1991

Construction contractors industry developments - 1991; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Construction Contractors Industry Developments—1991

Update to AICPA Audit and Accounting Guide *Construction Contractors*

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of construction 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 upon by a senior technical committee of the AICPA.

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Industry and Economic Developments

The construction industry is one of the largest segments of the economy of the United States. The industry is one of the most significant contributors to the gross national product, and employs more people and consumes more raw materials than virtually any other industry. Companies in the construction industry range in terms of size and sophistication from one-person remodelers and local businesspeople building in local residential and commercial markets to multinational contractors specializing in multimillion-dollar projects such as skyscrapers, highways, and petroleum pipelines.

The construction industry is generally very sensitive to changes in economic conditions. During recessionary periods, construction budgets are often the first to be cut back as resources are diverted to meet current operating needs. In the past, economic downturns have resulted in a high rate of failures among construction contractors. The construction industry is also highly competitive and, as a result, profit margins are generally low.

As the slump in the overall economy continues into another year, all segments of the construction industry are likely to feel its effect. State and local governments continue to be strapped for funds and, as a result, continue to cut their construction budgets. Consumers remain wary and, as a result, any turnaround in housing seems to be well into the future. The National Association of Home Builders recently predicted that housing starts would fall below one million this year for the first time since 1945.

During such times, construction contractors are more likely to become involved in riskier and less profitable contracts to avoid losing experienced workers and to pay fixed overhead costs. Involvement in less profitable contracts may not immediately become evident in operating results, since existing contracts may be completed at normal profit margins. Nonetheless, new contracts started during the same period are bid with narrower margins and have a greater risk of becoming loss contracts. Involvement in less profitable contracts may also be obscured by front-end-loading billing practices of contractors that accelerate cash flow in the earlier stages of projects. When contractors incur substantial losses on contracts that have been front-end loaded, the results are usually a cash deficiency toward the end of those contracts and an even greater need for new contracts as a source of cash flow.

Contractors are also continuing to experience significant cost increases. Insurance premiums for workers' compensation are continuing their upward trend and are becoming a major indirect cost for many contractors. Another source of significant cost increases for contractors is the so-called impact fee assessed by many municipalities on all new projects. Still other increases result from the need to obtain environmental impact studies in conjunction with new projects. Such cost increases are further reducing already strained profit margins.

Soft real estate markets increasingly are causing problems for contractors. Speculative projects are more difficult to justify, and such projects started in earlier years are experiencing significant losses. Project owners are becoming less liquid and contractors are experiencing increased difficulty in collecting receivables. Also, many financial institutions are slowing the frequency of progress draws on existing contracts and are unwilling to extend credit policies; these sureties can be expected to require more detailed financial information before writing bonds. In many cases, the sureties may require personal guarantees from contractors and cross-collateralization agreements from related entities.

Overall and Specific Risks

Because of the nature of construction contractors' operations and the methods used in accounting for contracts, audits of construction contractors' financial statements can be relatively complex. Estimates relating to future events affect the determination of contract costs, revenues, and gross profit.

An assessment of the degree of overall audit risk involved in construction contractors' financial statements can be made by comparing total gross profit from contracts in progress. As the percentage of gross profit subject to the estimating process increases, there is greater reliance on estimates and a commensurate increase in audit risk.

The following specific conditions generally indicate increased audit risk:

- Increased frequency of loss contracts
- Inconsistent gross profit rates realized on completed contracts
- Declining rates of gross profit recognized on contracts in progress compared to rates of gross profit realized from completed contracts during the period
- Deteriorating gross profit rates toward the end of the accounting period

- Lack of controls over bidding and estimating projects
- Inadequate monitoring of projects in progress
- Apparent incompetence, lack of skill, or poor training of field personnel estimating contract progress and costs to complete
- Participation in joint ventures that are not audited

Audit Issues

The construction industry is generally characterized by a high degree of risk. Quite often, a significant portion of a contractor's equity exists in the form of projects in progress. As a result, the risks associated with the financial statements of contractors with greater numbers of jobs open, with gross profit yet to be realized, are greater than those for contractors that have more closed jobs on which gross profit has been realized.

The following discussion highlights some of the areas in which auditors may encounter increased levels of risk.

Combining Contracts

As a general rule, each contract is a separate profit center for purposes of revenue recognition, cost accumulation, and income measurement. Nonetheless, sometimes a group of contracts may be so closely related that they are, in effect, parts of a single project with an overall profit margin, and accounting for the contracts individually may not be feasible or appropriate. For that reason, AICPA Statement of Position (SOP) 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts,* sets forth specific criteria that, if met, allow contracts to be combined for accounting purposes. Because combining or segmenting contracts may significantly affect periodic income recognition, auditors should carefully consider the circumstances, contract terms, and management's intent in assessing whether the criteria specified in SOP 81-1 are present.

Estimated Costs to Complete

Estimating the costs that will be incurred to complete the work required by a contract involves complex and highly subjective judgments. In auditing such estimates, auditors should fully understand the risk factors associated with the contracts. For example, consideration should be given to the fact that a contractor's financial exposure, as a result of inaccurate estimates to complete, is generally greater for fixed-price-type contracts than for cost-reimbursement contracts.

Similarly, contractors generally face greater exposure on fixed-price contracts that involve new, sophisticated projects because of uncertainty about technological feasibility. AICPA Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates,* provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in audits of financial statements.

Auditors may find it useful to apply analytical procedures to evaluate the performance history of a contractor's estimating department—for example, by considering whether prior year's estimates are close to or differ significantly from actual results. SAS No. 56, *Analytical Procedures,* provides guidance on the use of analytical procedures in the planning and overall review of all audits.

Retentions

Contract provisions often allow customers to withhold a defined amount or percentage of a contract price until certain conditions have been meet. Such amounts are sometimes retained for relatively long periods of time. Auditors should understand the basis for significant retentions, identify the conditions causing amounts to remain unpaid, and consider whether the contractor is making sufficient progress in satisfying the conditions necessary to ensure ultimate realization of retained amounts.

Change Orders and Claims

SOP 81-1 sets forth criteria that must be met for approved change orders or claims to be recognized in financial statements. When approved change orders or claims are recognized in the financial statements, auditors should consider whether those criteria are met.

When a contractor recognizes revenue on unapproved change orders or claims, the auditor should consider the propriety of such recognition by making inquiries of the contractor's attorneys, job site personnel, and management. Accounting for and auditing a contractor's claims against customers (or a subcontractor's claims against prime contractors) resulting from unapproved change orders requires a high degree of judgment. Factors that affect the realization of recorded claimed amounts are often complex, and the results of disputed matters may extend over long periods of time. During that time, management may make decisions about such matters as settlement and litigation strategy. As a result, amounts recovered may differ substantially from amounts originally anticipated and recorded by the contractor.

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This Audit Risk Alert supersedes *Construction Contractors Industry Developments—1990.*

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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—1991* (No. 022087). *Audit Risk Alert—1991* was printed in the November 1991 issue of the *CPA Letter*. Additional copies can be obtained from the AICPA Order Department.

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