economic difficulties are still affecting the contractor's ability to obtain new work at prerecession margin levels or the contractor is continuing to perform work that was bid earlier at below normal margins, gross profit may continue to remain low.]

    c. New legislation. [This answer is incorrect. New legislation that could impact the construction industry should be considered but it was not listed in the AICPA Audit Risk Alert.]

    d. Litigation. [This answer is incorrect. Contract disputes, litigation, and claims are fairly common in the industry and thus not included in the audit risk alert.]

8. Which of the following contract types is considered the riskiest type for a contractor?**(Page 287)**

    a. Fixed-price. [This answer is correct. A fixed-fee contract is the riskiest type of construction contract because it requires the contractor to estimate his costs upfront. Estimating errors can easily result in a loss.]

    b. Cost-plus. [This answer is incorrect. With cost-plus contracts, the contractor can bill the actual construction costs plus an agreed-upon profit percentage. Cost-plus contracts pose a moderate risk for the contractor.]

    c. Shorter-term. [This answer is incorrect. Auditors need to be alert for contract provisions that increase risk, such as penalties against the contractor for late completion. Also, shorter-term contracts are generally less risky than longer-term contracts.]

9. Which of the following statements is correct regarding fraud risk factors? **(Page 290)**

    a. Identification of fraud risk factors is a natural by-product of performing risk assessment procedures. [This answer is correct. The identification of fraud risk factors is a natural by-product of performing risk assessment procedures. Along with the other information obtained about the contractor and its environment, the fraud risk factors are an important component in identifying the risks of material misstatement at the financial statement and relevant assertion levels.]

    b. Auditors must look for fraud risk factors during planning. [This answer is incorrect. Auditors are not required to look for fraud risk factors during planning, but must consider whether such factors exist.]

    c. If a particular fraud risk factor is present then fraud must exist. [This answer is incorrect. According to AU-C 240, the presence of a particular fraud risk factor does not necessarily indicate the existence of fraud.]

    d. All events, opportunities, and attitudes must be present to form a fraud risk factor. [This answer is incorrect. Fraud risk factors are events or conditions that indicate an incentive or pressure to perpetrate fraud, provide an opportunity to commit fraud, or indicate attitudes or rationalizations to justify a fraudulent action. AU-C 240.24 states that the auditor should evaluate whether the information obtained from risk assessment procedures indicates that one or more fraud risk factors are present.]

CONSIDERATION OF FRAUD AND VIOLATIONS OF LAWS AND REGULATIONS UNIQUE TO CONTRACTORS

Introduction

AU-C 240 establishes standards and provides guidance on the auditor's responsibility to consider the risks of fraud and to design the audit to provide reasonable assurance of detecting fraud that results in the financial statements being materially misstated. The auditor's consideration of fraud is not separate from consideration of audit risk at either the financial statement or the assertion levels, but is integrated into the overall risk assessment process. This section explains fraud considerations unique to construction contractors in more detail.

Fraud-related Analytical Procedures

Revenue fraud-related analytical procedures are discussed earlier in this course. The AICPA Guide, at Paragraph 12.11, identifies the following additional unexpected or unusual relationships particularly relevant in the construction industry that may indicate a material misstatement due to fraud:

- Underbillings on uncompleted contracts that exceed 20% of equity or 25% of working capital—may indicate that the contractor is charging costs to an unrelated job.
- Underbillings that continuously increase—may indicate capitalization of losses.
- Overbillings that are not represented by cash—may indicate the use of cash collections to finance other possible loss contracts.
- Higher gross profit on uncompleted contracts than on closed jobs—may indicate an overly optimistic estimate of profitability on open jobs.
- Total costs on open and closed jobs that can not be reconciled with total costs in the income statement—may indicate closed jobs have been charged for current costs.

Types of Misstatements Caused by Fraud

From an audit perspective, *fraud* is an intentional act that results in a material misstatement in financial statements that are the subject of an audit. AU-C 240.A1 explains the following three conditions that generally are present when fraud occurs:

- *Incentive/Pressure.* Management or other employees have a reason to commit fraud.
- *Opportunity.* Circumstances, such as ineffective controls, the absence of controls, or the ability to override controls, enable management or other employees to commit fraud.
- *Attitude/Rationalization.* Management or other employees are able to justify the acceptability of committing fraud.

There are two broad categories of misstatements that are relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements resulting from fraudulent financial reporting.
- Misstatements resulting from misappropriation of assets.

The following are types of fraudulent financial reporting misstatements unique to construction contractors:

- Misstatement of gross profit on contracts.
- Omission of other revenue.

The following paragraphs discuss these types of misstatements. Misstatements resulting from misappropriation of assets are discussed later in this lesson.

Misstatement of Gross Profit on Contracts. Management of construction contractors may feel pressure to report certain financial results to sureties to maintain or enhance the contractor's bonding status and to lenders to meet debt covenant requirements. Because accounting for construction contractors involves subjective estimates relating to future events, gross profit on contracts is highly susceptible to management manipulation that can materially misstate the financial statements.

Both the completed-contract and the percentage-of-completion methods may be manipulated to misstate gross profit on contracts and conceal losses. The completed-contract method can be used to shift income between periods or to reduce taxable income in several ways. Contracts may be held open after completion to reduce taxable income (profitable contracts) or to avoid recognizing a deductible loss (loss contracts). This type of manipulation may come to light in reviewing customer correspondence or contract completion requirements in contract documents. The percentage-of-completion method can be manipulated through the computation of contract performance. Either costs incurred or estimated costs to complete may be manipulated to misstate the ratio. For example, the movement of costs from a completed to an uncompleted contract may increase gross profit. The auditor may consider the reasonableness of the percentage complete by comparing it to engineering or architecture certificates, customer correspondence, or billings when contract provisions relate billings to performance.

Manipulations of gross profit on contracts may be used to understate or overstate income. The authoritative literature seems directed to overstatements of income, assets, and equity. In the construction industry, particularly for small contractors, management may want to understate gross profit on contracts to avoid income taxes, or it may want to overstate gross profits to obtain or maintain debt and bonding capacity. Thus, a question that often arises in practice is whether the auditor is as responsible for material understatement as overstatement. Some auditors have even suggested that the auditor should deny responsibility for material understatement. Generally, overstatement of assets is easier to detect than understatement because even extensive testing of recorded assets may not detect omission of assets.

Best practices indicate that that in auditing the financial statements of a construction contractor, the auditor needs to be aware of the possibility of material understatement of gross profit on contracts. Normally, the auditor has tax return preparation responsibilities as well as audit responsibilities and will sign the return as preparer. The auditor cannot sign the tax return or express an unmodified opinion on the financial statements if there is an unresolved potential material understatement of gross profit on contracts. Generally, such a misstatement cannot be achieved without manipulation of recorded amounts. Thus, the misstatements will usually be in the records the auditor is testing rather than the result of omissions from the records. However, the auditor also needs to consider the possibility of omission of contracts at sites that are distant from the records. This type of fraud may come to light by noticing freight bills to sites not in the contract records, reviewing Forms W-2 with out-of-town addresses (laborers are usually hired locally), or noticing supposed use of distant subcontractors on local sites.

While estimates to complete, stage of completion, and related gross profit are critical estimates for contractors, some other significant estimates of construction contractors that are susceptible to management manipulation include:

- Contract penalties and incentives.
- Profit from change orders.
- Revenue from claims.
- Allocation of equipment cost.
- Accounts receivable allowance.
- Assumptions regarding impairments of long-lived assets.
- Assumptions regarding deferred tax valuation allowances and effective tax rates.

Change orders and claims can be easily manipulated, resulting in misstatement to the financial statements. For example, management might intentionally misrepresent the status of a contract change that is in dispute or

unapproved as to both contract price and scope, as a contract change rather than a claim. If such a contract change is not properly evaluated as a claim (and does not meet the requirements for evaluation as a claim, then the contractor may improperly recognize revenue or defer costs.

Omission of Other Revenue. Contractors sometimes omit revenue from miscellaneous sources to avoid paying taxes on it. This may occur in various ways. For example, equipment at a distant site may be sold with an unrecorded gain. Topsoil or fill material from excavations may be sold and the receipts not recorded. A contractor paving a highway may arrange to pave adjacent residential driveways and not record receipts. Another common practice is for a contractor to perform work for friends or relatives during slack periods at reduced charges and not record the reduced charges to these related parties. These misstatements are not likely to be detected unless their frequency or amount is significant. However, when the auditor is aware of misstatements from such sources and the misstatements are material, the auditor cannot express an unmodified opinion unless the misstatements are corrected. Generally, an even more stringent standard is applied to detected items when the auditor is also the tax return preparer. It is recommended that an auditor not sign a tax return as preparer when he or she is aware of omitted revenues or overstated expenses.

Misstatements Resulting from Misappropriation of Assets. Misstatements resulting from misappropriation of assets (often referred to as defalcation, embezzlement, or employee fraud) involves theft of the company's assets that results in the financial statements not being presented, in all material respects, in conformity with GAAP. Misappropriation of assets can be committed in many ways, including stealing cash receipts or other assets, or causing the company to pay for goods and services not received (or paying inflated prices for goods and services received). This type of fraud may also be facilitated by the falsification, alteration, or other manipulation of accounting records or source documents, possibly by circumventing controls. Misappropriation may be committed by one or more management officials, employees, or third parties. Some misstatements resulting from misappropriation of assets might result in misclassifications in the financial statements. For example, if an employee diverts cash for personal use by establishing a fictitious vendor and submitting falsified invoices coded to cost of goods sold, amounts reflected in the income statement may be misclassified assuming the amounts are not recoverable.

Asset misappropriation considerations for construction contractors include theft of tools and equipment used at job sites and laptops of field personnel that are portable and easily stolen. If theft is a concern, the auditor needs to identify those assets that employees can misuse at the contractor's expense. In addition, invoices from subcontractors may be inflated, requiring the contractor to pay more for services than prices originally agreed upon.

Some frauds involving misappropriation of assets may not result in the financial statements being materially misstated for any individual period, but may be perceived to be material, especially if the amounts involved accumulate over time. AU-C 200.07 observes that—

> The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by fraud or error, that are not material to the financial statements taken as a whole, are detected.

For example, assume that a bookkeeper in a small construction company steals $5,000 per year for several years and hides the fraud by inflating expenses each year. That amount is immaterial to each year. After several years, the fraud is detected and the amounts stolen aggregate $30,000, which might be considered material if the financial statements for any individual period were misstated by this amount. Because the financial statements are not materially misstated in any given period, the auditor is not responsible under professional standards for detecting such a fraud. This situation does result in a business risk for the auditor because many construction clients may have the expectation that the auditor will detect all cases of fraud, whether the financial statements are materially misstated or not. This perception of the auditor's responsibility goes beyond what is required by professional standards. To eliminate this expectation gap, it is important for auditors to inform their clients about the auditor's responsibility under professional standards. The auditor is required to communicate to the appropriate level of management if he or she determines there is evidence that fraud may exist, even if the matter is inconsequential.)

The auditor identifies the assets that are particularly susceptible to stealing and considers whether there are controls in place to prevent or detect the theft. If controls are inadequate to prevent or detect a material misstatement due to stealing, the auditor plans substantive procedures to detect the misstatement. If the auditor believes that specific identified risks of material misstatement due to stealing are mitigated by controls, the auditor might

decide that it is efficient to plan to test those controls. However, at the initial planning stage in the audit, the auditor is concerned with how the risk assessment will influence the audit approach to various financial statement areas and not with the detailed procedures to be applied to particular accounts.

In many construction contractors, one of the primary fraud risks is fraudulent, unauthorized disbursements (for example, bookkeepers writing checks to themselves. Many construction contractors are susceptible to such fraud because of a lack of segregation of duties. If the auditor concludes there is a risk that such disbursements may occur in amounts that could result in material misstatement of the financial statements, an audit response is required. Substantive tests of the cash balance recorded in the financial statements may not be sufficient to respond to a material risk of fraudulent cash disbursements. Audit procedures in response to this risk include analytical procedures to compare expenses to the prior year and current budget, and inspection of a selection of cancelled checks for unusual payees and endorsements.

Consideration of Violations of Laws and Regulations

AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, establishes requirements for the auditor's approach to violation of laws and regulations in an audit of financial statements. The objective of the auditor when considering laws and regulations in the audit is to obtain audit evidence for material amounts and disclosures in the financial statements that are *directly* determined by the provisions of laws and regulations. In addition, the auditor is required to perform specific procedures to identify potential noncompliance with laws and regulations that may have a material *indirect* effect on the financial statements.

Responsibilities When Planning the Audit. During the planning and risk assessment stage of the audit, AU-C 250.12 states that when obtaining an understanding of the entity and its environment, the auditor should obtain a general understanding of—

- The laws and regulations to which an entity is subject (the legal and regulatory framework) and the industry or sector in which the entity operates.
- How the entity complies with those laws and regulations.

AU-C 250.A8 provides the following examples of procedures the auditor might use to obtain a general understanding of the legal and regulatory framework and how the entity complies with that framework:

- Use the existing understanding of the entity's industry and regulatory and other external factors from the current and prior audits.
- Update the understanding of those laws and regulations that directly determine reported amounts and disclosures, such as tax and pension laws and regulations.
- Inquire of management about other laws and regulations expected to have a fundamental effect on the operations of the entity.
- Inquire of management about the policies and procedures adopted to prevent noncompliance (or help ensure compliance) and identify, evaluate, and account for litigation claims.
- Inquire of management about whether directives have been issued or periodic representations are obtained relating to compliance.
- Consider knowledge from prior audits of any history of noncompliance.

In planning and performing the audit, the auditor takes into account the knowledge of the applicable legal and regulatory framework obtained as part of obtaining an understanding of the entity and its environment.

Responsibilities When Performing the Audit. AU-C 250.13 explains that the auditor should obtain sufficient appropriate evidence regarding material amounts and disclosures in the financial statements that are determined by the provisions of laws and regulations generally recognized to *have a direct effect* on their determination.

Noncompliance with the provisions of other laws and regulations may result in fines, litigation, or other consequences for the entity, which may need to be accrued or disclosed in the financial statements but *do not have a direct effect* on determining amounts in the financial statements. The auditor is required to inquire of management and, when appropriate, those charged with governance about whether the entity is in compliance with other laws and regulations. In addition to inquiries of management about whether the entity is in compliance with other laws and regulations, AU-C 250.14 also requires the auditor to inspect any correspondence with the relevant licensing or regulatory authorities.

The following are some examples of violations of laws and regulations that may occur in the construction industry:

- *Bid Rigging.* Conspiring with other contractors or an employee of the organization seeking bids to ensure that a specific contractor is awarded the contract. This process may also involve kickbacks or bribes, as discussed below.
- *Kickbacks.* Paying (directly or indirectly) an employee of the organization seeking bids to ensure that the contractor is awarded the contract.
- *Bribes.* Paying government officials for special favors in awarding contracts, providing regulatory approvals, or other matters.

Payments associated with such violations of laws and regulations may be hidden in the accounting records to avoid detection by government auditors or others. The scheme used to conceal the illicit payments may also result in misstatement of the financial statements. For example, bribes and kickbacks may be made in cash and charged to travel and entertainment expense or selling expenses. They could also be concealed through payroll deductions for "ghost" employees. These violations fall into the category of misstatements that directly affect the financial statements, but they are not likely to be detected unless their frequency or amount is significant. Nevertheless, the auditor needs to be alert for violations that may be detected when performing audit procedures directed primarily to other audit objectives. For example, evidence might be identified during inspection of contract files and related correspondence, discussions with client personnel, or examination of contract-related disbursements. If the auditor finds evidence that a violation may have occurred, he or she should follow the guidance in AU-C 250.

UNDERSTANDING OF INTERNAL CONTROL

AU-C 315.13–.25 establish requirements for auditors related to consideration of internal control as part of an audit. It also provides guidance about how the entity's use of information technology (IT) affects the auditor's consideration of internal control in planning the audit. In addition, Chapter 8 of the AICPA Guide addresses some areas concerning internal control that are unique to construction contractors and at Paragraph 8.03, notes that appropriate controls of contractors over the following areas may allow the auditor to perform a more efficient audit:

- Estimating and bidding.
- Project administration and contract evaluation.
- Job site accounting and controls.
- Billing procedures, including determining the costs subject to reimbursement under cost-plus contracts.
- Contract revenues and costs.
- Construction equipment.
- Claims, extras, and back charges.
- Joint ventures.
- Internal audit function.

AU-C 315.13–.14 require auditors to obtain an understanding of internal control relevant to the audit. To obtain that understanding, auditors should perform risk assessment procedures to (a) evaluate the design of controls that are relevant to the audit and (b) determine if they have been implemented. A key consideration is whether and how a particular control prevents, or detects and corrects, material misstatements in relevant assertions related to transactions, account balances, or disclosures.

Components of Internal Control

AU-C 315.15–.25 requires the auditor to obtain an understanding of five interrelated components of internal control. These components are also defined and described in COSO's 2013 *Internal Control—Integrated Framework* (the 2013 Framework). The five components are as follows:

- Control environment
- Risk assessment
- Information and communication
- Monitoring
- Control activities

The 2013 Framework articulates 17 principles that are associated with the five components. The principles aid in understanding the requirements for effective internal control and provide clarity when designing and implementing systems of internal control. Each principle has several underlying points of focus for evaluating the principle.

In assessing the risk of material misstatement of the financial statements to develop an overall audit strategy, auditors generally focus on obtaining an understanding of the control environment, risk assessment, information and communication, and monitoring components, typically obtaining an understanding of the control environment first. The understanding of control activities is not needed until planning the nature, timing, and extent of further audit procedures at the assertion level. As a practical matter, however, auditors often obtain an understanding of control activities while obtaining an understanding of the other control components. As an entity's operations and systems become more complex, auditors will most likely need to increase their understanding of the internal control components to obtain the understanding necessary to assess the risk of material misstatement of the financial statements and to plan the nature, timing, and extent of further audit procedures.

Control Environment. The control environment sets the tone of an entity and influences the control consciousness of its people. The control environment is the foundation for all other components of internal control and provides structure and discipline. Among the important elements of the control environment are the attitude, awareness, and actions of management, as well as those charged with governance, concerning internal control. AU-C 315.A79 identifies the following elements of the control environment that may be relevant in obtaining an understanding of the control environment:

- Communication and enforcement of integrity and ethical values.
- Commitment to competence.
- Participation of those charged with governance.
- Management's philosophy and operating style.
- Organizational structure.
- Assignment of authority and responsibility.
- Human resource policies and procedures.

In the construction industry, the control environment is especially important because contractors often have operations occurring at various work sites. Additionally, in some respects, the control environment of many small

construction contractors is deficient due to a lack of segregation of duties, which is similar to that of many other small businesses. Not only does the limited number of accounting personnel make it easier to commit fraud, it also allows a higher incidence of honest mistakes to occur. The control consciousness and involvement of the owner/manager and senior management can improve controls. For example, if the owner/manager knows all the laborers and personally distributes paychecks, control risk for payroll is lowered.

The control environment for a construction contractor includes the process of construction project evaluation and control. Effectiveness in bidding on projects and estimating costs is important to the success of the contractor; thus, this area is an important aspect of the control environment. Established and systematic procedures for bidding and estimating are essential. The significant involvement of the owner/manager and other senior management in reviewing and approving bids and estimates and updating estimates as projects progress is important for an effective control environment. There is no official list of procedures to be followed by management to ensure effectiveness in this area. The auditor has to obtain a general understanding of this area through discussions with management, observation of the operation of the business, and inspection of documentation of bids and estimates. In considering the effectiveness of the contractor's control environment as it relates to bidding a contract and estimating the costs to complete, the auditor might identify the sources of data and factors used by contractor management in forming their assumptions and then determine whether that information seems relevant, reliable, and sufficient for that purpose. The bidding process may differ from the process used to estimate costs to complete.

Because construction activities occur at construction sites rather than a central location, senior management must have effective coordination and control of job sites for the control environment to be effective. Another significant aspect of a contractor's control environment is its organizational structure, especially the coordination and flow of information among personnel involved in supervision, estimating, bidding, and accounting for contracts. Lack of coordination among these personnel is usually a serious weakness, often negatively impacting proper tracking of cost measurements and allocations, equipment and other assets, timely billings, quality work standards, and compliance with laws and contracts.

Risk Assessment. Risk assessment for financial reporting purposes refers to the client's identification, analysis, and management of the risks of material misstatement of the financial statements. More simply, it can be described as identifying types of potential misstatements and designing control activities to prevent or promptly detect those misstatements.

A key step in the risk assessment process is identifying changed conditions (for example, forming a new joint venture, expanding operations into new geographic areas, or hiring a new contract supervisor) and taking necessary actions. This involves identifying and communicating both external and internal events or activities that may adversely affect the company's financial reporting objectives, and analyzing the associated risks. Changed conditions that may affect risks relevant to the financial reporting process include—

- Changes in operations.
- New personnel.
- New or revised information systems.
- Rapid growth within the construction contractor.
- New technology.
- New business models, products, or activities.
- Restructuring within the construction contractor.
- New accounting standards.

The earlier the effects of those risks are identified, the more effectively they can be dealt with.

The auditor should obtain an understanding of how management identifies and takes action to address risks relevant to the company's financial reporting objectives. This includes gaining an understanding of how the owner/manager estimates the significance of those risks and assesses the likelihood of their occurrence. For example, if the company is expanding its operations, the auditor needs to gain an understanding of the owner/manager's assessment of the impact on internal control and the steps he or she is taking to address that impact. For risks related to fraud, the auditor needs to gain an understanding of whether the contractor has assessed its vulnerabilities to fraudulent activity (including determining whether those exposures could result in material misstatement of the financial statements) and whether the contractor has identified and implemented the processes, controls, and other procedures needed to mitigate identified fraud risks. For some contractors, the use of IT may be important in providing timely information to assist the owner/manager in identifying and managing risks. Gaining an understanding of management's risk assessment is not a complex process. Normally, the auditor can gain this understanding based on his or her experience with the contractor, general observations of company operations, and discussions with the owner/manager.

Information and Communication. The information system relevant to financial reporting (the *financial reporting system*) consists of procedures and records established to initiate, authorize, record, process, and report transactions and conditions and to maintain accountability for the company's assets, liabilities, and equity. An information system may be automated, manual, or a combination of the two, depending on the size and complexity of the contractor. The quality of information generated by the financial reporting system has significant implications for the audit because it affects management's ability to control the entity's activities and prepare reliable financial statements.

A financial reporting system includes methods and records that:

- Identify and record all valid transactions.
- Resolve the incorrect processing of transactions.
- Provide, on a timely basis, sufficient detailed information about transactions to permit proper classification for financial reporting.
- Allow for the recording of transactions at their proper monetary value in the financial statements.
- Provide sufficient information to permit recording of transactions in the proper accounting period.
- Properly present the transactions and related disclosures in the financial statements.

AU-C 315.19 states that the auditor should obtain a sufficient understanding of the financial reporting system to understand:

- *Classes of Transactions.* The classes of transactions that are significant to the financial statements.
- *Accounting Procedures.* The automated and manual procedures used to initiate, authorize, record, process, correct as necessary, transfer to the general ledger, and report transactions in the financial statements.
- *Accounting Records.* The electronic or manual accounting records, supporting information, and financial statement accounts involved in initiating, authorizing, recording, processing, and reporting transactions.
- *Other Events and Conditions.* How the financial reporting system captures other events and conditions.
- *Financial Reporting Process.* The contractor's process for preparing financial statements, including significant accounting estimates and disclosures.
- *Journal Entries.* The controls over standard and nonstandard journal entries.

Obtaining sufficient knowledge of the financial reporting system to understand how misstatements may occur includes understanding the following aspects of transaction processing:

a. *Initiating and authorizing.*

   (1) How and by whom are transactions initiated and authorized?

(2) What source documents (or electronic means) are used to capture information for entry in the accounting system?

(3) How and by whom are transactions originally entered in the accounting system for processing?

b. *Recording, processing, and correcting.*

(1) What are the accounting processing steps, both automated and manual, from original entry to inclusion in the general ledger and who performs them? (Processing includes functions such as edit and validation, calculation, measurement, valuation, summarization, and reconciliation.)

(2) What accounting records and supporting documents are used or created when processing transactions?

(3) What accounts are involved?

(4) What subsidiary journals or ledgers are involved?

(5) How is the incorrect processing of transactions resolved?

c. *Transferring to the general ledger, reconciling, and reporting.*

(1) What procedures are used to enter transaction totals into the general ledger?

(2) What is the contractor's process for reconciling account detail to the general ledger for material accounts?

(3) How does it affect the contractor's control activities?

(4) What management reports or other information are generated from the system and how are they used by management in managing and controlling the contractor's activities?

A good understanding of the financial reporting system is always important in the audit of a construction contractor. The accurate accumulation of costs by contract is essential for reliable estimation of gross profit and ongoing review of where each contract stands once work begins. The auditor should assess whether contract costs include all direct and indirect costs. This assessment will be facilitated if the client can post individual contract records at an interim date. Scanning these records allows the auditor to identify job sites to be visited and obvious omission of contract costs. Early identification of omitted costs can permit the client's personnel to make corrections before the accounting records are closed at year-end.

The auditor may encounter many variations in the maintenance of accounting records for contract costs. Small contractors often maintain their general ledgers on the cash or tax basis. In those circumstances, general ledger accounts related to contract costs may not correspond with financial statement captions related to percentage of completion. The auditor needs to gain an understanding of the accounting processing and ordinarily prepares adjusting entries to convert the general ledger accounts to a GAAP basis. In many cases, these adjustments are only made in the auditor's workpapers and the client's records remain on the tax or cash basis. No matter what basis of accounting is used to maintain the accounting records, the key concern is whether the financial reporting system accurately accumulates contract costs by individual contract.

Communication. Communication relates to providing a clear understanding of internal control over financial reporting, how it works, and the responsibilities of individuals within the company related to internal control. The auditor needs to obtain a sufficient understanding of how management communicates financial reporting roles and responsibilities and other significant matters. The communication process includes both internal and external elements. For example, it includes communications between management and employees, those charged with governance, and regulatory authorities. Communication may take the form of policy manuals, memorandums, oral or electronic communications, etc., depending on the size and organizational structure of the contractor. Communication also relates to the flow of information upstream in an entity. For control activities to be effective, individuals

need to be able to report exceptions or fraud to the appropriate levels of management. For example, contract supervisors have to be able to report construction difficulties, such as disputes with subcontractors, to the owner/manager or other appropriate member of management on a timely basis.

Gaining an understanding of the contractor's communication processes need not be a complex process for auditors. The auditor does not need to spend a significant amount of time reviewing the contractor's accounting manuals, policies, or memoranda. Instead, the auditor can gain this understanding based on his or her experience with the client, general observations of its operations (including job site visits), and discussions with the owner/manager.

Monitoring. Monitoring is a process by which an entity assesses the quality of its internal control over time. Monitoring involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary. Monitoring activities can also reveal evidence or symptoms of fraud. Effective monitoring ensures that internal controls are modified as changes in conditions occur in the business. Monitoring can be accomplished through ongoing activities, separate evaluations, or a combination of the two. Monitoring can be virtually any activity that ensures that controls are operating as intended and continue to be properly designed. Regardless of the manner in which monitoring is accomplished, identified deficiencies ought to be reported to the individuals responsible for taking corrective action and to management and those charged with governance, as appropriate.

According to AU-C 315.23, the auditor should obtain an understanding of the major types of activities that management uses to monitor internal control over financial reporting, including control activities relevant to the audit. AU-C 315.25 further indicates that the auditor's understanding should include the sources of information related to monitoring and the basis on which management considers information to be sufficiently reliable for that purpose. The auditor considers both (a) the aspects of the monitoring process that enable management to appropriately identify and correct control procedures that are not operating as intended and (b) any circumstances that indicate management has failed to appropriately identify and correct such deficiencies.

Consideration of Internal Audit Function. One method some contractors use to monitor internal control is through separate evaluations by the internal audit function. Most small construction contractors do not have an internal audit function. However, if there is an internal audit function, the auditor should obtain an understanding of that function during audit planning. AU-C 315.24 indicates that if the entity has an internal audit function, the auditor should obtain an understanding of the nature of the function's responsibilities, how the function fits into the organizational structure, and the activities performed or to be performed by the function.

Control Activities. Control activities are the policies and procedures established to help ensure that management directives are carried out. That is, control activities are those actions that are taken to address risks that threaten the entity's ability to achieve its objectives, one of which is reliable financial reporting. Control activities usually involve two elements: (a) a policy that establishes what should be done and (b) the procedure that implements the policy. The auditor's understanding of the other components of internal control, including the control environment, risk assessment, information and communication, and monitoring, is used in assessing the risks of material misstatement at both the financial statement and relevant assertion levels. Certain components, such as the control environment, are more important for developing the overall audit strategy. In contrast, control activities are important at the relevant assertion level for detailed planning of the nature, timing, and extent of further audit procedures.

Control activities, which can be either automated or manual, are performed at various levels within the entity. The auditor focuses on identifying and obtaining an understanding of control activities that address areas in which the auditor considers material misstatements more likely to occur. The auditor concentrates on whether and how a specific control activity, individually or in combination with others, prevents, or detects and corrects, material misstatements in the classes of transactions, accounts balances, or disclosures that are significant to the financial statements. The auditor obtains an understanding of the entity's controls related to significant and fraud risks and also the controls related to risks for which substantive procedures alone will not be adequate. In addition, the auditor is required by AU-C 315.22 to understand how the entity has responded to risks arising from IT when considering control activities.

Control policies may be communicated either orally or in writing. This depends to a great extent on the size of the organization and the channels of communication within the entity. Another critical aspect of control activities is the

follow-up actions taken in response to identified discrepancies (for example, investigation by management or the owner/manager of unexpected variances noted while comparing contract costs to budgeted costs). Auditing standards specifically require the auditor to obtain an understanding of how the incorrect processing of a transaction is resolved. The auditing standards also specifically require the auditor to obtain an understanding of the process of reconciling detail to the general ledger for material accounts.

The areas in the audit of a construction contractor in which the auditor normally will consider obtaining a more detailed understanding of control activities, performing tests of controls, and assessing control risk at less than the maximum level are controls over the accumulation of job costs by contract and controls over the estimating process for extent of completion and costs to complete on contracts in progress.

For a construction contractor, the ultimate focus of the audit has to be on substantiating the reasonableness of gross profit on contracts, which usually includes a substantial estimated portion. The estimated gross profit consists of some objective elements, such as contract price (in a fixed-price contract) and costs incurred, but also is very dependent on the subjective estimate of percentage of completion. Even if a contractor uses the completed-contract method, which would be a rare occurrence, a subjective estimate of costs to complete is critical to evaluating whether losses on contracts in progress need to be recognized. For these reasons the effect of the control activities of a construction contractor on the audit is typically as follows:

a. A primarily substantive approach is taken to contract prices, billings, and receivables because it is efficient and effective to confirm these matters with customers and/or to examine documents supporting the amounts.

b. For the accumulation of contract costs, the approach may vary depending on the effectiveness of internal control. Tests of controls may permit assessing control risk below the maximum for some areas, but a primarily substantive approach may be most suitable for other areas. For example, assessing control risk below maximum and performing tests of controls may be the most efficient (when internal controls permit) approach for payroll and, in some instances, for direct costs other than payroll. This is the area of greatest variation in individual audits.

c. For the estimated costs to complete, and for percentage of completion if a method other than cost-to-cost is used, a combination of tests of controls and substantive procedures is usually appropriate. However, because of the subjective nature of the area, the primary focus is often on the control environment rather than on specific control activities.

d. For other areas of the audit, such as major equipment, claims, change orders, joint ventures, etc., a primarily substantive approach is normally used.

The auditor may obtain an understanding of control activities solely to plan effective substantive tests. However, procedures originally applied to obtain an understanding may provide sufficient evidence to permit an assessment of control risk below the maximum. For example, the auditor may make job site visits at an interim date as part of obtaining an understanding of the contractor's operations, including an understanding of control activities. Based on the information obtained, the auditor may conclude that control risk at job sites is less than the maximum and reduce the extent of job site visits at year end or conclude that year-end visits are not necessary.

Documentation

AU-C 315.33 requires documentation of the understanding of the entity and its environment, including internal control. For internal control, the auditor is required to document the understanding obtained for the five components of internal control noted earlier in this lesson. The auditor should also document the sources of the information used and risk assessment procedures that were performed to obtain the understanding.

Historically, auditors have documented their understanding of internal control using a variety of methods. These methods have included:

- Narratives or memorandum documents.
- Internal control questionnaires.

- Checklists.
- Flowcharts.

AU-C 315 permits auditors flexibility in the manner of documentation. The form and extent of documentation is influenced by factors such as the complexity, size, and nature of the entity and the use of technology. Where applicable, some auditors supplement their documented understanding with existing documentation of control systems prepared by the entity. Due to the increasing visibility of the importance of controls, many contractors have developed or enhanced their internal documentation and evaluation of internal controls. Auditors may consider inquiring of the client about the existence of such documentation along with any supporting evaluation of the effectiveness of controls. In those cases, the auditor may gain additional audit efficiencies and a better understanding of the client's internal control.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

10. Which of the following illustrates an example of an incentive and/or pressure to commit fraud regarding misstatements resulting from fraudulent reporting?

    a. Employee A still has not received a promised promotion after being with the company 17 years.

    b. Management has promised Employee B a large raise if he/she reaches certain unrealistic financial goals.

    c. Employee C has the sole responsibility/influence over project operations.

    d. Employee D takes advantage of poorly designed controls over program operations.

11. Which of the following is one of the types of fraudulent financial reporting misstatements unique to construction contractors?

    a. Misstatement due to misappropriation of assets.

    b. Misstatement of gross profit on contracts.

    c. Misstatement due to fraudulent financial reporting.

12. John, owner of John & Sons Construction (J&S), hires new employees only after performing due diligence such as background checks and skills assessment. John reassesses employee skills semiannually, and employees are involved in classroom training and cross-training exercises. John also encourages his employees to take advantage of employer-matching educational assistance. What component of internal control does this illustrate?

    a. Risk assessment.

    b. Control environment.

    c. Information and communication.

    d. Monitoring.

13. Which of the following statements is correct regarding information and communication relevant to financial reporting?

    a. Auditors should assess whether contract costs include all direct and indirect costs because the accurate accumulation of costs by contract is important for reliable estimation of gross profit.

    b. Most small contractors maintain their general ledgers on the accrual basis.

    c. The basis of accounting used to maintain the accounting records should be a key concern for the auditor.

    d. Any adjustment the auditor makes to entries to convert the general ledger accounts to a GAAP basis should be made in the client's records.

14. Which of the following statements is correct concerning monitoring?

    a. Monitoring activities usually do not uncover evidence of fraud.

    b. Monitoring must be accomplished through only ongoing activities.

    c. Monitoring ensures that internal control is an adaptive process.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

10. Which of the following illustrates an example of an incentive and/or pressure to commit fraud regarding misstatements resulting from fraudulent reporting? **(Page 295)**

    a. Employee A still has not received a promised promotion after being with the company 17 years. [This answer is incorrect. This is an example of attitude/rationalization to commit fraud.]

    b. Management has promised Employee B a large raise if he/she reaches certain unrealistic financial goals. [This answer is correct. Unrealistic program goals and aggressive budgets can often create incentives and pressure on employees to commit fraud.]

    c. Employee C has the sole responsibility/influence over project operations. [This answer is incorrect. This is an example of an employee placed in a position that provides an opportunity to commit fraud.]

    d. Employee D takes advantage of poorly designed controls over program operations. [This answer is incorrect. An employee has the opportunity to commit fraud when significant internal controls over operations are ineffective.]

11. Which of the following is one of the types of fraudulent financial reporting misstatements unique to construction contractors? **(Page 295)**

    a. Misstatement due to misappropriation of assets. [This answer is incorrect. Per AU-C 240, misstatement resulting from misappropriation of assets is one type of misstatement that is relevant to the auditor's consideration of fraud in a financial statement audit; however, it is not unique to construction contractors.]

    b. Misstatement of gross profit on contracts. [This answer is correct. AU-C 240 indicates that misstatement of gross profit on contracts is one type of fraudulent financial reporting misstatement that is unique to construction contractors. Another type unique to construction contractors is the omission of other revenue.]

    c. Misstatement due to fraudulent financial reporting. [This answer is incorrect. Misstatement resulting from fraudulent financial reporting is one type of misstatement that is relevant to the auditor's consideration of fraud in a financial statement audit, as cited in AU-C 240; however, it is not unique to construction contractors.]

12. John, owner of John & Sons Construction (J&S), hires new employees only after performing due diligence such as background checks and skills assessment. John reassesses employee skills semiannually, and employees are involved in classroom training and cross-training exercises. John also encourages his employees to take advantage of employer-matching educational assistance. What component of internal control does this illustrate? **(Page 300)**

    a. Risk assessment. [This answer is incorrect. Risk assessment for financial reporting purposes refers to the client's identification, analysis, and management of the risks of material misstatement of financial statements.]

    b. Control environment. [This answer is correct. The entity adequately illustrates its commitment to competent, well-trained employees. This is an element of the control environment.]

    c. Information and communication. [This answer is incorrect. Information and communication involves the information system relevant to financial reporting.]

    d. Monitoring. [This answer is incorrect. Monitoring is the assessment of internal control over time.]

13. Which of the following statements is correct regarding information and communication relevant to financial reporting? **(Page 303)**

    a. Auditors should assess whether contract costs include all direct and indirect costs because the accurate accumulation of costs by contract is important for reliable estimation of gross profit. [This answer is correct. A good understanding of the financial reporting system is always important in the audit of a construction contractor. The accurate accumulation of costs by contract is essential for reliable estimation of gross profit. The auditor should assess whether contract costs include all direct and indirect costs.]

    b. Most small contractors maintain their general ledgers on the accrual basis. [This answer is incorrect. The auditor may encounter many variations in the maintenance of accounting records for contract costs. Small contractors often maintain their general ledgers on the cash or tax basis.]

    c. The basis of accounting used to maintain the accounting records should be a key concern for the auditor. [This answer is incorrect. No matter what basis of accounting is used to maintain the accounting records, the key concern is whether the financial reporting system accurately accumulates contract costs by individual contract.]

    d. Any adjustment the auditor makes to entries to convert the general ledger accounts to a GAAP basis should be made in the client's records. [This answer is incorrect. The auditor needs to gain an understanding of the accounting processing and ordinarily must prepare adjusting entries to convert the general ledger accounts to a GAAP basis. In many cases, these adjustments are only made in the auditor's workpapers and the client's records remain on the tax or cash basis.]

14. Which of the following statements is correct concerning monitoring? **(Page 304)**

    a. Monitoring activities usually do not uncover evidence of fraud. [This answer is incorrect. Monitoring activities can reveal evidence or symptoms of fraud.]

    b. Monitoring must be accomplished through only ongoing activities. [This answer is incorrect. Monitoring may be accomplished by separate evaluations, ongoing activities, or a combination of the two.]

    c. Monitoring ensures that internal control is an adaptive process. [This answer is correct. Internal controls must be monitored for effectiveness, and changed to respond to changing conditions. Monitoring assesses the quality of internal control over time.]

Lesson 2: Planning Decisions, Judgments, and the Timing of the Engagement

INTRODUCTION

The information the auditor obtains about the contractor and its environment by performing risk assessment procedures is used to make several important planning decisions and judgments. The primary planning decisions and judgments based on this information are as follows:

a. The materiality level for the financial statements taken as a whole (preliminary planning materiality).

b. Materiality for particular items of lesser amounts than planning materiality.

c. The risks of material misstatement at the financial statement level.

d. The overall audit strategy (a collective group of judgments about the audit approach, including overall responses to risks).

e. Performance materiality at the individual class of transactions, account balance, or disclosure level.

f. Risks of material misstatement at the relevant assertion level related to classes of transactions, account balances, and disclosures.

g. The specific nature, timing, and extent of further audit procedures.

The audit planning process is iterative and continuous. Some risk assessment procedures are performed to consider audit risk and materiality at the financial statement level and the judgments about those matters in turn affect the considerations at the relevant assertion level for account balances, transaction classes, and disclosures.

Learning Objectives:

Completion of this lesson will enable you to:
- Determine the auditor's planning decisions and judgments, including the timing of the engagement.
- Identify special considerations for interim reviews.

Determining Materiality at the Financial Statement Level

According to AU-C 320, *Materiality in Planning and Performing an Audit*, at AU-C 320.10, the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall strategy for the audit. The preliminary judgment about materiality at the financial statement level is generally referred to as *planning materiality*. The need to establish planning materiality is directly related to the auditor's objective of obtaining reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be material to the financial statements. The auditor uses the concept of materiality both in (a) planning and performing the audit and (b) evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements on the financial statements. These two perspectives of the concept are usually referred to in practice as (a) *planning materiality* and (b) *evaluation materiality*.

Understanding the similarities and differences between planning materiality and evaluation materiality provides helpful background for making materiality decisions and judgments. AU-C 320.06 explains that planning materiality is not necessarily the amount below which uncorrected misstatements, individually or in the aggregate, will be evaluated as immaterial. Because of surrounding circumstances, the auditor may evaluate an amount as material even if it is below planning materiality. AU-C 320.06 observes that it is not practical to design audit procedures to detect misstatements that could be material solely because of their nature (qualitative considerations), but when evaluating the effect of uncorrected misstatements on the financial statements, the auditor considers not only the size

but also the nature of uncorrected misstatements and the particular circumstances of their occurrence. The implication of these matters explained in AU-C 320 is that determination of planning materiality is primarily a quantitative consideration, even though qualitative considerations influence evaluation decisions and judgments significantly.

Establishing Planning Materiality. The auditor's determination of materiality, according to AU-C 320.04, is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of users of the financial statements. AU-C 200.07 observes that generally misstatements or omissions are viewed as material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions made by users that are based on the financial statements, and that materiality decisions involve both quantitative and qualitative considerations. For construction contractors, surety underwriters and lenders are often common financial statement users. AU-C 320 does not adopt or provide a specific definition of materiality. AU-C 320.02 refers the auditor to the discussion of materiality in the financial reporting framework applicable to the preparation and fair presentation of the financial statements under audit.

If the financial reporting framework is GAAP, for example, then the pronouncements of the FASB would provide a frame of reference for making materiality decisions and judgments. For GAAP, the concept for determining materiality is the following definition from the nonauthoritative FASB Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting—Chapter 3, "Qualitative Characteristics of Useful Financial Information"*:

> Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information of a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report.

The reference to "based on the nature or magnitude or both" in that definition recognizes that qualitative as well as quantitative factors influence materiality judgments. As previously mentioned, however, in determining *planning* materiality the focus is generally on quantitative factors. For this reason, auditors have historically used some common rules of thumb in establishing planning materiality.

These rules of thumb generally apply a percentage to a benchmark amount from the financial statements. AU-C 320.A5 acknowledges the appropriateness of using this approach as a starting point in determining materiality for the financial statement as a whole and suggests the following factors to consider in selecting an appropriate benchmark:

- Elements of financial statements (for example, assets, liabilities, equity, income, and expenses).
- Nature of the entity, where it is in its life cycle, and the industry and economic environment in which it operates.
- Ownership structure of the entity and the way it is financed.
- Focus of financial statement users' attention on particular items (for evaluating financial performance, for example, revenue, gross profit).
- Relative volatility of the benchmark.

AU-C 320.A6 provides the following examples of benchmarks that might be appropriate depending on the nature and circumstances of the entity:

- Total revenue.
- Gross profit.
- Profit from continuing operations before tax.
- Profit before tax.

- Total expenses.
- Total equity.
- Net asset value.

The appropriate benchmark and the related percentage applied to it can vary with the circumstances. In addition to assessing what users of the financial statements are likely to regard as important, the auditor might find it necessary to consider how significant changes in (a) the economy or industry, (b) the contractor's budgets or forecasts, (c) the contractor's conditions, and (d) the contractor's financial position or operating results between the prior and current periods, affect determination of the benchmark and percentage applied.

Selecting a Benchmark. The guidance in AU-C 320.A5–.A6 on identifying an appropriate benchmark allows the auditor significant discretion and flexibility in making the selection. The auditor needs to give consideration to the focus of financial statement users' attention on particular elements of those statements or aspects of operations. A nonpublic contractor is generally financed by debt, which means total assets is one important focus. Another important focus is obviously the size and level of construction activity, which means total revenue is also an important focus. The guidance in AU-C 320 identifies both total assets and total revenue as appropriate factors or examples. This guidance also acknowledges the appropriateness of considering practical factors such as relative volatility of the benchmark. For these reasons, some auditors prefer to use the larger of total assets or total revenue as the benchmark. This has the advantages of relative stability, predictability, and being reflective of the level and size of contracting operations. The auditor needs to consider, however, whether the circumstances of the particular contractor would cause a user to focus on some other financial statement items.

Regardless of the benchmark the auditor uses for planning the extent of audit testing, he or she needs to be satisfied that the combined effects of the nature, timing, and extent of planned procedures will be adequate to provide reasonable assurance that the financial statements are free from material misstatement, even if a different materiality benchmark is used for evaluation of audit differences. A planning materiality benchmark primarily affects the extent of audit testing, but does not necessarily provide a basis for determining the adequacy of other aspects of audit planning; namely, the nature and timing of procedures. Also, the choice of a benchmark for planning purposes does not predetermine what will be relevant in evaluating detected misstatements at the conclusion of the audit. The auditor may use a *size-of-business* benchmark, such as assets or revenues, to plan the scope of audit testing but still use a *percentage-of-earnings* benchmark for the evaluation of audit findings.

Selecting a Percentage. There are no authoritative percentage guides for materiality. AU-C 320.A9 explains that a relationship exists between the percentage and the chosen benchmark. For example, a percentage applied to profit from continuing operations before tax will normally be higher than a percentage applied to total revenue. Because most contractors do not keep their books on a GAAP basis, before determining planning materiality, an estimate of the contractor's total revenues needs to be made. This estimate may be based on knowledge of comparable adjustments made in prior years or by working with the client and considering the revenue to be recognized on each contract in progress.

Determining Materiality for Particular Items of Lesser Amounts

AU-C 320.10 indicates that, in addition to determining a planning materiality amount for the financial statements taken as a whole, the auditor should consider whether, in the specific circumstances of the entity, misstatements of particular items of lesser amounts than planning materiality could be expected to influence economic decisions of users. Any such amounts determined represent lower materiality levels to be considered in relation to the particular classes of transactions, account balances, or disclosures in the financial statements for audit planning purposes. In other words, in addition to determining materiality at the financial statement level, the auditor determines whether there are particular classes of transactions, account balances, or disclosures for which a lower planning materiality amount is appropriate based on user perceptions of the particular items. Many auditors believe, for example, that a lower materiality threshold is appropriate for related party transactions and balances.

Determining Performance Materiality

The auditor's objective is to perform the audit to obtain reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial

statements. For this purpose, the auditor needs to establish a performance materiality amount (or amounts) at the individual account balance, class of transaction, or disclosure level.

Performance materiality is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. When applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level(s) for particular classes of transactions, account balances, or disclosures. AU-C 320.11 states that the auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.

Performance materiality is distinguishable from tolerable misstatement. As explained in AU-C 320.A2, the application of performance materiality to a particular audit sampling procedure is called *tolerable misstatement*. AU-C 530.A6 also provides the guidance that tolerable misstatement may be the same amount or an amount smaller than performance materiality. *Performance materiality* is materiality at the account balance or transaction class level. *Tolerable misstatement* is materiality at the test or procedure level, for a specific account balance or transaction class when that procedure or test is applied using audit sampling. Auditors need to establish at least one level of performance materiality. However, differing amounts can be established for various transactions classes, account balances, and disclosures.

A Practical Approach to Determining Performance Materiality. Professional standards do not discuss precisely how performance materiality is to be determined. At the conclusion of the audit, the auditor needs to be able to reach the judgment that the risk is relatively low that the financial statements as a whole are materially misstated. This ultimate objective can provide a general conceptual framework for determining performance materiality.

This suggested approach is used to determine performance materiality as a percentage of the auditor's judgment about the amount material to the financial statements taken as a whole. The percentage used is based on the auditor's expectation of uncorrected and undetected misstatements. Using this approach, a common rule of thumb is to calculate performance materiality as a fraction between 50% and 75% of materiality at the financial statement level (and materiality for items of lesser amounts, if applicable) with the percentage being increased from 50% as the likelihood of uncorrected and undetected misstatements decreases. (*PPC's Guide to Audits of Nonpublic Companies* provides extensive information regarding performance materiality and other materiality levels.)

Types of Misstatements

AU-C 450, *Evaluation of Misstatements Identified During the Audit*, at AU-C 450.A3, provides the following terminology to distinguish between the types of misstatements, which auditors may find beneficial in evaluating the effect of misstatements accumulated during the audit and communicating misstatements to management and those charged with governance:

a. *Factual Misstatement.* This is a misstatement about which there is no doubt.

b. *Judgmental Misstatement.* A judgmental misstatement is one that arises from judgments made by management related to accounting estimates that the auditor believes to be unreasonable. This type of misstatement may also arise due to the selection or application of accounting principles by management that the auditor considers to be inappropriate.

c. *Projected Misstatement.* This type of misstatement is the result of the auditor's best estimate of misstatement extrapolated to entire populations arising from the use of sampling procedures.

Factual misstatements are observed directly by the auditor when performing audit procedures. For example, an expense transaction recorded in the wrong accounting period is a factual misstatement, as is the difference between the amount of depreciation expense allowed for tax purposes versus the amount computed in accordance with GAAP (and therefore the amount charged to contract costs) when the client uses its tax basis depreciation in its GAAP basis financial statements. Judgmental and projected misstatements, while not actually observed by the auditor, arise from procedures performed during the audit. For example, the auditor may determine through performance of procedures that the contractor's calculation of percentage-of-completion on certain contracts is

unreasonable, resulting in the identification of a judgmental misstatement. Additionally, the auditor may determine the amount of a projected misstatement based upon the results of a sampling application. (However, as previously explained, there may not be any significant amount of projected misstatement because there are often no, or limited, audit sampling applications in an audit of a construction contractor.)

Clearly Trivial Misstatements. AU-C 450.05–.11 provide that auditors are required to accumulate and evaluate misstatements detected during the audit, other than those that are clearly trivial. The amount determined to be clearly trivial is the level for accumulating misstatements during the concluding audit work and is typically referred to as the amount for passed adjusting entries or the nonposting threshold. Misttatements detected in a particular audit are below this amount not posted to the summary of audit differences. This amount is set so that any such misstatements either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered. If the amount is set too high, the auditor might be exposed to material misstatements in the financial statements. If the amount is set too low, the auditor might encounter inefficiencies dealing with immaterial misstatements.

Best practices suggest that a practical rule of thumb for designating clearly trivial misstatements is to use 3%–5% of planning materiality, depending on expectations about misstatements. As is the case for all rules of thumb, this approach cannot be applied mechanically. For example, if the auditor expects a large number of small misstatements or becomes aware that misstatements passed at the workpaper level are tending to go in one direction, the auditor might lower the threshold for clearly trivial misstatements. AU-C 450.12 requires the auditor to document the amount below which misstatements would be considered clearly trivial.

Documentation Requirements—Materiality. AU-C 320.14 requires the auditor to document the following relating to materiality, including factors considered in their determination:

a. Materiality at the financial statement level.

b. If applicable, materiality level(s) for particular transaction classes, account balances, or disclosures.

c. Performance materiality.

d. Revisions, if any, as the audit progresses from a. through c. above.

Additional Materiality Concepts Needed for a Contractor Audit. In addition to the concepts of materiality previously discussed for planning and performing the audit, there is a need for materiality concepts that are unique to the audit of a construction contractor. These concepts are *contract materiality* and *individually significant contract*. The meaning of the concepts unique to construction contractors and their relationship to the materiality concepts and rules of thumb discussed previously are as follows:

- *Contract Materiality*—planning materiality less factual uncorrected misstatements. *Contract materiality* and *performance materiality* are the same except that in calculating *contract materiality* there is no option to use the 50% to 75% rule of thumb. The auditor deducts *factual uncorrected misstatements*, if any. (If there are no *factual uncorrected misstatements*, *contract materiality* will equal *planning materiality*.)

- *Individually Significant Contract*—an unusual contract (that is, a contract that has audit significance by its nature) or a contract that is significant because of its size (its dollar amount). See the discussion of factors to consider in determining individually significant contracts later in this section. (As a rule of thumb, *contract materiality* is often used as the cutoff for *individually significant contracts*, but an amount less than *contract materiality* may also be used.)

Exhibit 2-1 compares and contrasts the approach to using materiality guidelines in a typical nonpublic company audit versus a construction contractor audit.

Exhibit 2-1

Materiality Guidelines

	Approach	
Concept	**Typical Small to Midsized Nonpublic Company Audit**	**Typical Construction Contractor Audit**
Planning materiality—the preliminary judgment about the amount that is material to the financial statements taken as a whole.	Computed as a percentage of the larger of total assets or total revenue, or another benchmark from the financial statements multiplied by an associated percentage.	Same, except that preliminary adjustments may be necessary to state total revenue on a percentage-of-completion basis.
Contract materiality—the amount considered material in selecting contracts.	Concept not applicable to a typical nonpublic company audit.	Normally computed as an amount equal to planning materiality minus any factual misstatements that will not be corrected by the client.
Individually significant contract or contract item—a contract or contract item (or an accumulation of like items) selected for testing because of its unusual nature or its size.	Concept not applicable to a typical nonpublic company audit.	For confirmation purposes, this would normally be any contract in progress that has a *contract price* equal to or greater than contract materiality. For purposes of cost testing, this would normally be any contract in progress that has *costs incurred during the year* equal to or greater than contract materiality. In some situations, this cutoff amount can be lowered, but normally not below 1/2 of contract materiality.
Performance materiality—the amount considered material to a noncontract account balance or class of transactions.	Normally computed as 50% to 75% of planning materiality. May also be computed as planning materiality minus any factual (known) misstatements the auditor expects to detect that the client will not correct and likely misstatements estimated as a result of using audit sampling or analytical tests.	Same.
Individually significant noncontract item—an individual item (or an accumulation of like items) within a *noncontract* account balance or class of transactions selected for testing because of its unusual nature or its size.	Often this would be an item (or an accumulation of like items) that equals or exceeds 1/3 of performance materiality. However, performance materiality or any amount less than performance materiality may also be used.	Same, except this concept is often not applicable to a contractor audit unless the contractor has material *noncontract*-related accounts or activity.

* * *

Selection of Individually Significant Contracts. One of the important uses of materiality in the audit of a construction contractor is the selection of individually significant contracts from the schedule of contracts in progress. The following factors are generally considered in determining which contracts are significant:

- The contract costs incurred to date compared to the contract materiality. If the costs incurred to date equal or exceed contract materiality, the contract will normally be considered significant.
- The susceptibility of the contract to fraud, including both theft or similar loss of related assets and intentional misstatement by management.
- The nature of the contract and whether similar contracts have required significant adjustments in prior periods.
- The contractor's history of accurately estimating contract costs on similar contracts and the job supervisor's performance on other contracts.
- Contracts that have a high-assessed level of inherent risk for other reasons, such as new contract terms, new types of construction projects, new geographic areas, and claim experience.

The auditor always selects some individually significant contracts for testing. If no contract amounts exceed contract materiality, an approach similar to that described later in this section is followed.

Selection of Other Items. In other contract-related audit areas, the auditor may also use the approach of selecting all items above a certain cutoff amount for testing. In these other areas, an effective approach is usually to use 1/2 of contract materiality as the starting point and, if all or substantially all items are still below that amount, to continually reduce the amount until a reasonable number of items is selected. When audit sampling may be applicable and in noncontract-related areas, the risk assessment guidance in *PPC's Guide to Audits of Nonpublic Companies* might be considered. In addition, AU-C 240 requires auditors to incorporate an element of unpredictability in the selection of audit procedures from year to year as an overall response to fraud risk. To introduce an element of unpredictability, the auditor needs to avoid always selecting only items above a cutoff dollar amount, particularly when that cutoff amount does not vary significantly from year to year. The auditor can make a haphazard selection to test items below the cutoff amount to avoid providing client personnel with a roadmap of how to circumvent the audit approach.

Assessing Risks of Material Misstatement at the Financial Statement Level

Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. It is a function of the risk that the financial statements are materially misstated and the risk that the auditor will not detect such material misstatement. In this sense, audit risk is the risk of material misstatement remaining in the financial statements after the audit. Audit risk cannot be precisely measured as a percentage; thus, consideration of audit risk is necessarily judgmental, not mathematical.

AU-C 315.03 states that "the objective of the auditor is to identify and assess the risks of material misstatement, whether due to error or fraud, at the financial statement and relevant assertion levels." When considering audit risk at the financial statement level, the auditor considers risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. (These risks are also referred to as *overall risks*.) Risks of material misstatement at the financial statement level often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. These overall risks are often especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control. Risks at the financial statement level might also relate to the process of financial statement preparation, selecting and applying significant accounting policies, such as aspects of percentage-of-completion accounting, IT general controls, and entity-level controls other than the control environment.

At the individual account balance, class of transaction, or disclosure level, the risk of material misstatement consists of inherent risk and control risk. Some auditors have questioned whether these risks also need to be considered explicitly at the financial statement level. The answer is, "No." Best practices indicate that at the financial

statement level the assessment is an overall or combined assessment of the risks of material misstatement. There is no requirement to separately assess inherent risks and control risks at the financial statement level. The overall assessment of risks of material misstatement at the financial statement level is made relatively early in audit planning, based on information such as the effectiveness of the entity's control environment and identification of fraud risk factors.

Responding to Risks at the Financial Statement Level. AU-C 330.05 states that "the auditor should design and implement overall responses to address the assessed risks of material misstatement at the financial statement level." AU-C 330.A1 suggests possible responses to address risks of material misstatement at the financial statement level. These responses may include:

- Emphasis to the audit team to use professional skepticism.
- Assigning staff with higher experience levels or specialized skills or using specialists.
- Increasing the level of supervision.
- Using a greater degree of unpredictability in selecting audit procedures.
- Changing the nature, timing, and extent of substantive procedures (e.g., instead of interim testing, shift testing to period end or modify the nature of audit procedures to obtain more persuasive evidence).

In addition, the auditor should consider any specific relevant assertions that might be affected by the overall risks and develop responses at that level when designing the nature, timing, and extent of further audit procedures.

Exhibit 2-2 provides examples of overall risks and potential responses.

Exhibit 2-2

Examples of Overall Risks and Responses

Overall Risk	Example Responses
No communication of ethical values. Management exhibits behavior that occasionally reflects a loose regard for ethical business practices. (The auditor assumes a risk of management override of controls. This also assumes that the auditor does not perceive the risk to be so great to either decline or withdraw from the engagement.)	• Place higher emphasis on the use of professional skepticism. • Assign staff with higher experience levels. • Review accounting estimates for bias. • Evaluate business rationale for unusual transactions. • Examine more journal entries, particularly nonstandard journal entries. • Make greater use of unpredictability in audit procedures. • Increase the extent of fraud-related inquiries.
Turnover in key management during the year.	• Increase the level of supervision. • Review accounting estimates for bias. • Evaluate more closely the business rationale for unusual transactions.
Going concern considerations that may impact future financing, business investment, or other business opportunities.	• Increase the level of supervision or assign more experienced staff. • Shift substantive procedures to year end. • Review accounting estimates for bias. • Emphasize the use of professional skepticism.

Overall Risk	Example Responses
A minimal degree of compliance with restrictive loan covenants containing various required operating ratios for significant financing agreements.	• Shift substantive procedures to year end. • Review accounting estimates for bias.
Management exhibits a low regard for hiring competent finance personnel.	• Increase the level of supervision or assign more experienced staff. • Shift substantive procedures to year-end.

* * *

Other overall responses may also be appropriate to address identified fraud risks. Exhibit 2-3 provides examples of overall responses to fraud risks.

Exhibit 2-3

Overall Responses to Fraud Risks

Staffing and Supervision:
- Assignment of more experienced audit personnel to the engagement or increased supervision of engagement personnel.
- Assignment of personnel with industry or functional expertise.
- Involvement of specialists.

Selection and Application of Accounting Principles:
- Increased scrutiny of the client's selection and application of significant accounting policies, particularly those that deal with revenue recognition, asset valuation, or capitalizing versus expensing.

Incorporating an Element of Unpredictability:
- Altering the timing of tests.
- Changing sampling methods.
- Performing procedures at different locations, such as job site visits, or on an unannounced basis.
- Performing a different combination of substantive analytical procedures and tests of details.
- Testing account balances and assertions otherwise considered immaterial or low risk.

Other Overall Responses:
- Increased sensitivity to the nature, timing, and extent of documentation examined in support of material transactions.
- Increased recognition of the need to corroborate client explanations or representations concerning material matters, such as through additional analytical procedures, examination of documentation, or corroboration with others within or outside the company.
- Further consideration of the auditor's control risk assessment (if control risk has been assessed at less than the maximum) if identified fraud risks have control implications.
- Increased scrutiny of the nature and business reasons for unusual and/or overly complex transactions.

* * *

Because there is always a risk of management override of controls, AU-C 240.29 states that certain overall responses are required in every audit, as follows:

- Auditors should consider the knowledge, skill, and ability of individual engagement team members and the fraud risk assessment when assigning and supervising personnel.

- Auditors should consider the client's selection and application of accounting principles, especially in subjective areas.

- Auditors should incorporate an element of unpredictability in the selection of audit procedures from year to year.

Documentation. AU-C 315.33 requires the auditor to document the identified and assessed risks of material misstatement at the financial statement level. The auditor is also required by AU-C 330.30 to document overall responses to such risks.

Assessing Risks of Material Misstatement at the Relevant Assertion Level

The auditor's consideration of audit risk at the individual account balance, transaction class, or disclosure level directly assists the auditor in determining the nature, timing, and extent of further audit procedures for relevant assertions related to balances, classes of transactions, or disclosures. The auditor needs to understand the following basic concepts to perform the assessment of risks of material misstatement at the assertion level:

- The audit risk model.

- The risk of material misstatement.

- Relevant assertions.

The Audit Risk Model. AU-C 200.14 defines *audit risk* as "the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated." It further explains that audit risk is a function of the risks of material misstatement and detection risk. AU-C 200.14 defines those terms as follows:

- *Risk of Material Misstatement*—The risk that the financial statements are materially misstated prior to the audit. This consists of two components, described as follows at the assertion level:

  - *Inherent Risk*—The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

  - *Control Risk*—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

- *Detection Risk*—The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

The audit risk concept can be expressed in formula form based on the following:

- AR—Audit Risk

- RMM—Risk of Material Misstatement

- IR—Inherent Risk

- CR—Control Risk

- DR—Detection Risk

DR is a function of the effectiveness of the nature, timing, and extent of procedures applied by the auditor and can be viewed as being a function of the following two components:

- TD—Tests of Details Risk
- AP—Substantive Analytical Procedures Risk

Risk of Material Misstatement. The risk of material misstatement is a function of inherent risk and control risk. The auditor assesses those two risks and then designs audit procedures to reduce detection risk to an appropriately low level. Fraud risks encompass both inherent and control risk attributes. Therefore, the auditor's separate assessments of inherent and control risk include consideration of the risk of material misstatement due to fraud. The combined effect of inherent risk (IR) and control risk (CR) is the risk of material misstatement (RMM). In other words, the aggregate risk of material misstatement in the risk model is expressed as follows:

$$RMM = IR \times CR$$

Inherent risk and control risk are the entity's risks and exist independently of the audit. The risk of material misstatement (RMM), the product of IR and CR, is the auditor's combined assessment of the two risks. The auditor may make an overall, or combined assessment of the risk of material misstatement at the relevant assertion level or make separate assessments of inherent risk and control risk and then combine them. Thus, at the relevant assertion level, the audit risk model is as follows:

$$AR = RMM \times DR, \text{ where } DR = TD \times AP$$

The greater the risks of material misstatement, the less detection risk can be accepted. As a result, auditors would need to obtain more persuasive audit evidence.

In planning a particular test of details, the detection risk is established by the following relationship:

$$TD = \frac{AR}{RMM \times AP}$$

This model is not intended to be a mathematical formula including all factors that influence the assessment of audit risk, but some auditors find such a model in its formula form to be useful.

Relevant Assertions. AU-C 315.04 defines a *relevant assertion* as one "that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated." For example, the valuation assertion is usually not relevant to the gross amount of the accounts receivable balance, but is usually relevant to the related allowance for doubtful accounts. Relevant assertions are identified by evaluating the following:

- The source of likely potential misstatement in each significant class of transactions, account balance, and disclosure.
- The nature of the assertion.
- The volume of transactions or data related to the assertion.
- The nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertions.

Assessing the Risk of Material Misstatement at the Relevant Assertion Level. The assessment of audit risk at the relevant assertion level, whether made in quantitative terms (such as percentages) or nonquantitative terms (such as high, moderate, or low), is a judgment rather than a precise measurement of risk. The auditor needs to have an appropriate basis for the judgment about risk at the relevant assertion level. This basis is obtained through the risk assessment procedures performed to obtain an understanding of the entity and its environment. The only time that use of the formula for the audit risk model and specific percentages are necessary is when statistical

sampling is used, but the formula can be useful in other circumstances as well. The auditor's assessment of the components of the risk model is always made subjectively. Even when the auditor quantifies the components as a percentage, the judgment is subjective and not a mathematical calculation.

Determining Significant Audit Areas. The next step is to identify those audit areas that are significant. (An audit area encompasses the related account balances, transaction classes, and disclosures.) The following factors should be considered in determining which audit areas are significant:

- Relative materiality of the account balance to the overall financial statements.
- Relative significance of the transaction class to the entity's operations or to the overall financial statements (for example, because of either the materiality or volume of transactions flowing through the account during the period).
- The susceptibility of the account balance or transaction class to fraud, including both theft and similar loss of related assets and intentional misstatement by management.
- Audit areas that for other reasons (such as complex calculations, difficult or contentious accounting issues, new accounting standards, need for judgment, unusual nature of transactions, past history of significant adjustments, or other engagement risk factors) have a high assessed level of inherent risk or contain significant risks.
- Disclosures that require additional effort at the account balance level in individual audit areas to ensure their accuracy and completeness.

An aspect of the first element of significance previously listed is the dollar amount of the account balance in relation to the auditor's judgment of the amount material to the financial statements taken as a whole. Judgment is required even in making these quantitative comparisons because account balances are usually not completely misstated. Account balances other than liabilities and valuation allowances, with an ending balance below performance materiality, generally would be regarded as quantitatively immaterial and not significant. Account balances that are some multiple of performance materiality are generally quantitatively significant. Account balances that are approximately equal to performance materiality require careful consideration as to the nature of the account balance and prior experience with the client in evaluating significance.

Relative Significance to the Financial Statements. As indicated at AU-C 315.28–.31, the auditor's risk assessment should include an evaluation of whether the following risks are present:

- Significant risks that require special audit consideration.
- Risks for which substantive procedures alone do not provide sufficient appropriate evidence.

Significant Risks Requiring Special Audit Consideration. The auditor determines which of the risks identified by risk assessment procedures are risks that require special audit consideration. The auditor's determination of significant risks is based solely on the consideration of inherent risk, that is, before consideration of the effect of identified controls related to the risk. The auditor determines whether the risk is such that it requires special audit consideration by focusing on the following:

- The nature of the risk.
- The likely magnitude of the potential misstatement, including the possibility of multiple misstatements.
- The likelihood of the misstatement occurring.

Each of these aspects of the auditor's consideration needs attention in determining whether special audit consideration is necessary, but the nature of the risk is particularly important.

According to AU-C 315.29, the nature of the risk should be evaluated by considering the following:

- Is the risk a risk of fraud or theft?

- Is the risk related to recent significant economic, accounting, or other developments?
- Are the transactions complex?
- Does the risk involve significant transactions with related parties?
- Is there a relatively large degree of subjectivity in the measurement of the financial information related to the risk?
- Does the risk involve significant nonroutine transactions outside the normal course of business or that otherwise appear unusual?

An affirmative answer to any of these questions is likely to indicate the need for a specific audit response and, thus, a determination that the risk is a significant risk because it requires special audit consideration. Risks of material misstatement due to fraud are always significant risks. Risks of material misstatement due to error also may be deemed significant risks depending on their nature.

When considering the risk of misstatement caused by error, the auditor needs to be aware that there are several characteristics of contractors that affect the risk. For example, construction contractors frequently have lower pay scales, which may result in rapid employee turnover. Due to high turnover, contractors may have accounting personnel who have limited accounting experience or training. In addition, due to the complex nature of the construction contractor industry, it is not uncommon for these entities to follow accounting practices that are not in conformity with GAAP. Finally, some construction contractors do not have adequate accounting systems. These situations can significantly increase the risk of misstatement from error.

The auditor also needs to be alert for transactions that the contractor may not routinely record. For example, is the contractor involved in a joint venture and are the journal entries made to record that activity on an infrequent basis, such as quarterly or semi-annually? Certain types of contracts, transactions, or events may create a greater specific risk of material misstatement. For example, the accounting by a contractor that becomes involved in an environmental claim for the first time can be complex, and recording the claim in accordance with GAAP may be difficult until accounting personnel are more familiar with the requirements.

Risks for Which Substantive Procedures Alone Are Not Sufficient. As part of the auditor's risk assessment, he or she might identify those risks for which it is not possible or practicable to reduce detection risk at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures. Such risks often occur in audit areas in which there is highly automated processing with little or no manual intervention, that is, situations in which a significant amount of the entity's information is initiated, authorized, recorded, processed, or reported electronically.

Significant Risks in a Construction Contractor Audit

The most common high-risk areas for construction contractors are those areas and accounts associated with construction contracts, such as revenues, costs, estimates to complete, and percentage of completion. Common examples of areas that might be high risk, depending on the contractor, include the following:

- Recognizing contract revenue.
- Recognizing contract costs, including properly allocating costs to specific contracts.
- Assessing claims and change orders.
- Recognizing anticipated losses on loss contracts.
- Developing complete and accurate estimates to complete.
- Complying with debt covenants and bonding requirements.

- Declining revenue due to an unstable economy.
- Addressing the impact that bad publicity can have on obtaining future contracts.
- Declining backlog due to increased competition from other contractors or general economic conditions.
- Accruing environmental remediation liabilities.
- Recording and disclosing income taxes and deferred income taxes.

Significant Contract Risks. Because the primary focus in audits of construction contractors is normally the individual contracts, the existence of significant risks needs to be considered for each individually significant contract. Some of the factors that may increase or decrease the risk associated with a contract include the following:

- *The Stage of Completion.* Contracts that are less than 25% complete as of the audit date normally have a relatively low risk because little profit has been recognized, billings may not have been made, and a smaller portion of costs have been incurred. In addition, some contractors have adopted an accounting policy of not recognizing gross profit on contracts until they are at least 10% complete. At the other end of the spectrum, for contractors using the percentage-of-completion method of accounting, contracts that are 90% or more complete are normally lower risk because the remaining costs to complete can be more accurately estimated and a large proportion of the billings may have been made and collected.
- *The Type of Contract.* Fixed-fee contracts normally have higher risks than cost-plus contracts because with cost-plus contracts, the contractor can bill the actual construction costs plus an agreed-upon profit percentage. However, with fixed-fee contracts, the contractor agrees to complete the project for an agreed-upon price regardless of unanticipated problems or difficulties that may occur and accordingly, may only bill the contract amount (unless change orders are approved).
- *The Type of Contractor.* Certain types of contractors often incur more risk than others. For example, general contractors often have more risk on contracts than subcontractors due to the nature of the relationship and the contract terms.
- *The Type of Project.* A new type of project may significantly increase the risk of the project. For example, if a contractor previously built only single-family homes but now has a contract in progress to construct an office building with parking garage, the risk might be higher. Also, a more-complex project that includes unique features might increase risk.
- *The Relative Size of the Project.* A larger project generally poses a greater risk of material misstatement than a smaller project.
- *The Location of the Project.* Projects located in new geographical areas may increase the risks to a contractor. For example, risks may be higher because of a new work force, higher than expected costs, or unexpected building regulations. Also, a project in a location that is more susceptible to adverse weather conditions might create a higher risk.
- *The Architect, Engineer, and/or Inspector on the Project.* Architects, engineers, and inspectors can affect the costs and success of a construction project. For example, a detailed, rigorous inspector may require a contractor to install additional safety features that might not be required by a different inspector. Past experience with these professionals may be beneficial to the auditor in the risk assessment.
- *Provisions in the Contract.* Auditors need to be alert for contract provisions that increase risk, such as penalties against the contractor for late completion. Also, shorter-term contracts are generally less risky than longer-term contracts.
- *The Number of Claims and Change Orders.* Contracts with several claims or change orders normally expose the contractor to more risk.

- *Contracts with Significant Unbilled Receivables.* Significant unbilled receivables may be a result of negotiated contract terms which might not significantly increase risk, or they may be a sign of the contractor incurring unexpected costs to complete the contract which would increase risk.

- *Owners of the Project.* Risk may be increased due to the financial stability of the project owner. For example, if the project owner is currently facing financial difficulties, contracts with this entity may have a higher risk.

The interrelationships of factors that affect audit risk also need to be considered. For example, a contractor may have numerous fixed-fee contracts with a history of making poor estimates of the costs required to complete a project. Thus, the contractor is vulnerable to incurring losses on those contracts. How has management responded to this risk? What controls has management instituted to reduce the risk of misstatement? For example, senior management may have assigned someone to monitor the actual versus estimated costs incurred to date and prepare periodic reports showing this comparison. The auditor would then consider the factors relevant to the effective operation of that control, whether management is under any pressure (such as pressure to comply with restrictive debt covenants) to override the control, and what substantive procedures can be designed in response.

Schedule of Contract Activity. The schedule of contract activity is the beginning point for the auditor's assessment of risks related to specific contracts. The schedule includes all contracts completed during the period and all contracts in progress at the end of the period. The contractors' cost accounting systems may generate comparable schedules with summaries of billings and costs incurred to date for each contract. The auditor needs to test that amounts in the schedule of contract activity agree with or reconcile to the audited financial statements.

If the auditor wishes to plan the contractor audit as of an interim date, an interim schedule of contract activity needs to be obtained with applicable year-to-date information. After year end, the auditor obtains a final schedule with the complete period's data. The auditor identifies any new contracts obtained after the interim date to year end and also compares the activity on existing contracts after the interim date to year end to identify other significant contracts not identified at the planning date. In addition, the status of some contracts may have changed significantly or unexpectedly after the interim date to the end of the period. For example, a contract may have been expected to be substantially complete by the end of the period, but because of weather delays or other factors was only 70% complete at year-end. These types of events may cause the auditor to reconsider the significance, the assigned risk score, and/or the planned audit procedures for that contract.

Mitigating Factors or Controls. The auditor considers whether any mitigating factors or controls are in place that would lessen the effect of the identified contract risks. For example, an auditor may identify a significant risk with a contract due to its stage of completion, size, and term. However, this project may be very similar to others completed by the contractor in prior years, and the project manager may have historically demonstrated the ability to accurately estimate total costs and costs to complete as evidenced by the profit gain/fade analysis. In addition, controls may exist within the accounting department for the approval and recording of contract costs, billings, etc. The presence of these mitigating factors may allow the auditor to assign a moderate or low contract risk for that contract, as described in the following paragraph.

Contract Risk Score. Based on the significance of the contract, the significant risks affecting the contract, and any mitigating factors, the auditor assigns a contract risk score of high, moderate, or low to each contract. This is a very subjective step that requires the auditor to make a judgmental decision after considering all of the information obtained about the contract. However, this is not a simple determination of whether the risk for that contract is high, medium, or low. The auditor also has to consider the expected cause and direction of the potential misstatement of the contract, as well as the contractor's expectations.

A high risk score would generally be assigned to a significant contract with one or more significant risks. For example, a fixed-fee contract being managed by a new project manager that is 40% complete, has total costs to date of five times contract materiality, and has a tight deadline with substantial penalties for late completion would normally be considered a high risk contract. A moderate risk score might be assigned to a contract with a significant risk that is partially mitigated. A low risk score may be assigned to a contract that does not have any significant risks. Exhibit 2-4 presents some of the common characteristics associated with each contract risk score. It is important to note that not all of these characteristics must be present for a contract to receive the related risk score.

Exhibit 2-4

Common Characteristics Associated with the Contract Risk Scores

High Risk	Moderate Risk	Low Risk
• No mitigating factors or controls exist	• Some mitigating factors or controls exist	• Mitigating factors or controls exist
• Multiple fraud risk factors are identified	• Few fraud risk factors are identified	• No fraud risk factors are identified
• Estimated percentage of completion is 25%–90%	• Same as high risk	• Estimated percentage of completion is less than 25% or more than 90%
• The contract is a fixed-fee contract	• The contract is a fixed-fee contract, or could also be a cost-plus contract	• The contract is a cost-plus or similar contract
• The project is a new or complex type of construction	• The project may be a new or complex type or may be similar to others	• The project is very similar to others constructed by the contractor
• Numerous claims or change orders have been initiated	• Few claims or change orders have been initiated	• No claims or change orders have been initiated
• The billing status is substantially inconsistent with the type of contractor	• The billing status is inconsistent with the type of contractor	• The billing status is consistent with the type of contractor
• Historically, the project manager has been poor at bidding and estimating costs	• Historically, the project manager has made reasonable bids and cost estimates	• Historically, the project manager has been very accurate at bidding and estimating costs
• The project owner is having significant financial difficulties	• The project owner may be having minor financial difficulties	• The project owner has a strong financial status
• The contractor's job cost system is poor	• The contractor's job cost system is adequate	• The contractor's job cost system is excellent
• The project size is much larger than average	• The project size is average	• The project size is much smaller than average

High Risk	Moderate Risk	Low Risk
• The contractor has had no previous experience with the project owner	• The contractor has had some previous experience with the project owner	• The contractor has had significant previous experience with the project owner
• The contractor has had no or little previous experience with some or all of the subcontractors	• The contractor has had some previous experience with most of the subcontractors	• The contractor has had significant previous experience with most or all of the subcontractors

* * *

After assigning a contract risk score to each significant contract, the auditor can make an initial decision on the audit approach that is appropriate for each contract.

Establishing an Overall Audit Strategy

AU-C 300.07 states that the auditor should establish an overall strategy for the audit. The audit strategy is the auditor's operational approach to achieving the objectives of the audit. It is a high level determination of the audit approach and it includes the identification of overall risks, overall responses to those risks, and the general approach to each audit area as being substantive procedures or a combination of substantive procedures and tests of controls. Determination of audit strategy would normally be the responsibility of more-senior and experienced members of the audit team, including the audit partner, all of whom need to have the appropriate industry experience, given the judgments required.

AU-C 300.08 provides that in establishing the overall audit strategy the auditor should do the following:

a. Determine the key characteristics of the engagement that define its scope.

b. Determine the reporting objectives of the engagement to plan the timing of the audit and the nature of communications required.

c. Consider the significant factors that will determine the focus of the engagement team's efforts.

d. Consider the results of preliminary engagement activities.

e. Consider, if applicable, the knowledge from other engagements performed for the entity.

f. Determine the nature, timing and extent of resources needed to perform the audit.

Steps a. and b. are relatively straightforward factual determinations of the information to be audited, reporting objectives, the overall timing of the audit, and the written and other communications that will be required. Step c. is the heart of determining the nature, timing, and extent of audit procedures that will be necessary. In establishing audit strategy, these matters are dealt with at a high level rather than at the detailed audit plan level, which describes the nature, timing, and extent of procedures at the relevant assertion level. Steps d. and e. concern additional information that also may affect the focus of the engagement team's efforts. Finally, step f. concerns the personnel resources that will be needed to accomplish the audit objectives, including the involvement of specialists and other experts.

Significant Engagement Factors, Results of Preliminary Engagement Activities, and Knowledge Gained on Other Engagements. Important aspects of overall audit strategy that determine the focus of the engagement team's efforts generally include the following:

- Materiality considerations, including:
  - Planning materiality.

  - Contract materiality.
  - Materiality for components and component auditors.
  - Preliminary identification of significant components and material classes of transactions, account balances, and disclosures.

- Preliminary identification of areas where there may be higher risks of material misstatement, including those due to fraud.
- Effect of assessed risk of material misstatement at the overall financial statement level.
- Results of previous audits that involved tests of controls, including the nature of identified deficiencies and action taken to address them.
- Discussion of matters with firm personnel responsible for performing other engagements for the entity.
- Evidence of management's commitment to sound internal control, and importance attached to internal control, including appropriate documentation.
- Volume of transactions.
- Significant changes in accounting standards.
- Evaluation by audit area of whether the auditor plans to obtain evidence regarding the operating effectiveness of internal control, i.e., whether the auditor plans to use substantive procedures alone or a combination of substantive procedures and tests of controls.
- Manner of emphasizing the use of professional skepticism.
- Determination of general aspects of the nature, timing, and extent of further audit procedures, such as performing testing at the balance sheet date rather than at an interim date.
- Identification of recent significant developments affecting the contractor, its industry, its financial reporting, or its legal or economic environment.
- Determination of areas where client assistance is expected to be minimal.
- If the contractor has an internal audit function, determination of whether the work of that function will be used to obtain audit evidence or whether internal auditors will be used to provide direct assistance.

Nature, Timing, and Extent of Resources. In developing the overall audit strategy, the auditor incorporates decisions and judgments about overall responses to the risks of material misstatement at the financial statement level, as discussed earlier. A key outcome of developing the strategy is the determination of resources necessary to perform the engagement including:

- *Overall Personnel Resources* This includes the determination of the composition and deployment of the audit team (and if necessary, the engagement quality control reviewer), including the assignment of audit work to team members, especially the assignment of appropriately experienced team members to areas identified as having higher risks of material misstatement. The auditor also considers the extent of involvement of professionals possessing specialized skills. In addition, the timing of personnel deployment and engagement budgeting, especially for areas with higher risk, are considered.
- *Management and Supervision of Personnel.* This includes management and supervision considerations such as team briefing meetings, reviews by the partner and manager, and quality control reviews.

Timing of Developing the Audit Strategy. In some cases, the auditor may have sufficient information to establish a preliminary audit strategy prior to performing extensive risk assessment procedures based on knowledge from past experience with the client and the results of preliminary engagement activities. For example, in a continuing engagement, the auditor may be able to establish a preliminary audit strategy after completing the client continuance

procedures based on knowledge from the previous engagements and discussions with the client regarding any new issues or changes in client circumstances.

For new engagements, the auditor may have gained sufficient information while performing client acceptance procedures and gathering information for the fee proposal that would allow the development of a preliminary audit strategy. In fact, many auditors collect enough information during this process to make preliminary decisions on the assessment of overall risks, the determination of personnel requirements, use of specialists or other auditors, and other overall strategy matters. In these situations, the auditor simply needs to gather additional information throughout the performance of the risk assessment procedures to complete the overall audit strategy.

Revising the Initial Audit Strategy. It is not uncommon for auditors, after developing the initial audit strategy, to obtain information indicating that the audit strategy needs to be revised. AU-C 300.10 states that the auditor should update and modify the audit strategy as necessary throughout the engagement.

Communicating with Those Charged with Governance. The auditor may discuss elements of the overall audit strategy with those charged with governance. AU-C 260, The Auditor's Communication With Those Charged With Governance, at AU-C 260.11, requires the auditor to communicate with those charged with governance about the planned scope and timing of the audit. When these discussions occur, the auditor should be careful not to compromise the effectiveness of the audit, for example, by discussing the detailed nature and timing of audit procedures. The AICPA Guide at Paragraph 9.10 indicates that the auditor may consider communicating planning matters early in the audit engagement, and, for initial engagements, as part of the terms of the engagement.

Documentation. Establishing the overall audit strategy need not be complex or time consuming. AU-C 300.14 requires that the auditor document the overall audit strategy, the audit plan, any significant changes made to them during the audit, and the reasons. Professional standards do not necessarily require that a separate audit strategy memorandum be prepared to document in one place all matters that affect audit strategy. Many of the matters that relate to the overall audit strategy would be documented in the normal course of gathering information about the entity and its environment.

An efficient approach to documenting the audit strategy in the audit of a small contractor is to prepare a brief memorandum at the conclusion of the previous audit, based on a review of audit documentation and highlighting issues identified in the audit just completed, and then update and change it in the current period to provide a basis for planning the current audit. The update can be based on discussions with management or the owner/manager of the entity. As a practical matter, some auditors frequently prepare an "audit (or engagement) summary memo" as part of their engagement completion procedures to provide a convenient method of establishing a basis for planning the following year's audit engagement.

TIMING OF CERTAIN ENGAGEMENT PROCEDURES

Generally, performing some audit work at an interim date is more efficient and effective for a construction contractor client than it is for a typical small business client. This permits a CPA firm with construction contractor clients to shift audit personnel time away from the busy season, which can result in better use of personnel resources and improved morale. In addition, the auditor will have more time to resolve important accounting and reporting issues if they are identified at an interim date. To determine whether interim audit procedures would be beneficial and appropriate, the auditor considers the following items:

- *The Risks Associated with Each Contract.* Interim work may be performed on high risk contracts, but more procedures may need to be performed as of year end if significant construction work is expected to be performed in the remaining period.

- *The State of the Records at an Interim Date.* Some contractors do not keep their accounting records on the percentage-of-completion basis during the year, and some contractors may not have an accounting system capable of generating necessary reports at an interim date.

The primary areas in which there is an opportunity to efficiently and effectively perform work at an interim date are as follows:

a. job site visits,

b. review of contracts completed and in progress, and

c. tests of transactions for construction costs incurred.

When some audit work in these primary areas is performed at an interim date, it usually makes sense to attempt to schedule other audit work with flexible timing at the same time.

This discussion of primary areas that could benefit from interim procedures is not inclusive. Depending on the client and the risks associated with each contract, some of these procedures may be more effective if performed after the contractor's year end. Also, the extent of work on the project expected to be performed between the interim testing date and year end will affect this decision. For example, if there is only one month between the interim testing date and year end and because of holidays and bad weather, little work is expected to be performed; additional procedures may be performed effectively. However, before making this decision, the auditor needs to carefully evaluate whether interim procedures will yield the desired results.

If interim procedures are performed, the extent of testing required for the remaining period will depend on the length of the remaining period, the amount of contract costs incurred in the remaining period, and the risks related to the contract.

Job Site Visits

It is generally practical to perform job site visits at an interim date near year end when construction activity from the date of the visit to year end is not expected to significantly alter the stage of completion of the contract. Also, site visits may be performed at an earlier interim date as part of the planning process to improve the auditor's understanding of the contractor's operations. In many cases, site visits performed at an interim date may be viewed as tests of controls because they provide evidence of the operating effectiveness of internal control.

Review of Contracts Completed and in Progress

Normally, some worthwhile work on review of contracts can be performed at an interim date. For significant contracts, the auditor needs to become familiar with the basic terms of the contracts. This basic familiarity can be gained by selecting all significant contracts completed or in progress at the interim date and reviewing the signed contract; scanning the contract files, including correspondence; and discussing the contract with appropriate personnel. Completed contracts reviewed in prior periods would not require extensive work. It would be necessary at year end to review any significant projects started between the interim date and year end and to update knowledge on contracts reviewed at the interim date. However, such updating usually involves only review and inquiry, and the total time spent on contract review is not appreciably increased by shifting this work to an interim date.

Tests of Transactions for Costs Incurred

For some contract costs incurred, the audit approach is to select a sample of transactions and apply tests of details to the supporting documents. The nature and extent of such audit sampling procedures are discussed later in this course. When the auditor knows the approximate size of the population of transactions for the entire period, a portion of the transactions can be selected and tested at an interim date and the remainder can be selected and tested during final work. Also, when the auditor believes internal control related to the transactions being tested is operating effectively and will not change between the date of the interim work and year end, the entire sample may be selected at an interim date. In this case, it is necessary to perform some tests of controls to ensure that the effectiveness of the controls continues after the interim date. However, these tests of controls can often be limited to inquiry and observation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. Which of the following statements concerning the use of benchmarks is correct?

    a. A single benchmark is effective for all contractors and situations.

    b. Planning materiality is established by applying a percentage to a benchmark amount from the financial statements.

    c. Planning materiality benchmarks determine the adequacy of the nature of procedures.

    d. Planning materiality benchmarks consider the nature but not the size of the entity.

16. Which of the following is an example of the correct auditor response when there has been a turnover in key management during the year?

    a. Auditor W increases unpredictability in audit procedures.

    b. Auditor X examines additional journal entries.

    c. Auditor Y reviews accounting estimates for bias.

    d. Auditor Z shifts substantive procedures to year end.

17. Which of the following statements is correct regarding risk and the financial statements?

    a. There is always a risk of management override of controls.

    b. Audit risk can be mathematically determined.

    c. Risk of material misstatement applies to the financial statement level and the relevant assertion level.

    d. A key outcome of identifying overall risks and developing an overall strategy is the determination of potential auditor liability.

18. Which of the following is an example of incorporating an element of unpredictability when addressing identified fraud risks?

    a. Auditor E assigns personnel with industry experience to the audit.

    b. Auditor F performs a detailed inspection of the client's selection of significant accounting policies.

    c. Auditor G increased her level of scrutiny of the business reasons for overly complex transactions.

    d. Auditor H tests account balances that normally are considered immaterial.

19. Which of the following statements regarding significant risks to the financial statements is correct?

    a. Risks of material misstatement due to fraud may be considered significant risks depending on their nature.

    b. It is common for construction contractors to follow accounting practices that do not conform to GAAP.

    c. Because of the nature of the industry, construction contractors generally have satisfactory accounting systems.

    d. Because of the nature of the industry, construction contractors usually have a low turnover rate.

20. According to the text, there are common characteristics associated with contract risk scores. Which of the following examples would be considered a high risk?

    a. Johnson County Contractors (JCC) has an estimated percentage of completion of 15% on their contract.

    b. Tarrant County Contractors (TCC) has a contract to build a storage building in a residential neighborhood. The size of the project is average and the job cost system is adequate.

    c. Hill County Contractors (HCC) has a contract to build an office building. HCC will need to use a subcontractor to install all of the plumbing. They hire Smith Bros. to install the plumbing. HCC has used Smith Bros. for all of their previous jobs.

    d. Ellis County Contractors (ECC) has a fixed-fee contract to build a strip mall.

21. Which of the following examples best represents a moderate-risk contract?

    a. Dell Contractors has made reasonable cost estimates with their previous contracts.

    b. Apple Contractors has no mitigating factors.

    c. Sony Contractors has a billing status that is significantly inconsistent with the type of contract work they perform.

    d. Toshiba Contractors has a considerable amount of experience with the project manager.

22. Which of the following statements regarding the overall timing of an engagement is correct?

    a. The review of contracts should not be performed at an interim date.

    b. The entire sample cannot be selected and reviewed at an interim date.

    c. Reviewing previously reviewed contracts is time consuming and requires extensive work.

    d. Job-site visits can be performed at an interim date as part of the planning process.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. Which of the following statements concerning the use of benchmarks is correct? **(Page 312)**

    a. A single benchmark is effective for all contractors and situations. [This answer is incorrect. The appropriate benchmark and the related percentage applied to it can vary with the circumstances and nature of the entity.]

    b. Planning materiality is established by applying a percentage to a benchmark amount from the financial statements. [This answer is correct. Common rules of thumb generally apply a percentage to a benchmark amount from the financial statements. AU-C 320.A5 lists suggested factors to consider in selecting the appropriate benchmark.]

    c. Planning materiality benchmarks determine the adequacy of the nature of procedures. [This answer is incorrect. Planning materiality benchmarks should not be used to determine the adequacy of the nature and timing of procedures.]

    d. Planning materiality benchmarks consider the nature but not the size of the entity. [This answer is incorrect. Both factors are considered in the development of benchmarks for planning materiality.]

16. Which of the following is an example of the correct auditor response when there has been a turnover in key management during the year? **(Page 318)**

    a. Auditor W increases unpredictability in audit procedures. [This answer is incorrect. This is an appropriate response when there is no communication of ethical values and the auditor assumes a risk of management override of controls.]

    b. Auditor X examines additional journal entries. [This answer is incorrect. This is an appropriate response when management exhibits behavior that occasionally reflects a loose regard for ethical business practices.]

    c. Auditor Y reviews accounting estimates for bias. [This answer is correct. According to AU-C 330.05, this is an appropriate response by an auditor when considering the effect of an overall risk, such as a turnover in key management.]

    d. Auditor Z shifts substantive procedures to year end. [This answer is incorrect. This is an appropriate response in certain cases, such as when there are going concern considerations that may impact future business opportunities.]

17. Which of the following statements is correct regarding risk and the financial statements? **(Page 319)**

    a. There is always a risk of management override of controls. [This answer is correct. The risk of management override of controls is always an identified fraud risk, and AU-C 240.29 states that certain overall responses are required in every audit to try and prevent it.]

    b. Audit risk can be mathematically determined. [This answer is incorrect. Audit risk is subjective, not mathematical.]

    c. Risk of material misstatement applies to the financial statement level and the relevant assertion level. [This answer is incorrect. Risk of material misstatement is not necessarily identifiable with specific relevant assertions.]

    d. A key outcome of identifying overall risks and developing an overall strategy is the determination of potential auditor liability. [This answer is incorrect. A key outcome is the determination of resources necessary to complete the audit.]

18. Which of the following is an example of incorporating an element of unpredictability when addressing identified fraud risks? **(Page 319)**

    a. Auditor E assigns personnel with industry experience to the audit. [This answer is incorrect. The assignment of personnel with industry or functional expertise is an example of supervision and staffing used to address identified fraud risks.]

    b. Auditor F performs a detailed inspection of the client's selection of significant accounting policies. [This answer is incorrect. Increased scrutiny of the client's selection and application of significant accounting policies, particularly those that deal with revenue recognition, asset valuation, or capitalizing versus expensing is an example of selection and application of accounting principles used to address identified fraud risks.]

    c. Auditor G increased her level of scrutiny of the business reasons for overly complex transactions. [This answer is incorrect. Increased scrutiny of the nature and business reasons for unusual and/or overly complex transactions is an example of an overall response to fraud risk.]

    d. Auditor H tests account balances that normally are considered immaterial. [This answer is correct. Testing account balances and assertions otherwise considered immaterial or low risk is one example of incorporating an element of unpredictability when addressing identified fraud risks.]

19. Which of the following statements regarding significant risks to the financial statements is correct? **(Page 323)**

    a. Risks of material misstatement due to fraud may be considered significant risks depending on their nature. [This answer is incorrect. Risks of material misstatement due to fraud are always significant risks.]

    b. It is common for construction contractors to follow accounting practices that do not conform to GAAP. [This answer is correct. Due to the complex nature of the construction contractor industry, and accounting personnel with limited experience or training, it is not uncommon for these entities to follow accounting practices that are not in conformity with GAAP.]

    c. Because of the nature of the industry, construction contractors generally have satisfactory accounting systems. [This answer is incorrect. Some construction contractors do not have adequate accounting systems. These situations may impact the risk of misstatement from error.]

    d. Because of the nature of the industry, construction contractors usually have a low turnover rate. [This answer is incorrect. When considering the risk of misstatement caused by error, the auditor needs to be aware that there are several characteristics of contractors that affect the risk. For example, construction contractors frequently have lower pay scales, which may result in rapid employee turnover.]

20. According to the text, there are common characteristics associated with contract risk scores. Which of the following examples would be considered a high risk? **(Page 326)**

    a. Johnson County Contractors (JCC) has an estimated percentage of completion of 15% on their contract. [This answer is incorrect. According to the text, if the estimated percentage of the contract is less than 25% or more than 90%, the risk is considered low.]

    b. Tarrant County Contractors (TCC) has a contract to build a storage building in a residential neighborhood. The size of the project is average and the job cost system is adequate. [This answer is incorrect. If a contractor has a job cost system that is adequate and the project size is average, it would be considered a moderate risk contract.]

c. Hill County Contractors (HCC) has a contract to build an office building. HCC will need to use a subcontractor to install all of the plumbing. They hire Smith Bros. to install the plumbing. HCC has used Smith Bros. for all of their previous jobs. [This answer is incorrect. This contract would be considered low risk because HCC has significant previous experience with Smith Bros.]

d. Ellis County Contractors (ECC) has a fixed-fee contract to build a strip mall. [This answer is correct. Fixed-fee contracts normally have higher risks than cost-plus contracts because with cost-plus contracts, the contractor can bill the actual construction costs plus an agreed-upon profit percentage.]

21. Which of the following examples best represents a moderate-risk contract? **(Page 326)**

a. Dell Contractors has made reasonable cost estimates with their previous contracts. [This answer is correct. If a contract/project manager has a reputation of making reasonable bids and cost estimates, the contract is would be considered a moderate risk.]

b. Apple Contractors has no mitigating factors. [This answer is incorrect. According to the text, if a contract has no mitigating factors or controls, it is considered a high-risk contract.]

c. Sony Contractors has a billing status that is significantly inconsistent with the type of contract work they perform. [This answer is incorrect. A contract is considered high risk if the billing status is substantially inconsistent with the type of contractor.]

d. Toshiba Contractors has a considerable amount of experience with the project manager. [This answer is incorrect. If a contractor has significant experience with the project owner, the contract is considered low risk.]

22. Which of the following statements regarding the overall timing of an engagement is correct? **(Page 330)**

a. The review of contracts should not be performed at an interim date. [This answer is incorrect. Normally, some worthwhile work on review of contracts can be performed at an interim date. For significant contracts, the auditor must become familiar with the basic terms of the contracts.]

b. The entire sample cannot be selected and reviewed at an interim date. [This answer is incorrect. When the auditor believes that internal control related to the transactions being tested is operating effectively and will not change between the date of the interim work and year end, the entire sample may be selected and tested at an interim date.]

c. Reviewing previously reviewed contracts is time consuming and requires extensive work. [This answer is incorrect. A basic familiarity can be gained by selecting all significant contracts completed or in progress at the interim date and reviewing the signed contract; scanning the contract files, including correspondence; and discussing the contract with appropriate personnel. Completed contracts reviewed in prior periods would not require extensive work.]

d. Job-site visits can be performed at an interim date as part of the planning process. [This answer is correct. It is generally practical to perform job-site visits at an interim date near year end when construction activity from the date of the visit to year end is not expected to significantly alter the stage of completion of the contract. Also, site visits may be performed at an earlier interim date as part of the planning process to improve the auditor's understanding of the contractor's operations.]

AUDIT SAMPLING

Audit sampling is not used as often in the audit of the contract-related accounts of a construction contractor because the focus is on individual contracts. The audit approach for the contract-related accounts is to select contracts from a schedule of contracts in progress and a schedule of completed contracts. Even for a very large contractor, more than a couple of dozen contracts in progress at year end would be unusual, and many contractors have five or fewer projects in progress. Obviously, it is not practical to apply audit sampling to such a limited population. However, the remainder of this section discusses some areas for which sampling may be appropriate for a construction contractor.

If the contractor's operations include extensive noncontracting activities, or for other reasons, noncontract-related accounts are numerous and material, the auditor may wish to make more extensive use of audit sampling. Also, more extensive use of audit sampling may be appropriate for contract-related accounts in the unusual case when there is a relatively large number of small contracts or contract cost items. In those circumstances, the auditor may refer to *PPC's Guide to Audits of Nonpublic Companies* for an explanation of sampling approaches that may be used.

For contract-related accounts, the more common uses of audit sampling are as follows:

a. *Direct Labor Costs.* The contractor has a relatively large labor force, and the auditor believes it is necessary to supplement the normal analytical tests with tests of details of individual payroll transactions.

b. *Direct Costs Other Than Labor.* The auditor believes there is more than a relatively low risk of omission of direct costs other than labor from individual contract records. Thus, the auditor decides to perform tests of details of direct costs other than labor selected from the initial gathering point for costs in the accounting records, such as the disbursements journal.

The features of these audit sampling applications that influence the auditor's approach to sampling are selection of individual transactions and a primary concern with the accuracy and completeness of accounting processing.

Audit Sampling for Tests of Transactions—General

When audit sampling is used for tests of transactions, the auditor defines the population of items to be sampled and the physical unit to be selected. For example, if the population is payroll transactions for the entire year, the physical sample units would usually be canceled payroll checks for the period. After selecting the items, the auditor would obtain the other related source documents and make comparisons among those documents and the accounting records to determine whether the transactions were recorded correctly as to account, amount, and period, and posted properly to individual contract records.

Audit sampling for tests of transactions may be used for tests of direct labor, materials, and similar direct costs other than labor. Generally, the auditor will initially select individual contracts and test the material and labor charged to those contracts. However, in testing material and labor charges, the auditor may limit tests of details of materials to significant contract costs or may only analytically test payroll for the contracts selected. In these circumstances, the auditor may conclude that additional tests of payroll transactions or materials purchases are necessary and will then use audit sampling. In this case, as explained earlier, items are selected from the original accounting records, such as the disbursement journal, rather than from contracts.

When audit sampling is used for tests of transactions, the auditor may also perform tests of controls for those transactions at the same time if the auditor believes an assessment of control risk below the maximum is possible. This type of audit test is generally referred to in practice as a *dual-purpose* test because it is directed to both the substantive aspects of transactions and the effectiveness of internal control. In a dual-purpose test, the auditor selects a sample of transaction documents for both testing the operating effectiveness of an identified control and testing whether the recorded monetary amount of transactions is correct. In general, an auditor planning to use a dual-purpose sample would have made a preliminary assessment that there is an acceptably low risk that the rate of deviations from the prescribed control in the population exceeds the tolerable rate. For example, an auditor designing a test of control over entries in the payroll register may plan a related substantive procedure at a risk level that anticipates a particular assessed level of control risk. The size of a sample designed for dual purposes ought to be the larger of the samples that would otherwise have been designed for the two separate purposes. A smaller sample size for tests of transactions may be used when the auditor is able to assess control risk at below the

maximum for the processing of transactions being tested. Because the transactions and documents will need to be selected and examined for the substantive aspects of the test, it is normally efficient to attempt to identify internal controls that help ensure the accurate processing of the transactions being tested.

Sample Size for Tests of Transactions

The tests of transactions using sampling in the audit of a construction contractor generally focus on the accuracy of processing, and the auditor is concerned with whether there is a sufficiently low rate of processing mistakes. This is true because all transactions are processed through the same financial reporting system, and the likelihood of a mistake being made in processing a particular transaction is usually independent of the dollar amount of the transaction. In this type of sampling application, the auditor can use the method of attribute statistical sampling to estimate an appropriate sample size. However, it is not necessary to refer to a statistical textbook. A simple and sound approach to estimating sample size in these circumstances has been developed. A more extensive explanation is provided in *PPC's Guide to Audits of Nonpublic Companies*, but the essential points and a practice aid to implement the approach are explained here.

Normally, the auditor need only make a choice between a sample size of 60 or 25. The following two conditions apply to audit samples using this approach:

a. The audit procedure being applied using sampling is not the only procedure that contributes to the objective of the test.

b. A relatively low rate of monetary misstatement is expected.

These conditions are usually present in the audit of a construction contractor because the auditor would ordinarily have applied some procedures to similar transactions charged to significant contracts and identified any obvious mistakes permitted by the financial reporting system for client correction. The condition that permits the use of a sample of 25 rather than 60 is *internal controls pertinent to the aspect of transaction processing being tested appear effective and are being tested simultaneously*. If the auditor selects a sample of 25 transactions and after testing finds that internal controls are not operating effectively, then an additional 35 items could be selected for a total sample size of 60.

Sample Selection for Tests of Transactions

AU-C 530, *Audit Sampling*, at AU-C 530.08, requires a "representative sample" for audit sampling applications. This means that the items need to be selected in such a manner that all items have an opportunity to be selected. Among the methods that meet this requirement are simple random selection using random numbers, systematic selection (every nth item), or haphazard selection. The first two methods are explained in detail in sampling textbooks and the AICPA guide, *Audit Sampling*. The concept of haphazard selection is explained in the AICPA guide, *Audit Sampling*, as selecting in no specific pattern without bias for or against any items in the population. In other words, the auditor's selection should not be influenced by the size, location, or appearance of the item to achieve haphazard selection. The goal for all sample selection methods is to meet the general criterion for a representative sample that the method is free from selection bias.

The auditor might consider using random selection (with computer-generated random numbers or a random number table) or systematic selection with a random start. Using these approaches does not make the audit sampling application a statistical sample. Haphazard selection may be used when the population is not numbered or when other circumstances make use of one of the other methods impractical.

Exhibit 2-5 presents an example of random number listings generated using PPC's *Workpapers for Nonpublic Companies*. PPC's *Workpapers* provide practice aids not available in a PPC *Guide* and help standardize the format of the firm's workpapers. PPC's *Workpapers*, which are part of *Checkpoint® Tools* suite of Word and Excel-based productivity solutions, can be ordered by calling (800) 431-9025 or at **tax.thomsonreuters.com**.

Exhibit 2-5

Computer-generated
Random Numbers—Accounts Receivable

Company: ABC Construction, Inc. **Balance Sheet Date: 12/31/20X5**
Completed by: Frank Smith **Date: 11/24/20X5**
Account Balance or Transaction Class: Accounts Receivable
Population: 141 pages; 9 items per page
Number of items selected: 60
Number of substitute items selected: 10

Page Number	Item Number	Page Number	Item Number
5	7	81	4
8	3	81	1
9	7	85	8
11	2	88	5
14	7	90	2
16	1	92	2
24	7	96	4
24	9	96	5
24	3	101	7
26	6	110	7
33	8	115	1
33	2	116	7
34	3	117	4
35	5	120	7
37	4	123	2
39	7	124	5
40	4	125	6
40	5	126	5
41	1	128	3
42	7	131	6
43	7	138	5
45	8	139	9
47	2		
50	9		
51	5		
52	4		
53	9		
55	6		
60	5		
61	2		
63	4		
66	3		
67	9		
67	5		
68	8		
70	2		
72	6		
74	3		

* * *

Exhibit 2-6 provides a listing for replacements. These substitute random numbers can be used for duplicate numbers or when the source document that corresponds to the initial random number never existed or is legitimately voided. Source documents that were used but cannot be located should generally be treated as errors or deviations.

Exhibit 2-6

Computer-generated
Substitute Random Number—Accounts Receivable

Company: ABC Construction, Inc. **Balance Sheet Date: 12/31/20X5**
Completed by: Frank Smith **Date: 11/24/20X5**
Account Balance or Transaction Class: Accounts Receivable
Number of items selected: 10

Order Selected	Page Number	Random Number
61	109	5
62	10	9
63	83	2
64	92	8
65	17	8
66	33	6
67	92	9
68	33	1
69	71	7
70	48	5

* * *

The auditor may want to do some tests of transactions of costs incurred at an interim date. To do this, the auditor would need to know the approximate size of the population, for example, how many checks would be written during the year. To illustrate, assume the auditor is selecting canceled checks on November 30. The approximate number of checks for the entire year would be used in generating the random numbers. Most of the selections would be checks written through November 30 and would be tested at the interim date. The remaining selections would be checks written during December that would be tested during final work.

ESTIMATE OF AUDIT TIME AND BUDGET

Professional standards do not require the preparation of a time estimate or the documentation of the actual time spent in performing an audit, but common sense dictates that an auditor is more likely to be efficient and effective working under a time budget. At a minimum, an auditor ordinarily needs some estimate of the audit time anticipated to arrive at a fee estimate. Keeping track of the time spent as the audit progresses is important for billing the client, assessing whether adjustments are necessary to stay within the budget for the engagement, and proposing additional fees to the client.

Methods used in practice to budget and control time range from elaborate systems that budget time by each program step to a single total time estimate for the entire audit. Neither extreme is likely to be effective in a construction contractor engagement. Best practices suggest a system that accounts for time by each major audit program area, i.e., total time for cash, total time for accounts receivable, etc. Other major engagement processes outside of audit program areas also need to be considered such as planning activities, review and supervision, assistance with financial statements, and drafting reports. This provides enough detail to highlight major areas of time commitment, monitor work-in-progress, and arrive at a reasonable fee estimate. Using this budget technique, the auditor is not required to post time to the audit program; instead, time is posted to a summary schedule by major program area that is normally filed with the general or administrative workpapers.

In preparing the time estimate for the audit of a construction contractor, it is important to remember the unique aspects of the audit approach that have a significant effect on audit time, such as:

- How many contracts will be regarded as individually significant and selected for detailed testing?
- How many job site visits will be considered necessary?
- What audit work can be done at an interim date rather than at year end?
- What key schedules will the client prepare concerning contracts completed and in progress?

Generally, the auditor has to be reasonably confident about the answers to these questions to prepare a dependable time estimate and budget.

SPECIAL CONSIDERATIONS IN AN INITIAL AUDIT

AU-C 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*, and AU-C 210, *Terms of Engagement*, address the auditor's responsibilities in an initial audit. Many of the aspects of an initial engagement for a construction contractor are the same as for the audit of a typical nonpublic company, covered in *PPC's Guide to Audits of Nonpublic Companies*. This discussion focuses on those matters unique to the audit of a construction contractor.

First Time Audit—No Predecessor

If the contractor's financial statements have never been audited before, some very difficult auditability issues can arise. How will the auditor become satisfied as to the percentage of completion of contracts in progress at the beginning of the period? Generally, the client's accumulation of costs will not have been in accordance with GAAP and extensive clerical reperformance may be necessary to reconstruct the proper beginning balances.

The auditor may be able to overcome these problems given sufficient time and resources. However, this will usually not be a practical approach for the client. Few, if any, clients would be willing to pay the enormous cost of such an engagement. In many cases, the logical answer is to perform a review of the financial statements in accordance with SSARS and take those steps necessary to prepare for an audit of the following year's financial statements.

The auditor needs to be prepared to explain the reasons that a review engagement makes sense both to the client and to the bond underwriter or lender who required the client to obtain an audit. The auditor needs to describe what can be done to ensure that an audit can be performed next year. This will necessitate that the auditor have some confidence concerning the client's willingness to spend the time and incur the cost to make an unmodified opinion likely.

The auditor may be requested in those circumstances to audit the balance sheet and review the income statement. Best practices suggest that this type of engagement not be accepted. Generally, best practices indicate that mixing audit and review services is not logical. The financial statements are interrelated and the same level of service should be applied to all of them. Mixing levels of service makes even less sense for a construction contractor. How can a balance sheet be audited for a contractor without being satisfied about the percentage of completion on contracts in progress? For these reasons, best practices suggest a review service for the complete financial statements in an initial engagement.

Prior Audit by a Predecessor

When the prior year's financial statements were audited by a predecessor, there is less likely to be a serious auditability problem. However, the auditor will probably need to make a more detailed review of the predecessor's workpapers and, in general, spend more time on beginning balances than is usually the case in the typical small business audit.

The auditor needs to inquire about the predecessor's contract accounting and auditing experience and make a detailed review of the workpapers for contract-related accounts. Particular attention needs to be focused on documentation of job site inspections and whether the auditor's observations supported the client's percentage-of-completion estimates.

SPECIAL CONSIDERATIONS FOR INTERIM REVIEWS

Standards and Conditions for Performing the Review

AU-C 930, *Interim Financial Information*, addresses the responsibilities of an independent auditor engaged to review interim financial information of nonissuers, including companies participating in unregistered private equity exchanges. Under AU-C 930, interim financial information represents financial information or statements prepared and presented in accordance with an applicable financial reporting framework (for example, GAAP) covering a period or periods less than a full year or covering a 12-month period ending on a date other than the entity's fiscal year end. interim financial information may be condensed or in the form of complete financial statements.

Applicability. AU-C 930.02 indicates it applies when all of the following conditions are met:

a. the entity's latest annual financial statements have been audited by the auditor or a predecessor;

b. the auditor either (1) has been engaged to audit the entity's current year financial statements, or (2) audited the entity's latest annual financial statements and, in situations in which it is expected that the current year financial statements will be audited, the appointment of another auditor to audit the current year financial statements is not effective prior to the beginning of the period covered by the review;

c. the entity prepares its interim financial information in accordance with the same financial reporting framework as that used to prepare the annual financial statements;

d. when the interim financial information is condensed information, several additional conditions must be met.

The most likely circumstances when an audit firm will be applying AU-C 930 are when the firm has performed an annual audit and then performs the review or when the firm has been engaged to perform the audit, but performs the first review before the audit is completed. If all the conditions are not met, the auditor cannot perform a review under AU-C 930, and the review of interim financial information of a nonpublic entity would be performed under SSARSs.

Form of Interim Financial Information. Interim financial information of nonpublic entities may be condensed or in the form of complete financial statements. A Technical Question and Answer at Q&A 1900.01 indicates that nonpublic entities providing condensed interim financial statements should look to Article 10 of SEC Regulation S-X for form and content guidance when preparing those financial statements. Therefore, GAAP for condensed interim financial information of nonpublic entities consists of Article 10 of SEC Regulation S-X, *Interim Financial Statements*, for form and content and FASB ASC 270 for recognition and measurement.

Reporting. AU-C 930.29 states that the auditor's review report should be in writing. AU-C 930.A39 explains that a third party that requires a review of interim financial information may choose not to have the report accompany the information. In other words, the auditor is required to issue a written report, but the entity might not be required to include it with the interim financial information.

Overall Objectives and Approach. AU-C 930.05 states that the objective of the auditor when performing an engagement to review interim financial information is to obtain a basis for reporting whether the auditor is aware of any material modifications that should be made to the interim financial information for it to be in accordance with GAAP through performing limited procedures. A review consists primarily of performing analytical procedures and making inquiries of client personnel responsible for financial and accounting matters. The overall approach to a review is influenced by the fact that the review is performed by an auditor who either has or will perform an audit of the annual financial statements. As a result, some of the steps in a review can be combined with similar steps for the annual audit, and various efficiencies can be achieved by performing some audit work in the course of performing the interim review.

Interim Review Steps and Procedures

The steps and procedures that are ordinarily appropriate for the review of interim financial information of a nonpublic company are as follows:

a. Assess engagement acceptance or continuance.

b. Agree on engagement terms with the client.

c. Obtain or update the understanding of the entity and its environment, including its internal controls.

d. Perform analytical procedures, inquiries, and other review procedures.

e. Obtain a management representation letter.

f. Evaluate the results of the review procedures performed.

g. Communicate to management and those charged with governance.

h. Issue the review report.

Because review steps and procedures can be combined with related steps and procedures in the annual audit, some of the same forms and checklists may be used. Using the same forms and performing some audit procedures in the course of a review does not elevate the engagement to an audit. If the auditor was engaged to perform a review, the responsibility for the interim financial information remains a review and not an audit responsibility.

Assess Engagement Acceptance or Continuance. As with most engagements, the first step in performing a review of interim financial information is to assess client acceptance or continuance. The client acceptance/continuance is performed prior to each review, but may often be based on a review of the documentation prepared in conjunction with the annual audit. Assessments may be performed as follows:

- For a new client, if the client is acceptable for the annual audit, the client is ordinarily also acceptable for performance of the interim financial reviews, unless new information about the client has come to light since the initial client acceptance. The auditor should also ensure that there have been no changes in independence since the audit assessment was performed.

- For existing audit clients, generally, if the auditor is willing to continue its audit relationship with a client, there is no problem performing the interim reviews unless there have been significant adverse changes since the audit assessment. The auditor should also ensure that there have been no changes in independence since the audit assessment was performed.

For a new engagement, the auditor should also follow the requirements for initial engagements in AU-C 210, *Terms of Engagement,* which addresses contacting the entity's predecessor auditor and making certain inquiries before accepting the engagement.

Agree on the Terms of Engagement. AU-C 930.10 provides that the auditor should agree on the terms of the engagement with management or those charged with governance, as appropriate, and should document that understanding through an engagement letter or other suitable form of written agreement. The understanding can be covered in a combined engagement letter for the audit and review.

Obtain or Update the Understanding of the Entity and Its Environment, Including Internal Control. AU-C 930.11 indicates that to plan and conduct the review engagement, the auditor should have an understanding of the entity and its environment, including its internal control, as it relates to the preparation and fair presentation of both annual and interim financial information to accomplish the following:

a. Identify the types of potential material misstatements in the interim financial information and consider the likelihood of their occurrence.

b. Select the inquiries and analytical procedures that will provide the auditor with a basis for reporting whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with GAAP.

If the auditor has audited the most recent annual financial statements, the auditor would generally have obtained most of the knowledge needed to plan the review in the course of planning the audit. The auditor would review the relevant audit planning documentation and consider how the internal control over the preparation of interim financial information may differ from internal control over the preparation of annual financial statements.

If the auditor has not audited the most recent annual financial statements, it will still be necessary to obtain the equivalent of an audit-base of knowledge. In addition to reading the most recent annual and prior interim financial information and making inquiries of management about changes in business activities and internal controls, the auditor can obtain a base of knowledge by completing the relevant audit documentation while performing the review. The auditor might review the predecessor's relevant documentation with the predecessor's permission solely for the purpose of the successor's own understanding. The auditor focuses on how the process for preparing interim financial information differs from that for annual information.

Perform Analytical Procedures, Inquiries, and Other Review Procedures. After obtaining or updating his or her understanding of the entity and its environment, including internal control, the auditor needs to design and perform the review procedures—consisting primarily of inquiry and analytical procedures.

a. *Analytical Procedures*—AU-C 930.13 describes the types of analytical procedures that should be used to identify and provide a basis for inquiry about relationships and individual items that appear to be unusual and that may indicate a material misstatement.

b. *Inquiries and Other Review Procedures*—AU-C 930.14 describes the inquiries and other review procedures the auditor should perform.

For a review, the auditor ordinarily is not required to corroborate management's responses to inquiries. However, the auditor should consider the reasonableness and consistency of management's responses in relation to other review procedures and the auditor's knowledge of the entity's business and internal control. If the auditor becomes aware of information that leads him or her to believe that the interim financial information may not be in conformity with GAAP, the auditor should make additional inquiries or perform additional procedures as necessary to provide an adequate basis for the review report.

Obtain a Management Representation Letter. AU-C 930.21 indicates that written representations from management should be obtained for all periods covered by the review and identifies specific representations that should be obtained. The representation letter needs to be tailored as necessary to include additional representations related to matters specific to the contractor's business and the construction industry.

Evaluate the Results of the Review Procedures Performed. In an interim review, a misstatement is the auditor's best estimate of the total misstatement in the account balances or classes of transactions on which the auditor has performed review procedures. AU-C 930.19 states that the auditor should accumulate misstatements, including inadequate disclosure, identified in performing the review procedures or brought to the auditor's attention during the performance of the review.

Communicate to Management and Those Charged with Governance. When conducting a review of interim financial information, the auditor should determine whether any of the matters described in AU-C 260, *The Auditor's Communication With Those Charged with Governance,* as they relate to the interim financial information, have been identified. If so, the auditor should communicate the matters to those charged with governance. All of these communications may be oral or written, unless firm policy dictates otherwise. However, if the information is communicated orally, the auditor should document the communication. Communications with those charged with governance should be made sufficiently timely to enable them to take appropriate action.

Issue the Review Report. AU-C 930.29 requires the auditor's review report to be in writing. Additional interim financial information review reporting examples and guidance can be found in *PPC's Guide to Auditor's Reports*. If the client represents in a report, document, or written communication containing the reviewed interim financial information that the auditor has reviewed the interim financial information, the auditor should request that the client include the review report in the report, document, or written communication. If the client does not agree to include the review report, the auditor should request that their name neither be associated with the interim financial information nor referred to in the document. If the client does not agree to remove the auditor's name, the auditor should (a) advise the client that they are not permitted to use or make reference to the auditor's name, (b) communicate the noncompliance with the request to those charged with governance, and (c) consider what other

actions might be appropriate. When appropriate, the auditor might recommend that the client consult with its legal counsel about the application of relevant laws and regulations. Also, the auditor might consider consulting with the firm's legal counsel.

Coordinating the Interim Review and Annual Audit

Because the auditor doing the interim review will normally be performing the review between annual audits, various efficiencies can be achieved by coordinating the work. Certain procedures can be performed on the information accumulated to date at the date of the interim review and used in the audit. The following are examples:

a. *Reading Minutes.* Reading available minutes of meetings of stockholders, directors, and appropriate committees is a requirement in both interim reviews and annual audits. When performing a review, the auditor can read the minutes up through the interim date and read only those minutes remaining unread in the annual audit.

b. *Reviewing Major Transactions, Events, or Contracts.* If a nonpublic contractor has other major transactions or events, such as business combinations or restructuring, the auditor can audit those that have occurred through the date of the interim review. In addition, if the contractor has obtained or been awarded any significant new contracts during the review period, the auditor can obtain copies of those contracts and become familiar with their terms and provisions.

c. *Testing Internal Control.* If the auditor intends to rely on the effective operation of controls during the entire period, in performing the review the auditor can perform tests of controls on transactions that have occurred to date. During the audit, the auditor can decide what procedures are appropriate to extend the conclusion from the interim date to year end.

d. *Performing Major Substantive Tests at Interim Dates.* The auditor might decide to perform certain major substantive tests, such as job site visits or confirmation of receivables, at an interim date. These substantive procedures can be performed during the interim review and the auditor can decide what procedures are necessary at year end to extend the conclusions to that date.

e. *Reviewing Accounting Estimates Retrospectively for Bias.* AU-C 240.32 requires the auditor to perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to determine whether management's related judgments and assumptions indicate a possible bias. This retrospective review can be performed during the first interim review performed after the annual audits. By performing this work on a more timely basis better contemporaneous information may be available.

f. *Evaluating the Business Rationale for Significant Transactions.* AU-C 240.32 requires the auditor to gain an understanding of the business rationale for significant transactions outside the normal course of business (or that otherwise appear unusual) of which the auditor becomes aware. This work can be performed during the interim review if the auditor becomes aware of them during that time.

g. *Examining Journal Entries and Other Adjustments for Evidence of Possible Material Misstatement Due to Fraud.* Management's use of nonstandard journal entries to perpetrate fraud is a well-known technique. AU-C 240.32 imposes a requirement to review journal entries and other adjustments for indications of fraud. This requirement extends throughout the period covered by the annual financial statements. This review of transactions and adjustments to date can be performed during the interim review. The interim review may be particularly effective because fraudulent financial reporting can begin during the period and escalate at year end.

By coordinating the review procedures and annual audit procedures, the auditor can improve the efficiency and effectiveness of both engagements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. Which of the following is true regarding audit sampling for construction contractors?

    a. When using audit sampling for test of transactions, auditors can create a dual-purpose test.

    b. Auditing sampling is effective when testing contract-related accounts for construction contractors.

    c. If using the test of transactions in audit sampling for a construction contractor, the auditor should focus on dollar amount of the transactions.

24. Which of the followings statements regarding interim reviewer steps and procedures is correct?

    a. When establishing an understanding with the client concerning services to be performed, the auditor should document that through written communication.

    b. Once an auditor has obtained knowledge of the client's business, the auditor needs to design and perform the review procedures consisting primarily of substantive procedures.

    c. An auditor should obtain a management representation letter only for interim periods.

    d. An auditor does not accumulate misstatements when evaluating the results of interim review procedures.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. Which of the following is true regarding audit sampling for construction contractors? **(Page 336)**

    a. When using audit sampling for test of transactions, auditors can create a dual-purpose test. [This answer is correct. When audit sampling is used for test of transactions for construction contractors, the auditor may also perform test of controls for those transactions at the same time if the auditor believes an assessment of control risk below the maximum is possible. This type of audit test is generally referred to in practice as a *dual-purpose* test because it is directed to both the substantive aspects of transactions and the effectiveness of internal control.]

    b. Auditing sampling is effective when testing contract-related accounts for construction contractors. [This answer is incorrect. Audit sampling is not used as often in the audit of the contract-related accounts of a construction contractor because the focus is on individual contracts. The audit approach for the contract-related accounts is to select contracts form a schedule of contracts in progress and a schedule of completed contracts. Even for a very large contractor, more than a couple of dozen contracts in progress at year end would be unusual, and many contractors have five or fewer projects in progress. Obviously, it is not practical to apply audit sampling to such a limited population.]

    c. If using the test of transactions in audit sampling for a construction contractor, the auditor should focus on dollar amount of the transactions. [This answer is incorrect. The tests of transactions using sampling in the audit of a construction contractor generally focus on the accuracy of processing, not the dollar amount of the transactions. The auditor is concerned with whether there is a sufficiently low rate of processing mistakes.]

24. Which of the followings statements regarding interim reviewer steps and procedures is correct? **(Page 342)**

    a. When establishing an understanding with the client concerning services to be performed, the auditor should document that through written communication. [This answer is correct. According to AU-C 930.10, the auditor should establish an understanding with the client regarding the services to be performed and should document that understanding through a written communication with the client. The most efficient way to accomplish this requirement is to obtain a signed engagement letter or other suitable form of written agreement.]

    b. Once an auditor has obtained knowledge of the client's business, the auditor needs to design and perform the review procedures consisting primarily of substantive procedures. [This answer is incorrect. After obtaining or updating his or her understanding of the entity and its environment, including internal control, the auditor needs to design and perform the review procedures—consisting primarily of inquiry and analytical procedures.]

    c. An auditor should obtain a management representation letter only for interim periods. [This answer is incorrect. AU-C 930.21 indicates that written representations from management should be obtained for all periods covered by the review and identifies specific representations that should be obtained.]

    d. An auditor does not accumulate misstatements when evaluating the results of interim review procedures. [This answer is incorrect. In an interim review, a misstatement is the auditor's best estimate of the total misstatement in the account balances or classes of transactions on which the auditor has performed review procedures. AU-C 930.19 states that the auditor should accumulate misstatements, including inadequate disclosure, identified in performing the review procedures or brought to the auditor's attention during the performance of the review.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Construction Contractors—Course 3—Risk Assessment Procedures and Audit Planning (CONTG173)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com**/**ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $89 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     CONTG173 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you

complete three courses, the price for grading all three is $254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked by **August 31, 2018**. CPE credit will be given for examination scores of 70% or higher.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Construction Contractors—Course 3—Risk Assessment Procedures and Audit Planning (CONTG173)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. It is especially important to evaluate certain matters when assessing the ability to accept an engagement due to the higher risk nature of the construction industry. According to the text, which of the following is **not** listed as a factor to be considered in deciding whether the auditor has the ability to accept an engagement?

    a. Does the auditor have the ability to meet the deadline?

    b. Is the fee adequate considering the time involved?

    c. Is the auditor competent in the construction contracting industry?

    d. Is the auditor independent from the potential contractor client?

2. Which of the following is a preliminary engagement activity?

    a. Establishing a preliminary audit strategy.

    b. Performing preliminary analytical procedures.

    c. Holding an engagement team discussion.

    d. Issuing an engagement letter.

3. Panther Heights Contractors (PHC) is in the process of building a new residential subdivision. Management inquiries of audit client PHC would include communication with which of the following individuals?

    a. Sales personnel.

    b. Chief financial officer (CFO).

    c. Foreman.

    d. Valuation expert.

4. Which of the following ratios is **not** unique to construction contractor audits?

    a. Contract revenues to working capital.

    b. Gross profit percentage.

    c. Overbillings to underbillings.

    d. Months in backlog.

5. While conducting an audit of Cunningham Construction Contractors (CCC), Kenneth's main focus should be on which of the following?

    a. Quantitative factors.

    b. Control environment.

    c. Trends.

    d. Individual contracts.

6. Which of the following types of analysis is a common analytical procedure that is used to evaluate the accuracy of estimates, and involves reviewing the trends in contract gross profit during annual or interim periods throughout each contract's life?

   a. Profit gain/fade.

   b. Profit margin.

   c. Cash flow.

   d. Bid spread.

7. Observation and inspection are frequently used to do which of the following?

   a. Confirm or follow-up on the results of inquiries made of management and others.

   b. Identify unusual or unexpected relationships.

   c. Support the auditor's assessment of the risk of material misstatement.

   d. Understand controls over related party transactions.

8. Which of the following is specifically required to be addressed during the engagement team discussion?

   a. IT applications.

   b. Fraud-related matters.

   c. Significant audit risk areas.

   d. Significant control systems.

9. AU-C 240.15 indicates which of the following be discussed by the engagement team as a fraud-related matter?

   a. Complexity of transactions.

   b. Decisions concerning materiality levels.

   c. Factors that facilitate fraud rationalization.

   d. Personnel changes in the client's organization.

10. Which of the following statements is correct regarding the engagement team discussion?

    a. The discussion will include key members of the engagement team, the engagement partner, and possibly specialists.

    b. The engagement partner should not conduct a preliminary planning discussion with the client before holding a discussion with the engagement team.

    c. The audit team should rely on the procedures that were performed during the prior year audit when determining what procedures to perform in the current year.

    d. The engagement team should start the discussion by focusing on past favorable experiences with the integrity of management.

11. Which of the following types of construction projects involve a significant sensitivity to key economic indicators and relatively unstable market demand?

    a. General building.

    b. Heavy construction.

    c. Highway.

    d. Do not select this answer choice.

12. J&S Construction uses a billing arrangement that allows them to bill ahead for costs incurred on the project ahead of disbursements. J&S is using which of the following billing procedures?

    a. Front-end loading.

    b. Kickback.

    c. Bribe.

    d. Bid rigging.

13. If J&S's financial reporting system is adequate enough to collect and distribute construction costs in a way consistent with the estimates produced, according to best practices, which of the following accounting methods should be used?

    a. Percentage of completion.

    b. Completed contract.

    c. Cash basis.

    d. Tax basis.

14. Libby's audit client, Cunningham Construction Contractors (CCC) uses the completed-contract method of revenue recognition. Which of the following should Libby focus on?

    a. The contractor's ability to continue as a going concern.

    b. Acquiring evidence of whether contracts are complete.

    c. Proper measurement of contract performance.

    d. Accuracy of construction costs allocation.

15. Which of the following influences the consideration of fraud concerning misappropriation of assets?

    a. The degree to which assets susceptible to misappropriation are present.

    b. The size and sophistication of the client's business.

    c. Past favorable experience with the integrity of management.

    d. The auditor's judgments about materiality and the risks of material misstatement at the financial statement level.

16. Which of the following could indicate that a contractor is charging costs to an unrelated job?

    a. Overbillings that are not represented by cash.

    b. Underbillings that continuously increase.

    c. Underbilling on uncompleted contracts that exceed 25% of working capital.

    d. Higher gross profit on uncompleted contracts than on closed jobs.

17. Which of the following is **not** noted by AU-C 240.A1 as a condition generally present when fraud occurs?

    a. Pressure.

    b. Opportunity.

    c. Incompetence.

    d. Attitude.

18. Gayle, an auditor, is assessing the risk of material misstatement to develop an overall audit strategy for General Construction Contractors. Generally, Gayle would obtain an understanding of which component of internal control first?

    a. Risk assessment.

    b. Control environment.

    c. Monitoring.

    d. Control activities.

19. Which of the following items is a significant element of the control environment?

    a. Contract bidding.

    b. Vendor efficiency.

    c. Customer goodwill.

    d. Human resource procedures and policies.

20. Which of the following statements regarding the control environment is correct?

    a. Project bidding has little effect on the construction contractor's success.

    b. A general understanding of the control environment as it relates to contract bidding can come from discussions with management.

    c. AU-C 320 lists the procedures that management should follow to ensure efficiency in this area.

    d. Segregation of duties is generally not an issue.

21. Which of the following statements is correct concerning risk assessment?

    a. Identifying changed conditions is a key step in the risk assessment process.

    b. Risk assessment activities should not be affected by the complexity of the contractor's financial reporting system.

    c. Management of financial reporting risks only includes internal events.

    d. Risk assessment is not affected by new accounting standards.

22. Complete the following sentence:

    Control activities are/can—

    a. Be performed only at the relevant assertion level.

    b. Be either manual or automated.

    c. Performed by the auditor.

    d. Unaffected by IT.

23. Which of the following sources provides auditors guidance on how to document the findings of an entity and its environment including internal control?

    a. AU-C 240.

    b. AU-C 300.

    c. AU-C 315.

    d. AU-C 320.

24. Which of the following is **not** one of the benchmarks mentioned in the text as being provided by AU-C 320.A6?

    a. Net asset value.

    b. Total liabilities.

    c. Total revenues.

    d. Gross profit.

25. How does performance materiality differ from tolerable misstatement?

    a. Performance materiality is an amount smaller than tolerable misstatement.

    b. Performance materiality is determined at the financial statement level, while tolerable misstatement is determined at the transaction level.

    c. Tolerable misstatement is the application of performance materiality to an audit sampling procedure.

    d. Tolerable misstatement is 50-75% of performance materiality.

26. Which of the following types of misstatements may arise due to the application or selection of accounting principles by management that the auditor considers to be inappropriate?

    a. Likely.

    b. Judgmental.

    c. Factual.

    d. Projected.

27. Which of the following examples concerning audit risk is correct according to AU-C 315.03?

    a. Auditor Nate measures audit risk using a sliding scale percentage method.

    b. Auditor Ashleigh's objective is to identify and assess the risks of material misstatement from either error or fraud at the financial statement and relevant assertion levels.

    c. The risks of material misstatement consist only of inherent risk at the disclosure level as provided by auditor Alexa.

    d. Auditor Nick should assess inherent and control risk separately at the financial statement level.

28. According to the text, which of the following is the correct auditor response when management's regard for hiring competent personnel is considered an overall risk?

    a. Auditor A shifts substantive procedures to year end.

    b. Auditor B examines journal entries.

    c. Auditor C increases the extent of inquiries related to fraud risk.

    d. Auditor D increases unpredictability in audit procedures.

29. While performing an audit of J&S Company, Ashleigh runs the risk that her procedures will not identify a misstatement that exists in a relevant assertion that could be material. What type of risk is this?

    a. Inherent.

    b. Control.

    c. Detection.

    d. Do not select this answer choice.

30. The audit risk concept is expressed in formula form. Which of the following is a function of the effectiveness of the nature, timing, and extent of procedures that an auditor applies and can be viewed as being a function of TD—Tests of Details Risk and AP—Substantive Analytical Procedures Risk?

    a. AR—Audit Risk.

    b. IR—Inherent Risk.

    c. CR—Control Risk.

    d. DR—Detection Risk.

31. The risk of material misstatement is the combination of which of the following?

    a. Tolerable misstatement and inherent risk.

    b. Control risk and tolerable misstatement.

    c. Inherent risk and control risk.

    d. Detection risk and tolerable misstatement.

32. While performing an audit of J&S Company, Ashleigh should consider which of the following risks when determining which risks are significant?

    a. Inherent.

    b. Control.

    c. Detection.

    d. Material misstatement.

33. A contract must be less than what percent complete as of the audit date to be considered low risk?

    a. 25%.

    b. 30%.

    c. 35%.

    d. 50%.

34. Which of the following is an example of a characteristic associated with a moderate contract risk score?

    a. A&B Contractors have a contract in which numerous change orders have been initiated.

    b. C&D Contractor's billing status is not consistent with the type of contractor.

    c. E&F Contractors have accepted a contract in which the project is larger than average.

    d. G&H Contractors have accepted a contract which consists of building a complex structure.

35. What risk category would apply if a contractor had a cost-plus contract?

    a. High.

    b. High to moderate.

    c. Moderate to low.

    d. Low.

36. In which of the following examples does the auditor exhibit the *heart* of determining the nature, timing, and extent of audit procedures that are necessary when establishing the overall audit strategy?

    a. Auditor A considers the significant factors that determine the focus of the engagement team's efforts.

    b. Auditor B determines the key characteristics of the engagement that define its scope.

    c. Auditor C considers the results of preliminary engagement activities.

    d. Auditor D determines the nature, timing, and extent of resources necessary to perform the audit.

37. Which sample selection method is recommended when the population is not numbered?

    a. Haphazard selection.

    b. Systematic selection.

    c. Random selection.

    d. Attribute statistical sampling.

38. What is a logical alternative to an audit of a contractor's financial statements that have never been audited before?

    a. Perform a review engagement.

    b. Perform a preparation engagement.

    c. Perform a compilation engagement.

    d. Perform a detailed review of the predecessor's workpapers.

39. When conducting a review of interim financial information, which of the following statements is most accurate regarding the communication of matters described in AU-C 260, that have been identified, to those charged with governance?

    a. All communications must be oral.

    b. All communications must be written.

    c. All communications may be oral or written, unless firm policy dictates otherwise.

    d. Do not select this answer choice.

40. Reading available minutes of meetings of directors, stockholders, and appropriate committees is a requirement of which of the following?

    a. Annual audits.

    b. Interim reviews.

    c. Annual audits and interim reviews.

    d. Do not select this answer choice.

GLOSSARY

Analysis of relationships between financial and nonfinancial amounts: When comparing financial and nonfinancial amounts, it may be most effective to use a base that (a) would be expected to have a reasonable relationship to revenue and (b) could not easily be manipulated by management or the owner/manager.

Applicable Financial Reporting Framework: A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements; for example, accounting principles generally accepted in the United States of America (U.S. GAAP), International Financial Reporting Standards (IFRS) issued by the IASB, or an OCBOA (other comprehensive basis of accounting).

Attitude/rationalization: Management or other employees are able to justify the acceptability of committing fraud.

Audit risk: The risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.

Bid rigging: Conspiring with other contractors or an employee of the organization seeking bids to ensure that a specific contractor is awarded the contract.

Bribes: Paying government officials for special favors in awarding contracts, providing regulatory approvals, or other matters.

Budgetary comparison: Comparison of actual amounts with budgets or contract estimates may also indicate unusual variations.

Contract materiality: Planning materiality less factual (known) uncorrected misstatements.

Control activities: Policies and procedures established to help ensure that management directives are carried out. That is, control activities are those actions that are taken to address risks that threaten the entity's ability to achieve its objectives, one of which is reliable financial reporting.

Control risk: The risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the entity's internal control.

Detection risk: The risk that the auditor's procedures will not detect a misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements.

Explanatory material: Represents material that provides additional guidance on professional requirements or identifies other procedures or actions.

Fraud risk factors: Conditions or events that indicate incentives/pressure to perpetuate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Fraud risk factors may be related to fraudulent financial reporting or misappropriation of assets.

Front-end loading: Billing and collection ahead of disbursements for costs incurred on a project.

Incentive/pressure: Management or other employees have a reason to commit fraud.

Individually significant contract: An unusual contract (that is, a contract that has audit significance by its nature) or a contract that is significant because of its size (its dollar amount).

Interim financial information: Financial information or statements covering a period less than a full year or for a 12 month period ending on a date other than the entity's fiscal year end. Interim financial information may be condensed or in the form of complete financial statements.

Inherent risk: The susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.

Kickbacks: Paying (directly or indirectly) an employee of the organization seeking bids to ensure that the contractor is awarded the contract.

Monitoring: A process by which an entity assesses the quality of its internal control over time. Monitoring involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary.

Opportunity: Circumstances, such as ineffective controls, the absence of controls, or the ability to override controls, enable management or other employees to commit fraud.

Predecessor auditor: An auditor who (a) reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of the financial statements and (b) has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated.

Presumptively mandatory requirements: Presumptively mandatory requirements are identified by the word "should." If a SAS uses the words "should consider" for a procedure, the consideration of the procedure is presumptively required.

Ratio analysis: Ratio analysis is the analysis of relationships between financial statement items by computing the ratio of one financial statement amount to another.

Risk assessment procedures: Obtaining an understanding of the contractor and its environment, including its internal control, is an essential aspect of the consideration of risk. Thus, audit procedures performed to obtain that understanding are referred to as risk assessment procedures because the information obtained by performing those procedures is used to support the auditor's assessment of the risk of material misstatement.

Risk assessment process: Involves performing procedures, obtaining an understanding of various matters about the entity and its environment, and making decisions and judgments about assessed risks and other matters based on the understanding.

Trend analysis: Auditors may analyze trends in the components of revenue accounts or transaction types. It may be helpful to look at several trends or relationships to identify inconsistencies or unusual patterns.

Unconditional requirements: Unconditional requirements are those that an auditor must follow in all cases if the circumstances apply to the requirement. These requirements use the words "must" or "is required."

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Companion to PPC's Guide to Construction Contractors—Construction Contracts, Audit Programs and Procedures, and Concluding the Audit (CONTG171)

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4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
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4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Construction Contractors—Course 3—Risk Assessment Procedures and Audit Planning (CONTG173)

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2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
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3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

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Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
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1. What did you find **most** helpful?
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