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**AUDIT RISK
ALERTS**

Federal Government Contractors Industry Developments—1993

**Complement to AICPA Audit and Accounting Guide
*Audits of Federal Government Contractors***

AICPA

American Institute of Certified Public Accountants

NOTICE TO READERS

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

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Federal Government Contractors Industry Developments—1993

Industry and Economic Developments

In the face of federal government spending cutbacks, government contractors continue to respond to a declining number and amount of government contract awards by restructuring their business base or choosing not to continue to compete for government contracts. Many defense contractors are pursuing strategies for alternative uses of technology in the commercial marketplace. Some contractors may be experiencing increased operating costs as a result of charging idle personnel to overhead for extended periods. Many companies have significantly reduced their work force but find that additional cost-cutting measures are necessary to remain competitive. Some contractors have responded to government cutbacks and highly competitive foreign companies in the same market by consolidating their core lines of business, or by acquiring related divisions from other contractors and disposing of noncore business lines. Such restructurings allow contractors to eliminate overlapping engineering and support staff, while creating synergies by broadening their technological base and increasing market base.

The decline of available procurement contracts has fueled an increase in the number of appeals and protests. In the first half of 1993, over 300 cases were filed with the General Services Board of Contract Appeals, most of which were appeals relating to procurements of computer and telecommunications equipment and services by all federal agencies.

Because of government-customer budget constraints, many contractors continue to experience increases in claim activity related to the cancellation of contracts. The claims may result from (1) contract performance problems and concerns, (2) letter contracts or other expedited procurement processes initiated by the government, or (3) government-initiated contract terminations, cancellations, or delays. Some contractors have filed, or are in the process of filing, contract claims to recover additional costs.

The U.S. Office of Management and Budget (OMB) released in December 1992 a report entitled "Summary Report of the SWAT Team on Civilian Agency Contracting; Improving Contracting Practices and Management Controls on Cost-Type Federal Contracts." The SWAT

Team recommended, among other things, numerous changes to the Federal Acquisition Regulation (FAR) Part 31 cost principles. The SWAT Team's suggested changes currently are being processed through the FAR regulatory structure.

During the six-month period ended March 31, 1993, the Defense Contract Audit Agency (DCAA), the audit arm of the Department of Defense (DOD), disallowed nearly \$1.1 billion of incurred costs based on its review of the direct and indirect costs charged to government contracts to determine that the costs are reasonable, allocable, and allowable as prescribed by FAR, the Defense Federal Acquisition Regulation Supplement, and provisions of the contract. Examples of disallowed costs include the following:

- Unreliable and unacceptable data supporting equitable adjustment claims for delays, disruptions, constructive change orders, and unforeseen field conditions
- Incomplete analyses supporting indirect cost charges
- Improper allocation of corporate home office expenses and health care costs

Other examples of expressly unallowable costs identified by government auditors included alcoholic beverages, personal use of company automobiles, advertising and trade shows, and scholarships for employee dependents. Compliance with the applicable cost principles and Cost Accounting Standards (CAS) may have a direct effect on the amount of revenue recognized under cost-reimbursement contracts on negotiated contracts when cost or pricing data is submitted.

Regulatory Developments

Cost Accounting Standards Board Initiatives

Applicable laws and regulations regarding CAS and cost allowability may affect the amount of revenue and costs accrued under government contracts depending on the type of contracts involved. AICPA Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), requires the auditor to consider laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. Auditors should carefully evaluate the financial statement impact of current CAS and cost allowability (cost principles) on contract revenues and costs, and the impact of any new CAS issued.

The Cost Accounting Standards Board (CASB) continues to examine issues relating to the measurement of costs, the assignment of cost to accounting periods, and the allocation of cost to objectives. In

promulgating new or revised CAS, by law the CASB must undertake a four-step process by issuing Staff Discussion Papers, Advance Notices of Proposed Rulemaking (ANPRM), Notices of Proposed Rulemakings (NPRM), and final Rulemakings. This rulemaking process can take several years from development of a staff discussion paper to a final rule.

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

<u>Staff Discussion Papers</u>	<u>Issued</u>
Asset Revaluations Resulting from Mergers and Business Combinations	August 1991
Contract Price Adjustments for Organizational Changes	April 1993
Revised CASB Disclosure Statement Form	April 1993
<u>Advanced Notice of Proposed Rulemaking</u>	
Composition, Measurement, Adjustment, and Allocation of Pension Costs	January 1993
<u>Notice of Proposed Rulemaking</u>	
Establishment of CAS for Educational Institutions	December 1992
CAS Applicability and Thresholds	April 1993

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

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

- To raise the threshold for full CAS coverage to \$25 million from \$10 million.
- To establish a \$1 million trigger contract mechanism for the initiation of full CAS coverage.
- To expand requirements for modified CAS coverage to include compliance with CAS 405, *Accounting for Unallowable Costs*, and CAS 406, *Cost Accounting Period*.
- To eliminate the alternative *10 percent or more* government sales test criterion for initiation of full CAS coverage.

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- To eliminate the requirement for a separate CASB waiver where the procuring agency has waived the requirement for submission of certified cost or pricing data.

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

The concept of modified CAS coverage was designed to address the problems of application of CAS to smaller government contractors and to contractors for whom government business represented only a relatively small share of total sales volume. Under current standards, modified coverage may be awarded to a business unit that received less than \$10 million in CAS-covered contracts in the immediately preceding cost accounting period if the sum of such awards was less than 10 percent of the business unit's total sales during that period. Modified coverage requires only that the contractor comply with CAS 401, *Consistency in Estimating, Accumulating and Reporting Costs*, and 402, *Consistency in Allocating Costs Incurred for the Same Purpose*.

The proposed increase of the so-called trigger contract amount is also intended to decrease the burdens associated with the application of full coverage. Under the NPRM, a contractor would be subject to full CAS coverage if it receives \$25 million in CAS-covered contracts, including at least one CAS-covered contract of \$1 million or more. A contractor with \$25 million in CAS-covered contracts valued at \$500,000 each, but without a single \$1 million contract, would not be subject to full coverage.

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

A final rule on revisions to CAS coverage thresholds may be issued and become effective by the end of 1993.

Composition, Measurement, Adjustment, and Allocation of Pension Costs. In January 1993, the CASB issued an ANPRM proposing to revise CAS relating to accounting for pension costs under negotiated government contracts. The CASB proposal includes requirements for the components, measurement, assignment, and allocation of pension costs for qualified and nonqualified defined benefit pension plans. The CASB addressed certain problems that have emerged since the original promulgation of the pension standards, CAS 412, *Cost Accounting*

Standards for Composition and Measurement of Pension Costs and CAS 413, Adjustment and Allocation of Pension Costs. The ANPRM would: (1) permit deferment of the start-up amortization of actuarial gains and losses for a period of two years, and (2) shorten the amortization period for these gains and losses from the present 15 years to five years. The ANPRM also considers deleting the requirement of funding into a qualified trust in order to make the cost allowable; however, this requirement would be waived only to the extent that funding cannot be accomplished due to Internal Revenue Code limitations. The ANPRM proposes to allow accrual of nonqualified pensions costs, but only to the extent that these costs are funded into a *Rabbi Trust* using the complement of the corporate income tax rate multiplied by these costs. As the result of comments received on the ANPRM, the NPRM on this issue may be changed significantly from the ANPRM.

Asset Revaluations Resulting from Mergers and Business Combinations. The CASB continues to study the treatment of gains and losses associated with the revaluation of tangible capital assets following business combinations by government contractors. A CASB Staff Discussion Paper was issued on this subject in August 1991. The CASB staff is expected soon to solicit further public comments on this issue by issuing another staff research paper. A FAR cost principle, Section 31.205-52, *Asset Valuations Resulting from Business Combinations*, is now effective for certain contracts that define as unallowable costs depreciation, amortization, and cost of money on depreciable property and gains and losses on its disposition that result from a business combination when the purchase method of accounting is used and the related assets have been revalued generally leading to a step-up in asset basis.

Guidance issued by the DCAA to its auditors suggests that for business combinations that occurred prior to July 23, 1990 (effective date of FAR 31.205-52), the government contracting officer examine each situation "on a case-by-case basis to achieve equity or protect the government's interests. . . ." DCAA auditors are further instructed to advise the contracting officer to enter into an advance agreement if they encounter prior combinations in which—

- Agreements between the government and the contractor imply the acceptance of the costs into the future.
- The acquired company had little or no government business before being acquired and the "acquiring company subsequently entered government business with the asset valuations established by the combination."
- An extensive amount of time has elapsed between the combinations and the effective date of the cost principle.

The guidance offers five to ten years as a reasonable period of time that should be considered when applying the limitations.

An appeal from a contracting officer's final decision on the issue of applicability has yet to be filed with a board of contract appeals. Independent auditors should be alert to the outcome of any such appeal. Auditors should carefully evaluate the allowability of costs under cost principle 31.205-52, including a review of any agreements between the government and contractor on the treatment of such costs.

Proposed Revisions to the CASB Disclosure Statement Form. Contractors with greater than \$10 million in government contracts covered by CAS are required to file a disclosure statement containing details of the accounting practices of all recognized business segments doing business with the federal government. In April 1993, the CASB issued a Staff Discussion Paper on a revised draft Cost Accounting Standards Board Disclosure Statement Form (CASB DS-1), which solicited views from the government procurement community with respect to the current format of the Disclosure Statement. Comments were requested by July 2, 1993.

Cost Allowability and Allocability Issues

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

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

- Reasonableness of compensation costs for closely held corporations.
- Voluntary management reductions to claimed indirect cost rates in lieu of separately identifying and segregating unallowable costs in the indirect cost rate proposals.
- Guidance on the definition of *common control* as it relates to limitations on rental charges between organizations.
- Costs of postretirement benefits other than pensions (OPEB) including costs of non-CAS covered contractors electing the

so-called *terminal funding* where the contractor accrues and funds the entire cost of a retiree's postretirement benefits upon the employee termination.

- The basis for the federal government to share in excess defined-benefit pension plan assets that revert to a contractor upon termination.
- The federal government's share of any credits received by contractors for airline promotional benefits (that is, frequent flyer bonus credits).

The DCAA also has provided new guidance to its auditors in the following areas:

- Evaluating contractor cost/benefit analysis in support of the use of private aircraft
- Costs associated with political campaign activities at contractor facilities
- Determining if refunds and/or credits are appropriate when the contractor receives foreign tax credits
- Allowability of legal costs relating to bid protests
- Allowability of severance payments and early retirement incentive payments
- Evaluation of environmental costs (see the section that follows on "Environmental Costs")

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

Educational Institutions That Receive Federal Research Awards. Revised guidance on establishing indirect cost rates for educational institutions that are recipients of federal research funds were issued by the OMB in July 1993. Revised OMB Circular A-21, *Cost Principles for Educational Institutions*, is effective for the establishment of indirect cost rates for all fiscal years beginning on or after January 1, 1994, with early implementation encouraged.

In addition to limiting reimbursement of administrative costs to 26 percent of modified total direct costs, the Circular provides guidance on the definition of *organized research* to include both university-supported research and federally sponsored research, allocation methods for depreciation and use of jointly used space, the definition of *modified* total direct costs, the use of provisional rates or fixed rates and carryforward provisions, the development of separate fringe benefit rates where benefits for varying classes of employees vary significantly, and the exclusion of certain costs from indirect rates. The

Circular notes that the CASB, which issued a proposed rule in December 1992 to apply CAS to educational institutions awarded federal contracts, is considering rules to apply certain CAS to educational institutions receiving negotiated contract awards in excess of \$500,000. The Circular also indicates that the OMB plans, in the near future, to extend the CASB's regulations and standards applicable to educational institutions to all awards (contracts and grants) made to institutions that are major recipients of federal research funds.

Independent auditors should carefully evaluate the financial statement effects of allowable and unallowable indirect costs on revenues, receivables, and income, and be alert to the issuance of additional requirements by the CASB and OMB.

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

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

Federal legislation (the Contract Costs Act) has been introduced to extend penalties for unallowable costs in indirect cost proposals to civilian agency contractors. The law would apply to all indirect cost settlement proposals submitted more than 210 days after the bill's enactment. Some industry experts expect passage of the bill without substantive amendment later this year.

Contract Price Adjustments for Organizational Changes. CAS-covered contractors are required as a condition of contracting with the federal government to disclose their cost accounting practices and to agree to

a contract price adjustment for any increased cost paid by the government by reason of a change in those cost accounting practices. Some contractors believe that organizational changes do not equate to a change in cost accounting practice when the method or technique for measurement, assignment, and allocation of costs to cost objectives does not change. In a 1992 Armed Services Board of Contract Appeals (ASBCA) decision concerning Martin Marietta Corp., the ASBCA held that a regrouping of home office cost in business segments as a result of a corporate reorganization did not constitute a change in cost accounting practice in the case of the following:

- The only accounting method or technique used in determining the specific groups was the beneficial or causal relationship test.
- The changes in groups were the result of changes in the beneficial or causal relationships between the home office functions and the various segments of the enterprise and not a result of a change in the accounting method or technique used to determine the groupings.

The decision is pending on appeal before the U.S. Court of Appeals for the Federal Circuit. A CASB Staff Discussion Paper issued in April 1993 solicited views regarding the application of CAS regulations on changes in cost accounting practices in cases where a contractor elects a change to its organizational structure during contract performance.

Independent auditors should be alert to further legal and CASB developments in this area, and carefully evaluate the effect of any organizational changes on contract price adjustments and the related financial statement effect on reported revenues, receivables, and income.

Environmental Costs. A proposed environmental cost principle developed last year regarding the allowability of environmental costs has been held up for issuance for public comment by the Clinton Administration. The pending proposal would divide environmental costs into two categories: (1) ongoing prevention and disposal costs, and (2) costs of correcting environmental damage. Costs in the first category generally would be considered allowable. However, allowability of costs in the second category would be based on the contractor's demonstrating that it—

- Was performing government contracts at the time the conditions were created.
- Was conducting business prudently and in compliance with laws and regulations.
- Acted promptly to minimize damage.

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- Has diligently pursued legal and contributory sources (for example, insurance, or indemnification) to defray the cost.

Also, the Defense Logistics Agency's Defense Contract Management Command and the DCAA have begun a joint audit of environmental costs at five contractor locations to determine the allowability of the costs, with the aim of developing agency-wide guidance and procedures regarding the allowability of contractors' environmental costs included in overhead proposals.

Auditors should be alert to the issuance of any new regulations or guidelines in this area.

Legislative Lobbying Costs. DAC 91-5 makes unallowable the cost of preparing any material, report, lists, or analysis on the actual or projected economic or employment impact in a particular state or congressional district of an acquisition program for which all research and development, testing and evaluation has not been completed.

Audit Issues and Developments

Claims, Change Orders, and Requests for Equitable Adjustment

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

Allowable and Allocable Costs Charged to Contracts

Government auditors continue to question or disallow direct or indirect costs charged to government contracts based upon whether the costs are reasonable, allocable, and allowable as prescribed by the FAR, provisions of the contract, and other applicable regulations and requirements. Laws and regulations regarding cost allowability and allocability affect the amount of revenue and costs accrued under government contracts depending upon the type of contract, and thus

compliance with the applicable cost principle or CAS may have a direct effect on the amount of revenue and costs recognized. SAS No. 54 provides guidance on the nature and extent of the considerations the independent auditor should give to the possibility of illegal acts by clients. The auditor considers laws and regulations that are generally recognized to have a direct and material effect on the determination of financial statement amounts. Auditors should carefully evaluate the allowability and allocability of amounts to government contract costs.

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

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

Accounting Issues and Developments

Postretirement Benefits Other Than Pensions

Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, is likely to create OPEB cost that is greater than the expense allowed as a contract cost used to determine contract revenue. The full amount calculated in accordance with generally accepted accounting principles may be allowable if the contractor has elected to fully fund it and has used the cumulative-effect method in a prior year to adopt FASB Statement No. 106. A number of issues, including tax laws regarding deductibility of OPEB costs, changes in CAS, funding, negotiation of forward pricing arrangements with

respect to OPEB expenses, and the timing of adoption of FASB Statement No. 106, may further complicate the allowability of such costs. In addition, auditors should be aware that the DCAA has taken the position that a change from the pay-as-you-go method of accounting for OPEB costs to that required by FASB Statement No. 106 may result in a change in costs accounting practice for contract costing purposes, which would result in the disallowance of any increased costs allocated to current contracts, including cost-type contracts. Some industry experts disagree with the DCAA's position.

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

1. The current industry environment and related business-base concerns when the OPEB expense is projected to be recovered via contract costing.
2. The computations and assumptions used (including the amounts and years in which the amounts are recovered) to support the asset, which may be subjective. For example, given the current environment, questions arise of whether future contract values should include funded backlog, total contract backlog, loss contracts, contracts with small margins, or contract options.

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

Commercial Nonrecurring Costs

Many federal government contractors are moving into commercial markets and increasingly are using the program method of accounting for products manufactured for delivery under production-type contracts, which may result in the deferral of costs. Under this method, cost are accumulated and accounted for by programs rather than by individual units or contracts. A program consists of the *estimated* number of units of a product to be produced by an enterprise in a continuing, long-term production effort for delivery under existing

and anticipated contracts. Auditors should be aware that the Audit and Accounting Guide *Audits of Federal Government Contractors* states that program accounting has had very limited applications because of the significant uncertainties associated with making reasonably dependable estimates of the total number of units to be produced and sold, the length of time to produce and sell them, and the associated production costs and selling prices. Additionally, the recoverability of the deferred costs is subject to a greater degree of risk and, accordingly, becomes more difficult to estimate in the current uncertain business environment. Program accounting is further discussed in paragraphs 3.57 through 3.60 of *Audits of Federal Government Contractors*.

Environmental Costs

Contractors increasingly are faced with significant costs related to environmental cleanup activities. In some cases, contractors may be able to recover all or a portion of these costs depending on the treatment of the costs in future overhead rates. Auditors should consider the treatment of cleanup costs in future overhead rates when assessing a contractor's financial reporting related to environmental cleanup matters. *Audit Risk Alert—1993* includes additional information on accounting for and disclosure of environmental cleanup costs.

Business Restructurings

The uncertain economic and business environment is necessitating the reorganization, restructuring, and downsizing of many government contractors.

Contractors involved in business restructurings are finding it advantageous to secure advance agreements with the government for the treatment of such costs. However, there are still conflicts between GAAP and the FAR related to the accounting treatment of certain items, such as pension curtailments and settlements. Auditors should be aware of these differences and should consider the related accounting and reporting issues involved in business restructurings of government contractors.

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This Audit Risk Alert replaces *Federal Government Contractors Industry Developments—1992*.

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Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1993*, which may be obtained by calling the AICPA Order Department at the number below and asking for product number 022099.

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

