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Construction contractors industry developments - 2005/06; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Construction Contractors Industry Developments — 2005/06

Strengthening Audit Integrity
Safeguarding Financial Reporting

American Institute of Certified Public Accountants

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This Audit Risk Alert is intended to provide auditors of construction contractors with an overview of recent economic, industry, technical, and professional developments that may affect the audits they perform.

This publication is an Other Auditing Publication as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply Statements on Auditing Standards.

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Construction Contractors Industry Developments—2005/06

How This Alert Can Help You

This Audit Risk Alert can help you understand technical accounting issues in the construction industry. The knowledge that this Alert delivers can assist you in achieving a more robust understanding of the business environment in which the company operates. Also, this Alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

This Alert describes trends and issues facing most contractors in many of the construction markets in the country. National trends and industry-wide benchmarks can help you understand financial statement relationships and how they may affect the company. However, broad national trends have their limitations. Keep in mind that your company will be affected much more by local economic, political, and industry conditions that exist in the specific markets your company serves.

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2005/06* (product number 022336kk).

References to Professional Standards. When referring to the professional standards, this Alert cites the applicable sections of the codification and not the numbered statements, as appropriate. For example, SAS No. 54 is referred to as AU section 317 of the AICPA *Professional Standards*.

Industry and Economic Developments

Read the AICPA general *Audit Risk Alert—2005/06* for an overview of the current U.S. and global economic environment.

Effects of Hurricane Katrina

The physical and psychological damage caused by Hurricane Katrina is likely to reverberate through the global economy in ways that will curb growth well into 2006, economists say. Most economists predict, however, that Hurricane Katrina will reduce, not derail, U.S. economic growth.

A spike in already-high energy costs in the United States and around the world tops the list of risks, especially since oil prices are unlikely to return to the levels of early 2004 when they were 50 percent lower than they are today. Hurricane Katrina shut down large portions of oil and gas production in the Gulf of Mexico at a time when worldwide energy output was already stretched thin. While the storm's impact was most acute in the United States, it also sent fuel costs higher around the globe, squeezing consumers in Europe and Asia and hurting everyone from truckers to fishermen to airlines. But most analysts agree that the sharp increase in gasoline prices since the storm was a "temporary disruption." Oil industry officials say that several refineries and pipelines will soon be back in operation. Initially, 25 percent of U.S. crude oil production and a large portion of refining capacity were knocked out by the storm. Much of the pressure on oil supplies has been relieved by the release of 60 million barrels from emergency supplies. The full extent of the damage to oil and natural gas infrastructure in the Gulf of Mexico is not yet known, but it is expected to be some time before output is back to normal. The same goes for the facilities that refine crude oil into gasoline, heating oil, and jet fuel.

The storm also wiped away up to half a million jobs in New Orleans and other Gulf Coast areas. And its tab is almost certain to top $100 billion, with only about a quarter of that covered by insurance, according to an assessment by Risk Management Solutions of Newark, Calif.

The federal government has pledged billions of dollars of rebuilding funds, but it will take months for the basic recovery efforts to be completed before the money for reconstruction starts flowing.

In Katrina's aftermath, forecasts for U.S. economic growth in the fourth quarter have dropped from 3.5 percent on an annualized basis to 2.5 percent. And that is probably what gross domestic product will average for all of 2006, economists said.

Some local economies will no doubt benefit from the fact that New Orleans will be out of commission for months. Tourists who might have visited the Big Easy will go elsewhere, corporate conferences will be relocated, and cities throughout the South will witness a tightening of their rental housing markets as evacuees from New Orleans reestablish their lives elsewhere.

But when winter arrives and the higher cost of home heating strikes the Northeast and Midwest, consumer spending, particularly among lower income families, is expected to take a noticeable hit. Michael P. Niemira, chief economist at the International Council of Shopping Centers, said the U.S. retail sector will face its toughest Christmas since the September 11, 2001, terrorist attacks.

While the humanitarian situation is horrific, the economic blow may not be as bad as first feared. Treasury Secretary John Snow and Federal Reserve Chairman Alan Greenspan have stated that it would not have a significant long-term effect on the U.S. economy, although growth will be slowed for a short period. Mr. Snow described the impact of the hurricane as mind-boggling and acknowledged that the U.S. economy was facing a challenging time. But its inherent strength, he said, meant that economic growth would only be hit for three to four months.

The Gulf Coast was hit again just three and a half weeks after Hurricane Katrina, by Hurricane Rita, a category 3 storm. Although Hurricane Rita caused far less destruction than Katrina, it still caused between $2.5 billion and $6 billion in insured damage.

The rebuilding of the Gulf Coast after Hurricanes Katrina and Rita will likely have a positive effect on the construction industry. The opportunities for new work will be immense, but while it has positive implications for contractors, it will present many challenges as well. Auditors should be aware of the following risks for their construction contractor clients:

- Accepting work beyond their abilities to manage
- Accepting work that could put dangerous pressures on their financial capacity (for example, not having sufficient working capital)
- Expanding their labor force with people who are unfamiliar with the entity's practices and methodologies

General Industry Trends and Conditions

Construction activity through July showed widespread improvement compared to the first seven months of 2004, but the devastation wrought by Hurricanes Katrina and Rita will have varied impacts on construction markets for the rest of 2005 and into 2006.

Construction outlays in July were reported at a seasonally adjusted annual rate of $1.099 trillion, unchanged from June, which was revised up from a previously reported $1.093 trillion. June spending was restated as a 0.6 percent decline from a 0.3 percent fall previously reported.

The gains were well distributed. Private residential construction climbed 12 percent year-to-date, private nonresidential construction was up 5.3 percent, and public construction was 5.8 percent higher. Within the private residential market, multifamily construction jumped 20 percent, nearly twice the growth rate for single-family and improvements. Manufacturing construction continued to lead the private nonresidential category with a 27 percent year-to-date advance, followed by "multiretail" (general merchandise stores, shopping centers, and shopping malls), 23 percent; communications, 12 percent; and lodging, 9.4 percent. The leading public categories, educational and highways and streets, were up 5.9 and 7.2 percent, respectively.

However, these figures overstate "real" growth because they don't adjust for a large run-up that has occurred in the cost of cement, steel, copper, gypsum, and petroleum-based inputs. Unfortunately, Hurricanes Katrina and Rita will push many of these costs much higher. Contractors use a lot of diesel fuel for off-road equipment, their own trucks, and the multitude of deliveries of materials and equipment. Petroleum or natural gas is a key ingredient in asphalt, roofing materials, plastic pipe, and insulation. And energy costs are built into the price of mining, milling, making, molding, and transporting metals, concrete, and most other construction materials.

Cement was already in short supply in 32 states and the District of Columbia, and the disruption to ocean, barge, and rail transport from Hurricanes Katrina and Rita, and the loss of power to cement plants in the storms' path, will cut further into cement supplies. At the same time, the urgent need to stabilize and rebuild roads, other infrastructure, and buildings will increase demand for cement and other materials.

Construction Put in Place

One of the most widely used measures of construction activity is *construction put in place*, which is tracked monthly by the Bureau of Statistics at the U.S. Department of Commerce. The *value of construction put in place* (value-in-place) is a measure of the value of construction installed or erected at the site during a given period. For an individual project, this includes:

- New buildings and structures.
- Additions, alterations, major replacements, and so on, to existing buildings and structures.
- Installed mechanical and electrical equipment.
- Installed industrial equipment, such as boilers and blast furnaces.
- Site preparation and outside construction, such as streets, sidewalks, parking lots, utility connections, and so on.
- Cost of labor and materials (including owner-supplied).
- Cost of construction equipment rental.
- Cost of architectural and engineering (A&E) work.

- Any miscellaneous costs of the project that are on the owner's books.

The total value-in-place for a given period is the sum of the value of work done on all projects under way during this period, regardless of when work on each individual project was started or when payment was made to the contractors. For some categories, estimates are derived by distributing the total construction cost of the project by means of historic construction progress patterns.

Exhibit 1, "New Construction Put in Place," presents details of construction put in place for various market segments. (Note that the amounts are in billions of dollars and represent seasonally adjusted annual rates.) To add some perspective, in January 1992, at the start of the current construction boom, the total new construction put in place was $452 billion, as compared with the estimated 2005 amount of $1,099 billion—a gain of more than 143 percent during the period.

EXHIBIT 1 New Construction Put in Place

(Billions of Dollars—Seasonally Adjusted Annual Rate, in Current Dollars)

	July 2005	*July 2004*
Private construction	856.1	758.3
Public construction	243.2	238.9
Total construction	**1,099.3**	**997.2**
Residential building	615.8	537.5
Nonresidential building		
Office	33.9	31.4
Power	24.8	24.0
Commercial	65.4	61.6
Lodging	11.7	11.6
Other nonresidential	104.5	92.2
Total nonresidential	240.3	220.8
Total private construction	**856.1**	**758.3**
Highways and streets	63.9	65.7
Infrastructure	35.1	28.9
Educational	63.7	63.8
Other public buildings	23.8	24.3
Other public construction	56.7	56.2
Total public construction	**243.2**	**238.9**

The U.S. Census Bureau of the Department of Commerce announced that construction spending during July 2005 was estimated at a seasonally adjusted annual rate of $1,099.3 billion, nearly the same as the revised June estimate of $1,099.7 billion. The July figure is 6.0 percent above the July 2004 estimate of $1,037.5 billion. During the first seven months of this year, construction spending amounted to $617.9 billion, 9.3 percent above the $565.4 billion for the same period in 2004.

Spending on private construction was at a seasonally adjusted annual rate of $856.2 billion, 0.2 percent above the revised June estimate of $854.5 billion. Residential construction was at a seasonally adjusted annual rate of $615.8 billion in July, 0.2 percent above the revised June estimate of $614.6 billion. Nonresidential construction was at a seasonally adjusted annual rate of $240.4 billion in July, 0.2 percent above the revised June estimate of $239.9 billion.

In July, the estimated seasonally adjusted annual rate of public construction spending was $243.2 billion, 0.8 percent below the revised June estimate of $245.2 billion. Educational construction was at a seasonally adjusted annual rate of $63.7 billion, 0.6 percent below the revised June estimate of $64.1 billion. Highway construction was at a seasonally adjusted annual rate of $63.9 billion, 2.4 percent below the revised June estimate of $65.5 billion.

> **Help Desk**—You can access current statistics of construction put in place and other construction industry information at www.census.gov.

Private Construction

Residential Building

The residential building segment of the construction industry includes new single- and multifamily housing as well as residential repairs and improvements. Conditions with the most impact on the demand for residential construction include the following:

- *Housing affordability.* Housing affordability is the extent to which potential buyers have the means to purchase a home. Affordability can be measured in several ways by considering average home prices and income levels. For example, some analysts create an "affordability index" by comparing median home prices to household income levels. As income levels get closer to housing prices, the average home becomes affordable to more local residents.

- *Interest rates.* Most homes are financed, and interest rates therefore have a tremendous effect on the affordability of housing. As interest rates rise, the cost of home financing increases; as they fall, the cost of financing decreases. However, interest rate changes do not have an immediate impact on home-buying markets—usually rates have to be in effect for several quarters to reverse home-buying trends.
- *Land availability/pricing.* As one of the major costs of residential building, land availability and pricing have a major impact on the affordability of housing. With land suitable for residential building becoming scarce in certain parts of the country, housing prices will be affected.
- *Demographics.* Shifts in demographics can have a significant impact on housing demand. For example, the aging of the U.S. population has increased demand for low-maintenance and multifamily housing. A large number of baby boomers are now entering their peak earning years, which is expected to affect the affordability and demand for single-family homes.
- *Market velocity.* According to industry sources, more than half of all home improvements occur within 18 months after a new owner moves in, or within 12 months before the home is sold. Thus, during times when new and used home markets are active, residential remodeling and improvement activity also increases.

As one of the main drivers of construction's recent 10-year expansion, home building continues to lead the industry's growth. However, there are signs that years of strong growth in the national housing market may finally be leveling off. Overall, new housing starts in July, which include apartment buildings and condominiums, were flat. The new housing figures, released by the Commerce Department, bolster the view of economists who have predicted a gradual slowdown in housing starts and an easing of price increases as mortgage rates tick up with the prospect of passing the 6 percent mark by next year.

Although sales have certainly been sizzling this year, putting the country on track for a fifth straight year of record purchases of new and existing homes, homes in some areas are staying on the market longer before they sell and the Mortgage Bankers Association reports that its index of demand for home mortgages now stands 11 percent below a June peak.

The issue of how much of a slowdown will occur and whether home prices will fall or just not rise at double-digit rates will depend to a large extent on the course of interest rates in coming months.

Ironically, the devastation from Hurricanes Katrina and Rita could turn out to help the housing industry, mainly through falling interest rates. Investors pushed rates lower after the storms in anticipation that Hurricanes Katrina and Rita and the resulting surge in energy prices would act as a drag on economic growth and could persuade the Federal Reserve to pause in its 14-month campaign to push rates higher. As a result, rates on 30-year mortgages dipped to 5.71 percent, down from a high this year of 6.04 percent set in late March.

David Seiders, chief economist for the National Association of Home Builders, said rebuilding from the hurricanes' devastation probably will not have much impact on the overall housing market since residential building permits for all of Louisiana and Mississippi last year amounted to just 1.8 percent of the national total.

But analysts are forecasting that housing sales will begin to decline from record levels by the end of this year and into 2006. The slowing sales pace is expected to end the super-sized price gains many parts of the country have experienced.

Nonresidential Building

Nonresidential building in July grew 3 percent to an annual rate of $172.1 billion. Much of the upward push came from health-care facilities, which soared 42 percent. July included the start of five large projects valued at $100 million or higher, including a $300 million hospital in Cleveland, Ohio; a $148 million hospital complex in San Francisco, Calif.; a $140 million hospital expansion and seismic upgrade in Seattle, Wash.; a $135 million hospital addition in Jacksonville, Fla.; and a $106 million hospital in Granville, N.C. Showing large percentage gains compared to weak contracting in June were transportation terminals, up 81 percent; and manufacturing plants, up 66 percent. Growth was also registered in July by warehouses, up 17 percent; and stores, up 3 percent.

Nonresidential building in July showed reduced contracting for hotels, down 37 percent; and offices, down 15 percent. For both structure types, the declines were relative to a June that was the strongest month so far in 2005. On the institutional side, July showed a slower pace for churches, down 1 percent; public buildings (courthouses and detention facilities), down 2 percent; school construction, down 6 percent; and amusement-related projects, down 18 percent.

Office Market

The U.S. office market took a big step toward recovery in the second quarter, with absorption exceeding 30 million square feet and the vacancy rate falling below 15 percent. Healthy demand for office space was widespread, with both downtown and suburban markets enjoying a robust quarter. Office construction picked up slightly but is still at relatively low levels. Rents posted another modest increase continuing a trend for the past several quarters.

Office construction took a surprising jump in the second quarter with 12.6 million square feet completed—the most since the fourth quarter of 2003, when 16.1 million square feet was completed. This was 18.9 percent more than the 10.6 million square feet completed in the first quarter or the 11.6 million square feet completed in the second quarter of 2004. Office construction has been subdued since the middle of 2002, with completions barely averaging 10 million square feet per quarter.

The outlook for the office market remains positive for the third quarter and indeed for the balance of 2005. The most important feature of the first half of the year was the sustained growth in employment. The first quarter saw job creation total 546,000, followed by a further 542,000 new jobs in the second quarter. Specific to the office market, "office using employment" increased by 154,000 in the first quarter and 153,000 in the second quarter. Second half projections show continued job creation, which can only be good news for office markets. On the supply side, new office construction is expected to pick up in coming quarters as under-construction activity jumped from 40.3 million square feet at the end of the first quarter to 58.4 million square feet at the end of the second quarter.

Industrial Market

The industrial real estate market experienced an extremely robust second quarter this year, with absorption totaling 69.4 million square feet—far surpassing the 40.9 million square feet recorded during the first quarter of 2005 and 42.2 million square feet during the second quarter of 2004—according to a report by Colliers International, the global real estate services firm.

All the drivers of the U.S. industrial market are going strong—with a subsequent greater need for warehouse space, according to Colliers International. Transportation and distribution companies, manufacturers, retailers, the housing market, and consumer spending all continue to post positive results. There are no indications the industrial market will wane anytime soon.

New construction during the second quarter totaled 30.5 million square feet, exceeding both the 23.2 million square feet recorded during the same quarter last year, and the 27.0 million square feet recorded during the first quarter of 2005. Almost half of the nation's new warehouse construction occurred in five markets: Chicago (2.9 million square feet), Atlanta (2.9 million square feet), Central New Jersey (2.9 million square feet), Seattle (2.7

million square feet), and Inland Empire of California (2.5 million square feet).

Retail and Other Commercial Markets

The favorable conditions witnessed over the past several years have continued into 2005 with the economy on the upswing, steady job creation, disposable income on the rise and, most importantly, consumers who continue to spend. This has led retailers to increase sales and open new stores in a wide variety of centers. Occupancy levels have increased and rents have moved higher. Community rents, neighborhood rents, and power center rents have all increased during the year by 9 percent, 4 percent, and 16 percent, respectively. Going forward, rising interest rates have some concerned, but leasing conditions generally look favorable for some time to come. However, some analysts are predicting that the U.S. retail sector will face its toughest Christmas since the September 11, 2001, terrorist attacks due to the effects of Hurricanes Katrina and Rita.

Hospitality Market

Hotel construction spending, which has been very erratic, is up 28 percent since the bottom of the hotel building cycle two years ago. Although hotel construction spending fell 10 percent in November, December, and January of 2004, most analysts expect a cumulative 66 percent increase by the end of 2006. That will bring the 2004-to-2006 gain to 80 percent compared to 125 percent during 1995-to-1997 at the same period in the previous building cycle.

The expected building boom is being fueled both by an unusually favorable real estate financial environment and by large increases in demand for hotel rooms. Last year, according to Smith Travel Research, hotel operators added only 1 percent more rooms while they raised the occupancy rate 4 percent and boosted room rates 4 percent. Hotel profits improved sharply, although only to the bottom of the normal range. Together with unusually cheap credit costs, this prompted investors to bid up the price of hotel properties enough that building a new hotel is now a better investment than buying an existing hotel in many markets.

Most real estate investors now believe that hotels offer higher returns than other types of commercial buildings. It is now much easier for hotel developers to get construction loans because real estate investment trusts (REITs) are flush with cash they need to invest and developers have learned to add condos to hotel projects and use the condo down payments for some of their financing.

Portsmouth, N.H.-based Lodging Econometrics recently released its Lodging Development Forecast that reports the hotel "pipeline"—which consists of hotels in early planning stages and those under construction or scheduled to start in the next 12 months—increased for the fifth straight quarter in the first quarter of 2005, to 2,388. The hotel pipeline has been growing since it bottomed out in the fourth quarter of 2003, and the forecast looks bright for the future of hotel construction. The report predicts that an estimated 322,177 hotel rooms will be built between the first quarter of 2005 and the first quarter of 2006.

> **Help Desk**—The demand for construction can vary significantly among different geographic regions. One of the most comprehensive analyses of commercial real estate demands and construction activity is published by the Society of Industrial and Office Realtors (SIOR). Annually, SIOR publishes *Comparative Statistics of Industrial and Office Real Estate Markets*, which provides detailed real estate and construction statistics on all the country's larger cities. You can purchase and download this publication directly from the publications section of the SIOR Web site at www.sior.com.

Public Construction

According to the Associated General Contractors of America (AGC), public construction is heading for a modest revival, with gains in highway, school, and most other categories. Highway construction will rise modestly. Congress approved a 2-percent increase in federal-aid funds for fiscal 2005 (ending September 30), with small increases likely in future years. State fuel and vehicle tax receipts, which typically fund the state share of highway spending, are growing slowly as well.

Educational spending will benefit from the housing boom. Single-family houses appreciated 13 percent nationally in the year ending July-September 2004, according to the Office of Federal Housing Enterprise Oversight. Where property-tax assessments keep pace, school districts that depend on property taxes can afford more construction. School construction is likely to shift more toward high schools and away from elementary schools. Census estimates that the elementary-school population in 36 states has fallen since 2000 as the "baby boom echo" cohort is becoming older.

State higher-education construction, as well as other categories, will benefit from a pickup in state general-fund revenues. Income and sales tax receipts climbed 7.5 percent in fiscal 2004 (covering July 2003 to June 2004 for most states) after much slower growth in 2001 and 2003 and a sharp decline in 2002, according to a February 2005 tally by the Nelson A. Rockefeller Institute of Government. That will enable legislatures to reverse some of the construction cuts and freezes imposed in the last several years. However, delays in the design, permit, hearing, and contract phases that follow legislative approval mean the public pickup in construction may not gather steam until 2006. Meanwhile, federal assistance and direct spending for water, wastewater, and building construction are likely to slow by 2006 due to tight budgets for domestic discretionary programs.

Putting the pieces together yields a total for construction put in place in 2005 that will be close to the 2004 level, with growth resuming in all three segments by 2006. Meanwhile, more of the dollar total will represent new projects rather than merely higher materials prices.

The important news affecting public works, of course, is the August enactment of the new multiyear federal transportation bill, after a delay of close to two years. The new bill includes a 38 percent funding increase compared to the previous legislation, plus its passage removes the uncertainty over long-term financing that had hampered state departments of transportation.

Surety Industry Trends

The surety industry is critical to the well-being of the construction industry. Nearly half of all work performed by contractors is bonded, so any change in the surety market will have a significant effect on the construction industry.

Surety bonding is a rigorous process in which surety companies prequalify contractors and then guarantee that the contractors will complete their projects and pay first-tier subcontractors, laborers, and materials suppliers (those hired directly by the general contractors). Construction projects can involve three types of surety bonds:

- Bid bonds provide financial assurance that the bid has been submitted in good faith and that the contractor intends to enter into the contract at the bid price.
- Performance bonds protect the owner from financial loss should the contractor fail to perform the contract in accordance with its terms and conditions.
- Payment bonds guarantee that the contractor will pay subcontractors, laborers, and suppliers associated with the project. (Government property is not subject to mechanic's liens, meaning that laborers, suppliers, and subcontractors would be without redress if the contractor defaulted and there were no payment bond.) Section 270 of the Miller Act, enacted in 1935, governs performance and payment bonds on federal construction projects.

Additionally, each of the 50 states, the District of Columbia, Puerto Rico, and almost all local jurisdictions have enacted legislation requiring surety bonds on public works projects. Generally referred to as "Little Miller Acts," those laws often set minimum thresholds for which state agencies and local governments may require surety bonds. Sometimes, no threshold is set, and the local entities themselves determine what minimum project value necessitates surety bonding.

While surety credit is similar to obtaining bank credit, it still is a form of insurance. Surety bonds and insurance both are risk transfer mechanisms that are regulated by state insurance commissioners, and both provide protection against financial loss.

Unlike other lines of insurance, however, surety actually is a form of credit. Whereas bankers either lend money or extend a line of credit, a surety grants a “pledge guarantee.” The surety does not lend the contractor money but instead allows the surety’s financial resources to be used to back the commitment of the contractor; if the contractor defaults, the surety pays for completion of the contractor’s work.

The basic function of surety is prequalification. That process involves a surety underwriter taking an in-depth look at the contractor’s entire business operation and thoroughly analyzing the contractor’s financial strength and capacity to perform before credit is extended. The underwriter will concentrate on the three “C’s”—character, capacity, capital—when making bond credit decisions.

To issue a surety bond, the surety must be confident that the contractor has good character, experience matching the requirements of its contracts, financial strength, an excellent credit history, an established banking relationship and line of credit, and ownership of (or the ability to obtain) the equipment to carry out the contract.

The surety industry has weathered the turbulent times of the late 1990s and the first years of the 21st century, and has come through intact and on course for a potential recovery. The large losses faced by the industry in the past few years served as a wakeup call to the industry. By returning to the fundamentals, namely solid underwriting practices, many experts believe that the industry is heading toward recovery. However, some of the sureties may experience some additional short-term losses as the result of loosening of underwriting standards demonstrated by some sureties in the 1990s.

Even though there have been a number of high-profile mergers in the surety market, there have been instances of surety company failures. In most cases, capacity remains sufficient to support the nation's construction needs. However, contractors in different market sizes may see changes in the near future and those contractors considered "marginal" may be dropped by their surety.

- Capacity for small and emerging contractors remains available, although they will be subject to the same underwriting standards as their larger peers. Small and start-up contractors who have difficulty meeting today's underwriting standards may opt to explore the U.S. Small Business Administration's Surety Bond Guarantee Program.
- The midmarket contractor is least likely to be affected by capacity issues. This segment is the primary target of the industry, and qualified contractors will continue to receive strong support. However, in some cases, contractors are being required to provide audited financial statements instead of reviewed financial statements, and some sureties are requiring quarterly reporting. The same back-to-basics underwriting standards apply: quality financials, capital retention, and personal and corporate indemnity are all required.
- Contractors in the $250 million-and-over market may need to address changes in the industry. Surety companies are less likely to assume the risks of massive, multiyear projects on their own. Co-sureties, segmented bonding, and joint ventures may be more common, due to the fact that approximately 80 percent of the reinsurers from the 1990s are gone because of the massive surety losses incurred in the past few years. The tightened reinsurance market is a factor in the need for more creative surety solutions on mega-projects.

There are also alternatives to surety, generally referred to as alternate products. These insurance products were originally designed to protect a general contractor from subcontractor default. Unlike a surety bond, an alternate product has a deductible and guarantees payment in the event of default, but not performance.

Although this is a relatively new concept, some think it may be a way to circumvent some of the limitations of the surety industry.

With further consolidation in the marketplace, continued tight terms and conditions for surety credit will continue. With the 10 largest premium volume surety companies now controlling more than 65 percent of the market, it is likely that premium rates will increase. Less negotiation will be available on terms such as bonding subcontractors, acceptable contract specifications, full indemnity, and other underwriting requirements. There will also likely be a rise in the frequency of credit schemes using creative, unlicensed surety entities and alternative products.

In some parts of the country, sureties are requiring clients to upgrade from reviews to audits. Other sureties are willing to accept reviewed financial statements when accompanied by a review of the client's internal controls. In some cases, sureties are also requiring quarterly financial statements, in addition to year-end statements. In addition, some smaller contractors are being required to strengthen their financial position with personal guarantees and additional indemnity.

Contractors can expect sureties to look at their work programs more closely, which can lead to changes in the amount of capacity sureties are willing to offer. Although many surety companies have the capacity to support an increased work program, they may not have the same appetite for risk they had in the past. Nevertheless, a contractor with a solid reputation and sound financials should have no problem obtaining the surety credit it needs. Overall, the surety industry is attempting to return to a healthy state and will continue to respond to the challenges in the construction industry.

At this critical juncture in the surety industry's life cycle, the following steps may be helpful to ensure that your client's surety relationship remains free from any dramatic exposure to the surety industry's changes. Your client may need to:

- Meet regularly with its surety underwriters and bond agents and foster a partnering relationship.

- Know its surety—its results, reinsurance, capacity limitations, credit, and AM Best (a worldwide insurance-rating and information agency) ratings.
- Plan for more lead time for larger or unique projects and major decisions.
- Provide high-quality and timely financial information.
- Understand the working capital and equity requirements for the bonding program.
- Understand the adjustments that the surety makes to the financial statements to arrive at bonding capacity. You should be aware that this can be one of the biggest pressures on a contractor and recognize the associated audit risk.
- Involve its surety in major financial decisions.
- Understand the working capital and equity requirements for your bonding program (single and aggregate limit).
- Use a professional CPA and attorney who specialize in construction contractors and relationships with sureties.
- Use a professional surety broker who specializes in surety, and have a "backup" surety available in case the current surety is unable to provide proper coverage.

Construction Cost Trends

Cleaning up after Hurricanes Katrina and Rita could clean out construction suppliers over the next year. Builders working far away from the Gulf Coast are likely to experience shortages, lagging deliveries, and higher prices, experts say.

The fallout comes at a time of already-high demand for construction materials and equipment. Regional cement shortages are hurting contractors in many states. Availability of larger equipment, such as earthmoving machines, is tight. Nominal prices for highway diesel, averaging $2.59 per gallon, are at an all-time high. Each week brings a new record in diesel prices, according to the U.S. Department of Energy. And Hurricanes Katrina and Rita will push many of these costs much higher, according to Ken Simonson, chief economist for the Associated General Contractors of America.

Heavy equipment dealers in the Gulf Coast area expect to see a run-up for construction machines, such as crawler dozers, excavators, and wheel loaders. The region's need for equipment over the next 12 months is going to be twice the normal demand, experts say. Machinery analysts have forecasted per-unit sales of construction equipment to increase by a hearty 8 percent to 10 percent this year. Hurricanes Katrina and Rita may push up next year's modest forecast of 2 percent to 5 percent.

The crunch could also tighten global supplies of construction machinery, whose demand is expected to rise to $106 billion by 2009 from last year's $81.4 billion, according to Freedonia Group Inc., a market research firm in Cleveland. U.S. machinery exports climbed a staggering 44 percent during the first half of 2005, according to the Milwaukee-based Association of Equipment Manufacturers.

Ready-mix concrete prices are up 16 percent since they began to rise quickly late in 2003. Prices rose 0.9 percent in March and April but declined slightly in May and June. The price increases to date have been driven by sharply higher imports of cement at premium prices, strained capacity at U.S. cement plants, and bigger margins for ready-mix suppliers. Also, higher diesel and natural gas prices have contributed to cost increases at cement plants and ready-mix fleets.

Cement was already in short supply in 32 states and the District of Columbia before Hurricanes Katrina and Rita, and the disruption to ocean, barge, and rail transport from the storm, as well as the loss of power to cement plants in the storms' path, will cut further into cement supplies. At the same time, the urgent need to stabilize and rebuild roads, other infrastructure, and buildings will increase demand for cement and other materials.

The construction industry has been urging the Commerce Department and the Southern Tier Cement Committee to reach immediate agreement on a way to allow Mexican cement into the Gulf states without the punitive 55 percent duty now in place.

The hurricanes' impact on industry is also stretching far beyond oil refineries. The storms knocked out lumber mills as well. The Gulf Coast region is fertile ground for yellow pine, which is sold as plywood, oriented strand board, and pressure-treated lumber. Prices for yellow pine and related products have already gone up 10 percent. Hurricane Katrina boosted lumber prices overnight, and the storms will continue to increase construction costs in other, subtler ways—through fuel surcharges on deliveries, for instance. Experts say prices are likely to go even higher with increased demand for lumber when the work of rebuilding Hurricane Katrina damage begins in earnest.

On a brighter note, the buyers' market for labor is expected to continue into next year. June's 5 percent unemployment rate overstates the tightness in the labor market because labor-force growth has been unusually low recently. The missing workers are partly resulting from measurement error and partly from the usual withdrawal from the labor force when jobs are hard to find. Monthly job gains are expected to rise slightly over the next year from the 180,000 during the spring without any further decline in the unemployment rate. Rather, the unemployment rate is more likely to rise in the next few months. A stable unemployment rate requires about 60,000 people to reenter the labor force each month. Experience in similar economic conditions in the late 1990s suggests that this is likely.

> **Help Desk**—The *Engineering News Record* publishes detailed quarterly cost studies that track average prices for a wide variety of materials and labor classifications in major cities across the country. You can access summaries of the studies at the magazine's Web site at www.enr.com.

Construction cost trends such as those previously mentioned must be considered in the estimates developed by construction contractors. With construction costs rising an average of 24 percent, according to some analysts, you should be aware of the effect on your client's signed contracts and committed future pricing.

Doing Business With FEMA During Disaster Recovery

Hurricanes Katrina and Rita caused massive destruction and damage that will require a multitude of services and products during the recovery process. The services of independent contractors are usually acquired through sealed bidding or negotiations; however, the Federal Emergency Management Agency (FEMA) accepts capability statements and informational packages. The following information should be included:

- Company name
- Business address
- Contact information
- Type of service or product offered
- Type of equipment
- Number of workers being provided
- Cost for service or product
- Whether the company is volunteering services

FEMA also procures goods and services through the General Service Administration's Federal Supply Schedule (information available at www.gsa.gov/regions.htm) and identifies qualified small businesses through the U.S. Small Business Administration's Pro-Net. Companies can register with Pro-Net on the SBA's Web site (www.sba.gov).

In addition, state and local governments make purchases for disaster recovery services and products. Contractors should check the emergency management or other appropriate Web sites of the affected states for information.

Help Desk—For more information about doing business with FEMA, visit www.fema.gov/ofm or call the FEMA Acquisitions Office at (202) 646-4006.

Legislative Issues and Developments

Transportation Act

In July, Congress passed the Safe, Accountable, Flexible and Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU), a measure that will provide more than $286 billion in funding for new highways, roads, airports, bridges, transit facilities, and other transportation-related projects.

SAFETEA-LU reauthorizes federal aid for highways, mass transit, safety, and research programs through fiscal year 2009. The bill provides more than $50 billion for transit programs and $6 billion for transportation safety and contains a $15-billion highway bond plan.

The legislation comes nearly two years after SAFETEA-LU's predecessor, TEA-21, expired in 2003. In the interim, Congress approved 12 extensions to ensure that states continued to receive funding.

Energy Bill

Congress also voted in July to pass comprehensive energy legislation.

The legislation touches nearly every sector of the energy industry, expanding oil and gas production and creating the first inventory of U.S. offshore oil and gas resources. Additionally, the bill provides tax incentives for renewable energy, nuclear power, and coal production; requires utilities to follow nationwide electric reliability rules; and provides incentives for energy efficiency and conservation measures.

However, the final bill did not address a number of controversial items, including a provision that would have shielded manufacturers of the controversial gasoline additive methyl tertiary butyl ether (MTBE) from most product lawsuits associated with groundwater contamination, and the issue of drilling in the Arctic National Wildlife Refuge (ANWR) in Alaska.

Republican leaders intend to pursue the ANWR proposal through the budget "reconciliation" process after the August congressional recess. Unlike most bills in the Senate, the budget measure cannot be filibustered and only needs a simple majority for passage.

Current Audit and Accounting Issues and Developments

Guidance Related to Natural Disasters

Auditing Technical Practice Aids

In September, following the destruction caused by Hurricane Katrina, the AICPA's Audit and Attest Standards Team issued several Technical Practice Aids (TPAs) to address some of the questions that arose in the aftermath of this disaster. TPA section 9070.05, entitled "Consideration of Impact of Losses From Natural Disasters Occurring After Completion of Audit Field Work and Signing of the Auditor's Report But Before Issuance of the Auditor's Report and Related Financial Statements," addresses the auditor's responsibilities with respect to consideration of a material subsequent event that occurs after completion of field work and after the signing of the auditor's report but before issuance of the auditor's report and the audited financial statements.

According to the TPA, a loss from a natural disaster occurring after year end would be considered a type II subsequent event. Paragraph .05 of AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), defines such a subsequent event as an event that provides evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in an adjustment to the financial statements. Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading. For example, if your client owns a major distribution center in an area that is declared a disaster area by the local, state, or federal government due to Hurricane Katrina (or another natural disaster), you, along with management, should assess the damage done to that asset and the impact on the entity's current and future operations and determine whether disclosure of the impact of the disaster is required to keep the financial statements from being misleading.

TPA section 8345.01, "Audit Considerations When Client Evidence and Corroborating Evidence in Support of the Financial Statements Has Been Destroyed by Fire, Flood, or Natural Disaster," and TPA section 8345.02, "Considerations When Audit Documentation Has Been Destroyed by Fire, Flood, or Natural Disaster," provide guidance to auditors facing the question as to what to do when client evidential matter and/or audit documentation is destroyed due to fire, flood, or natural disaster (such as Hurricane Katrina).

Accounting Technical Practice Aid

Also in September, the AICPA issued TPA section 5400.05, "Accounting and Disclosures Guidance for Losses from Natural Disasters," to identify accounting literature which gives guidance on the following accounting issues that may arise in accounting for losses from natural disasters:

- Classifying, in the statement of operations, losses from a natural disaster of a type that is reasonably expected to recur
- Recognizing an asset impairment loss related to a natural disaster
- Recognizing a liability for nonimpairment losses and costs related to a natural disaster
- Accounting for insurance recoveries to cover losses sustained in a natural disaster, and additional considerations related to business interruption insurance recoveries
- Fulfilling required disclosures regarding the impact of a natural disaster

Help Desk—These TPAs can be accessed at www.aicpa.org/download/members/div/auditstd/TPA-Subsequent%20Events.\pdf, www.aicpa.org/download/members/ div/auditstd/TPA_Destruction_of_Documentation.pdf, and www.aicpa.org/download/acctstd/Natural_disaster_TPA_5400.05.pdf.

Exchanges of Nonmonetary Assets

In December 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 153, *Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29*. The guidance in Accounting Principles Board (APB) Opinion No. 29, *Accounting for Nonmonetary Transactions*, was based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in that Opinion, however, included certain exceptions to that principle. APB Opinion No. 29 provided an exception to the basic measurement principle (fair value) for exchanges of similar productive assets. That exception required that some nonmonetary exchanges, although commercially substantive, be recorded on a carryover basis.

FASB Statement No. 153 amends APB Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. According to FASB Statement No. 153, a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange.

Impact on Contractors

Because of the change in the accounting for exchanges of nonmonetary assets, construction contractors are likely to see an increase in the historical cost of equipment over time. This increase in historical cost of equipment will result in higher depreciation expense, which may reduce margins on contracts. Likewise, higher depreciation may justify higher revenue on reimbursable cost type contracts. In addition, contractors must consider the immediate income effect for gain or loss recognition on any equipment transactions.

FASB Statement No. 153 is effective for nonmonetary exchanges occurring in fiscal periods beginning after June 15, 2005.

Variable Interest Entities

FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, issued in January 2003, affected the reporting of a large number of companies associated with special-purpose entities (SPEs, entities established for a specific purpose). The concepts in FASB Interpretation No. 46 were very complex and far-reaching. In December 2003, the FASB issued Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FASB Interpretation No. 46(R)), which revised and clarified certain of the concepts in the original document.

FASB Interpretation No. 46(R) interprets Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, which, for approximately half a century, was the principal authoritative literature governing when an investor should consolidate an investee. ARB No. 51 concluded that consolidated financial statements are "usually necessary for fair presentation when one of the companies in the group directly or indirectly has a controlling interest in the other companies." FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, issued in October 1987, amended ARB No. 51 to remove one of the three exceptions provided in ARB No. 51 that allowed an investor to avoid consolidating a majority-owned investee. ARB No. 51, with certain exceptions, required consolidation of an investee if an investor had a controlling financial interest in the investee. In general, a controlling financial interest was exhibited by an ownership interest of more than 50 percent of the investee's voting stock.

In 1990, to address the consolidation of SPEs for which voting rights were not considered substantive, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions." Issue 90-15 required a lessee to consolidate an SPE-lessor if all the following conditions were met:

- Substantially all the SPE's activities involved assets to be leased to the lessee.

- The lessee was exposed to the substantive risks and was entitled to substantially all the residual rewards of the leased assets and the SPE's financing arrangements.
- The SPE's owners had not made a substantive residual equity investment that would be at risk throughout the term of the lease.

The consolidation of most SPEs was avoided based on the third condition not being met (in other words, the SPE's owners had made a substantive residual equity investment). As practice evolved, a "substantive residual equity investment" came to mean an amount equal to 3 percent of the fair value of the SPE's assets.

Then the Enron scandal exploded. Enron had set up an elaborate array of entities to shift debt away from the company's books, while absorbing substantially all the risk associated with that debt either through guarantees of the debt or the SPE's assets. The extent of those guarantees came as a surprise to many investors.

In response, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, which requires a guarantor to recognize the fair value of its guarantee obligations as a liability and provide certain disclosures about the nature of guarantees it has provided, and FASB Interpretation No. 46 (which subsequently was replaced by FASB Interpretation No. 46(R)).

Importance in Construction

FASB Interpretation No. 46(R) may have a significant impact on construction companies. Some of the more common arrangements that may be affected by FASB Interpretation No. 46(R) include the following:

- Real estate developers frequently form separate legal entities to own property to be developed. The purpose of the separate legal entity is to isolate the developer's other assets from the project to be developed in the event the project is unsuccessful.

- The owners of closely held construction contractors may establish separate legal entities to acquire equipment that is then leased to the contractor. Often, such entities are created for estate-planning purposes.
- Contractors may also form joint ventures to develop a project. Joint venture partners could include another party with unique capabilities in some facet of the project. In some circumstances, such as when the bid documents require that a prime contractor perform more than half of the work, two or more contractors may form a joint venture to become the prime contractor, to meet the contractual requirements.

Each of these separate legal entities may meet the criteria in FASB Interpretation No. 46(R) to be a variable interest entity (VIE), which necessitates a careful consideration of the Interpretation's provisions.

It is common in the construction industry for a contractor to report its interests in a joint venture by consolidating its proportionate interest in the venture. The AICPA Audit and Accounting Guide *Audits of Construction Contractors* (the Guide), issued in 1981, provided guidance on how to account for joint ventures. In addition, EITF Issue No. 00-1, "Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures," recognized the specialized, long-standing practice that had developed in the construction industry by permitting companies to continue consolidating their proportionate interests in investees in the construction industry. However, after the issuance of FASB Interpretation No. 46(R), companies can no longer take it for granted that pro-rata consolidation is appropriate.

Variable Interest Entities

FASB Interpretation No. 46(R) introduced a number of new concepts into the literature. FASB Interpretation No. 46(R) does not define a VIE, but it does describe the characteristics of one. As described by FASB Interpretation No. 46(R), a VIE is an entity for which a controlling financial interest is provided through ownership of interests other than voting stock. Rather, a controlling financial interest arises out of the economics—a holder of variable interests that is either exposed to a majority of the VIE's expected losses or is entitled to a majority of its expected residual rewards is the party with a controlling financial interest, even if none of the interests is in voting common stock.

FASB Interpretation No. 46(R) is complex. Judgment is called for in analyzing entities with which a company has business arrangements to determine if those entities are VIEs and, if so, whether consolidation is required.

In applying FASB Interpretation No. 46(R), an investor and its related parties (which include the investor's officers, employees, and directors; parties that have a "close business relationship" with the investor; and parties that cannot sell, pledge, or exchange their interests in an entity without the investor's prior approval) must first determine whether they have a variable interest.

Variable interests include, but are not limited to, equity investments; debt instruments; guarantees; beneficial interests; service contracts; leases, including guarantees or fixed-price purchase options; forward contracts; and options. In essence, almost any asset, liability, or off-balance-sheet contractual arrangement between parties could qualify as a variable interest. However, a variable interest is distinguished from other assets, liabilities, and off-balance-sheet contractual arrangements by virtue of the fact that a variable interest under FASB Interpretation No. 46(R) is one that absorbs the variability in the entity's return. For example, a party that guarantees the value of real estate held by a developer (or guarantees the developer's bank borrowings used to finance the real estate) has a variable interest because, through the guarantee, the guarantor will absorb any negative variability in returns on the real estate that result in the value of the real estate declining.

If it is decided that a party has a variable interest and it is not immediately clear that the interest is so minor it could not possibly result in that party being required to consolidate the entity in which the variable interest is held, that party must determine whether the entity is a VIE. Paragraph 5 of FASB Interpretation No. 46(R) indicates that an entity is a VIE if any one of the following criteria is met:

1. The total equity investment at risk is insufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders. For this purpose, the total equity investment at risk:
   a. Includes only equity investments in the entity that participate significantly in profits and losses, even if those investments do not carry voting rights.
   b. Does not include equity interests that the entity issued in exchange for subordinated interests in other variable interest entities.
   c. Does not include amounts provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity (for example, by fees, charitable contributions, or other payments), unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.
   d. Does not include amounts financed for the equity investor (for example, by loans or guarantees of loans) directly by the entity or by other parties involved with the entity, unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.
2. As a group the holders of the equity investment at risk lack any one of the following three characteristics of a controlling financial interest:
   a. The direct or indirect ability through voting rights or similar rights to make decisions about an entity's activities that have a significant effect on the success of the entity. The investors do not have that ability through voting rights or similar rights if no owners hold voting

rights or similar rights (such as those of a common shareholder in a corporation or a general partner in a partnership).

   b. The obligation to absorb the expected losses of the entity. The investor or investors do not have that obligation if they are directly or indirectly protected from the expected losses or are guaranteed a return by the entity itself or by other parties involved with the entity.
   c. The right to receive the expected residual returns of the entity. The investors do not have that right if their return is capped by the entity's governing documents or arrangements with other variable interest holders or the entity.

3. The equity investors as a group also are considered to lack characteristic 2a if (*a*) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, their rights to receive the expected residual returns of the entity, or both and (*b*) substantially all the entity's activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights. For purposes of applying this requirement, enterprises shall consider each party's obligations to absorb expected losses and rights to receive expected residual returns related to all that party's interests in the entity and not only to its equity investment at risk.

In some situations, it will be easy to determine if any of these conditions is met. In most circumstances, however, that will not be the case.

The requirements of FASB Interpretation No. 46 were originally to be applied immediately to all VIEs created after January 31, 2003, and no later than the beginning of the period beginning after June 15, 2003 (July 1, 2003, for a calendar-year company that issues quarterly financial information that purports to comply with generally accepted accounting principles [GAAP]), to VIEs created before February 1, 2003. Because of concerns raised by constituents over the operationality of FASB Interpretation No. 46, the FASB delayed its effective date in October 2003 for those entities created before February 1, 2003. FASB Interpretation No. 46(R) modified the effective date provisions in FASB Interpretation No. 46 as follows.

For public entities that are small business issuers, FASB Interpretation No. 46(R) must be applied to all VIEs no later than the end of the first reporting period that ends after December 15, 2004 (the year ending December 31, 2004, for calendar-year companies), including those VIEs to which FASB Interpretation No. 46 had already been applied (for example, those created after January, 31, 2003).

For public entities that are not small business issuers, FASB Interpretation No. 46(R) must be applied to all VIEs no later than the end of the first reporting period that ends after March 15, 2004 (the quarter ending March 31, 2004, for calendar-year companies), including those VIEs to which FASB Interpretation No. 46 had already been applied.

A nonpublic entity is required to apply FASB Interpretation No. 46(R) to all VIEs in which it holds variable interests by the beginning of the first reporting period beginning after December 2004 (January 1, 2005, for a calendar-year company). A nonpublic entity is required to apply FASB Interpretation No. 46(R) immediately to VIEs created after December 31, 2003.

In addition, FASB Interpretation No. 46(R) required public companies to apply either FASB Interpretation No. 46 or FASB Interpretation No. 46(R) to entities that previously would have been evaluated under the accounting literature as SPEs by the end of the first reporting period ending after December 15, 2003.

FASB Interpretation No. 46(R) expanded the consolidation requirements by requiring existing unconsolidated VIEs to be consolidated with their primary beneficiaries if the entities do not effectively disperse risk among the investing parties. As such, VIEs that effectively disperse risks will not be consolidated unless a single party holds an interest or combination of interests that effectively recombines risks that were previously dispersed.

Expected Losses

If an entity is a VIE, the primary beneficiary entity and its related parties need to determine if they—or another investor—are exposed to a majority of the entity's "expected losses." If so, the party exposed to a majority of expected losses is required to consolidate the VIE. That party is referred to in FASB Interpretation No. 46(R) as the VIE's "primary beneficiary."

If no investor is exposed to a majority of "expected losses," the enterprise and its related parties would need to determine if they are entitled to a majority of the entity's residual rewards. If so, the entity entitled to major rewards would be required to consolidate the entity.

If the enterprise is not required to consolidate the VIE, it would account for its investment in the entity using whatever method is appropriate under other accounting literature. (For equity investments, appropriate accounting methods may include using the equity or cost method, or recording at fair value if the investment has a readily determinable fair value and the enterprise and its related parties do not exercise significant influence over the entity's activities. If the variable interest is based on guarantees or other contractual arrangements, disclosure is required.)

Where significant investments do not result in consolidation, disclosure should include the nature of the investment, the exposure to losses, the purpose and size of the investment, and activities with the VIE.

In determining whether an entity's equity is sufficient to cover "expected losses," it is important to understand that "expected losses" do not only arise in situations where an investor loses its stated invested principal.

As used in FASB Interpretation No. 46(R), "expected losses" can arise when an investment underperforms expectations. For example, if the property held by a real estate limited partnership is expected to appreciate by 10 percent per year for the five-year life of the partnership, the partnership would incur "expected losses" for any possible scenario where appreciation could be less than 10 percent per year.

So, if it were possible that the property could appreciate by 6 percent annually, the entity would need to have sufficient equity to "absorb" the opportunity cost related to the 4 percent difference between the expected return and the possible return.

Control of Entities' Activities

Fees paid to any of the investors, for any reason, must be deducted from the equity invested when considering whether the equity is sufficient to absorb losses and whether the equity investors, as a group, control the activities of an entity.

For example, if a developer is the general partner in a limited partnership and receives a fee at inception in excess of its investment, the limited partnership entity would be deemed to be a VIE. This is because FASB Interpretation No. 46(R) requires an investor with equity in the entity to be able to control its activities to not be considered a VIE.

In this example, the general partner—who is the only party with the right to control the ongoing activities of the partnership, the other partners being passive investors—does not have equity in the entity since the fees it received at inception exceeded its investment. That conclusion could require a limited partner to consolidate if the limited partner owns more than 50 percent of the limited partnership interests even though that limited partner's risks are limited to its accumulated and undistributed investment.

Conclusion

As a result of FASB Interpretation No. 46(R), you should review your client's participations in VIEs to evaluate whether these entities should be consolidated. In many cases, real estate partnerships, LLCs, and other entities guaranteed by the operating entity (for example, the contractor) or its owner will have to be consolidated. To ensure compliance, review the full provisions of FASB Interpretation No. 46(R) when accounting for your clients' partnerships and alliances.

FASB Staff Positions. The FASB has issued and proposed several FASB Staff Positions (FSPs) related to Interpretation No. 46(R) that may be of interest to construction contractors and their auditors. FSPs are available on the FASB Web site at www.fasb.org.

State Statutes Affecting Construction Contractors

You should be aware of the existence in some states of "lien" laws. Those laws vary from state to state but generally provide that funds received or receivable by a contractor constitute trust funds that may only be used to pay specified contract-related costs. Review with your client and his or her counsel the applicable statute in each state in which the client operates to evaluate whether amounts that constitute trust funds under those statutes have been properly applied. Other state statutes may also have audit or disclosure requirements. You should consider such statutes in the performance of an audit and in the evaluation of the adequacy of financial statement disclosures.

Reviewing Contracts

To obtain a general understanding of a contractor's operations, you should review the terms of a representative sample of the contractor's contracts, including significant contracts, currently in force. These should include both contracts with customers and contracts with subcontractors. You should use this information in the preliminary review of contracts and also in the other stages of the audit. You would expect to find the following information:

- 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, such as escalation, cancellation, and renegotiation
- Penalty or bonus features relating to completion dates and other performance criteria
- Bonding and insurance requirements
- Location and description of project

Contract files may indicate bids entered by other contractors. If these are available, you should consider investigating significant differences between such bids and the related contracts to evaluate whether there may be inherent errors in the estimating and bidding process.

Auditing Fair Value Measurements and Disclosures

Financial statements of construction contractors contain a number of significant fair value measurements and disclosures. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), contains significantly expanded guidance on the audit procedures for fair value measurements and disclosures.

AU section 328 provides overall guidance on auditing fair value measurements and disclosures. It does not, however, provide guidance on auditing specific assets, liabilities, components of equity, transactions, or industry-specific practices. That guidance will be developed in the future or is available in:

- Other standards, such as AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1)
- Nonauthoritative publications, such as the recently released auditor's toolkit entitled *Auditing Fair Value Measurements and Disclosures: Allocations of the Purchase Price Under FASB Statement of Financial Accounting Standards No. 141*, Business Combinations, *and Tests of Impairment Under FASB Statements No. 142*, Goodwill and Other Intangible Assets, *and No. 144*, Accounting for the Impairment or Disposal of Long-Lived Assets

Under AU section 328, your substantive tests of fair value measurements involve (1) testing management's significant assumptions, the valuation model, and the underlying data; (2) developing independent fair value estimates for corroborative purposes; or (3) examining subsequent events and transactions that confirm or disconfirm the estimate.

When testing management's significant assumptions, the valuation model, and the underlying data, you evaluate whether:

1. Management's assumptions are reasonable and reflect, or are not inconsistent with, market information.
2. The fair value measurement was determined using an appropriate model, if applicable.
3. Management used relevant information that was reasonably available at the time.

You should note that this evaluation is required even if the fair value estimate is made by a valuation specialist.

Job Site Visits

Visiting contract sites can be a very useful audit procedure. All or part of the accounting function relating to a given project may be performed at a temporary job site office staffed by a limited number of trained accounting personnel, and internal control at job sites may be ineffective. Such a visit can provide an opportunity to view the progress of a contract and confirm that the job is progressing in accordance with the plans, specifications, and terms of the contract. Site visits might be warranted for significant contract sites where work is in the very early stages of the contract. Such a visit may help you identify the complexities of performing the contract. The site visit may also provide you with the opportunity to interview operational personnel and gain a better understanding of the responsibility the company has for performing the contract. At the site visit, it also might be helpful to speak with available subcontractors to get additional information about the progress of the contract. You may also be able to speak with a representative of the owner of the project. Furthermore, you should consider observing equipment and uninstalled inventory at the site. You may also obtain evidence that the job actually exists! The use of specialists for certain site visits may be warranted, especially on high risk contracts.

It is usually desirable, before selecting the job sites to be visited, to consider (1) the contractor's internal control, (2) the size, nature, significance, and location of projects, and (3) projects that have unusual features or that appear to be troublesome. Unusual or troublesome contracts may include those accounted for under the percentage-of-completion method on the basis of estimates in ranges or on the basis of zero-profit estimates, those that are combined or segmented for accounting purposes, those with significant unpriced change orders or unsatisfied claims, and those subject to unusual risks because of factors such as location, ability to complete turnkey projects satisfactorily, postponement or cancellation provisions, or disputes between the parties. You may want to consider the use of specialists on certain high risk contracts. See the section in this Alert titled "Using the Work of a Specialist."

Job site visits may be made at any time during the year or at the end of the year. However, if the contractor's internal control is inadequate and if the contractor has in progress any large projects that individually have a material effect on the contractor's results of operations or any projects that have unusual features or that appear to be troublesome, you should consider selecting those projects for visits at or near the year end.

Auditing Contract Costs

The auditing of contract costs involves two primary areas: the accumulated costs to date and the estimated cost to complete. You should keep in mind that in the audit of a contractor the emphasis is on the contract and the proper recording of contract revenues and costs. The determination of the accuracy of both the cost incurred to date and the estimated cost to complete is necessary for each contract in order to determine whether the gross profit on a contract is recognized in conformity with GAAP.

Income for a contractor is determined by the ultimate profit or estimated profit on each contract and is not based on the billings to date or the cost incurred to date. Under the completed-contract method, profit recognition is deferred until the contract is substantially completed; therefore, the cost incurred to date on uncompleted contracts is not reflected in the determination of current income unless a loss on the contract is anticipated. Conversely, the percentage-of-completion method requires that projected gross profit on the contract be estimated before the gross profit for the period under audit can be determined.

Costs Incurred to Date

You should be satisfied that the contractor has properly recorded costs incurred to date by contracts, and that the contractor has included in accumulated contract costs identifiable direct and indirect costs and an acceptable and consistent allocation of overhead to specific contracts. In addition, you should gain assurance that costs for completed versus uncompleted contracts are not misapplied. For cost-plus contracts, you should satisfy yourself that the contractor has not recognized contract revenue based on unreimbursable contract costs. The extent of substantive testing will depend, in part, on your assessment of control risk.

Estimated Cost to Complete

A contractor's ability to estimate job costs is critical from both an operational and a financial reporting standpoint. Contractors that cannot accurately estimate job costs will be unable to manage their working capital and maintain consistent levels of profitability over an extended period. For most contractors, the estimate of costs to complete a project is the fuel that drives revenue recognition. For that reason, inaccurate or unsupported estimates of costs to complete jobs in progress can result in materially misstated financial statements.

When auditing construction estimates, you should be familiar with guidance provided in AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1); the AICPA Practice Aid *Auditing Estimates and Other Soft Accounting Information*; Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*; and the Audit and Accounting Guide *Audits of Construction Contractors*.

Estimated costs to complete involve expectations about future performance, and you should (1) critically review representations of management; (2) obtain explanations of apparent disparities between estimates and past performance on contracts, experience on other contracts, and information gained in other phases of the audit; and (3) document the results of work in these areas. Because of the direct effect on the estimated interim and final gross profit or loss on the contract, you should evaluate whether the contractor's estimate of cost to complete is reasonable. The information that you should consider using in the review of estimated costs to complete includes the following:

- Your knowledge of internal control, with particular emphasis on your assessment of control risk in areas such as estimating and bidding, project management and contract evaluation, contract costs, and claims, extras, and back charges, including a summary of the results of internal audits and a discussion of the contractor's historical experience.
- A comparison of costs incurred to date plus estimated cost to complete with the original bid estimate, along with explanations of unusual variances and changes in trends.
- A summary of work performed, to determine that actual or expected contract price and estimated costs to complete include price and quantity increases, penalties for termination or late completion, warranties or contract guarantees, and related items.
- A review of project engineers' reports and interim financial data, including reports and data issued after the balance sheet date, with explanations for unusual variances or changes in projections. Of particular importance would be a review of revised or updated estimates of cost to complete and a comparison of the estimates with the actual costs incurred after the balance sheet date. Be sure to request the most recent work-in-progress schedule to test for accuracy of the estimates.
- A review of information received from customers or other third parties, such as subcontractors, in confirmations and in conversations about disputes, contract guarantees, and percentage complete, that could affect total contract revenue and estimated cost to complete.

- Discussions with the contractor's engineering personnel and project managers who are familiar with, and responsible for, the contract in process.
- A review of the reports of independent architects and engineers.
- A review of information received from the contractor's attorney that relates to disputes and contingencies.
- Analytical procedures including comparing prior year's estimates with subsequent actual results and determining the reasonableness of the estimated gross profit percentage as compared to jobs completed during the current fiscal period.

Although not all the above types of evidence are available for all audits of all construction contractors, you should keep in mind that your objective is to test the overall reasonableness of the estimated cost to complete in the light of the information obtained from those and other available sources.

Audit Considerations of Various Types of Contracts—Revenue Issues[1]

Fixed Price. This type of contract can be considered the riskiest for both the contractor and the auditor. This is generally the type of contract that one has in mind when considering the need for adequate auditing procedures. As the riskiest contract type in an audit, the auditor must employ all of his or her available audit tools to verify the total contract amount, the collectibility and likelihood of contract changes, and the status of the contract as of the balance sheet date. Auditing procedures related to revenue for this type of contract can consist of (1) contract confirmation; (2) testing of the contractor's business functions over estimating, billing, collection, project management, and generally all controls that influence the contractor's ability to manage estimates; (3) use of testing the contractor's subsequent performance; (4) measuring the contract job gain or fade trends by comparing the contractor's

1. These audit considerations were developed by Eric P. Wallace, CPA, and are used by permission.

ability to estimate by using original estimated contract revenues and costs and comparing these figures to period end amounts and final contract amounts for a period of several years; and (5) using other analytical procedures.

Cost Type. This is a lower risk type of contract. The audit procedures should be focused on the contract provisions concerning the definition of contract costs and the associated revenue entitlements of the contractor. If the contract clearly defines allowable costs, overhead calculations and allocations, agreed-upon profit, and payment terms, the auditor's job is easier and can then be focused on the realization of collection and the creditworthiness of the owner. There are many variations of the cost-type contracts that present various degrees of concern and additional audit requirements for the auditor.

Time and Material. These types of contracts are also lower risk revenue issues for the auditor as long as the contractor has identified all of its costs, including its overhead costs, and defined its needed gross profit. The audit focus in this type of contract comes back to the contractor's internal controls and the ability to fully identify and capture its costs—direct, indirect, and overhead. Often, time and material contracts cannot be confirmed due to the contract's length of time. Other auditing procedures can be employed, such as internal control systems testing and/or subsequent billings and collections of the outstanding time and material costs as of the period end.

Unit Price. Unit price contracts are often small variables of fixed price contracts. Under a unit price contract, the contractor knows the amounts that will be due as each unit price is performed. The auditor's procedures in this area should consist of (1) verifying the work performed with outside parties through the use of confirmations, including the terms of the contract; (2) verifying the terms of the contract concerning the provisions for unit prices, their amounts, and contract billing terms by examining the contract; and (3) determining the revenue balance available to be performed and billed under the contract. Other procedures to be applied can be similar to the procedures applied to fixed price contracts.

Service Contract. This category of contract can include a blend of other contract types, such as time and material. The auditor should separate out these other contract type elements and perform the appropriate testing under those categories. A service contract can consist of the provision of labor only or labor and material. The terms of the contract should be reviewed for the risks that the contract presents to the contractor and to the auditor. For example, does the contract cover maintenance only with breakdowns covered at fixed time and material rates and costs? The risk of loss on such a contract would be minimal. On the other hand, does the service contract provide for the provision of a guaranteed service, such as uninterrupted power (which may be necessary for the function of a hospital). This type of contract would require more extensive auditing procedures that would involve auditing the contractor's ability to produce reliable estimates similar to a fixed price contract. If a service contract has only provisions for maintenance and the minimal supply of parts, the revenue auditing procedures would consist of (1) scheduling out the earned and unearned parts of the contract and recording the unearned part as deferred revenue; (2) examining the contractor's system that tracks the performance of the required or contractual provision of periodic services, if any, to see that they have been performed (this could result in a liability that would need to be measured); (3) determining whether the contractor has the ability to job cost each service contract in order to determine whether the service contracts require a loss reserve; (4) testing the service revenues and costs analytically to see if the gross profits earned are typical compared to industry averages; and (5) testing the contractor's prior abilities to estimate with reasonable certainty. Service contracts that have provisions that require estimations should be tested in a manner similar to a fixed price contract.

Construction Management. Construction management (CM) contracts can also be a blend of various types of contracts that were described and defined above. The particular attributes or details of the contract should be examined to see if these other attributes exist. For example, the contract may call for the CM to act as agent under a fee arrangement, but permit it to perform certain parts of the construction if it deems that it can perform the work for 5 percent less than the lowest bidder. The construction part will need to be tested and audited as a construction contractor. The audit risk that a CM contract presents will depend on the CM contract terms. If a CM contract calls for a fee based upon a percentage of costs, audit risk is lower. On the other hand, if the CM fee is a fixed price, the auditor will need to examine its revenue recognition methods and test the progress to date. An example of this would be where a CM estimates that it will take 1,000 man-hours to earn the CM fee of $500,000 over an 18-month period. The auditor can examine the hours performed to date and the estimate of the hours to complete. In addition, the calculation of hours to date to total estimated hours can be compared to the physical estimate of percentage of completion for reasonableness. Testing of the CM internal controls and prior abilities to estimate with reasonable certainty can also be used to gather audit evidence.

Design Build. This is the newest type of contract and is continuing to be an increasingly popular vehicle for contract performance. The audit risk involved in this type of contract focuses on the detail of the contract terms. Is the contractor going to be reimbursed for its costs under a cost-type arrangement? Is the contract broken out into various pieces where the contractor bid separately on the design and construction work in different phases? The answers to these questions and other facts and circumstances should lead the auditor to make judgment calls about the appropriateness of the use of audit procedures described under the contract types listed above. If a design build contract outcome is uncertain, the auditor should consider the possibility that the contract should be accounted for under alternative revenue recognition methods such as zero profit or the completed contract method until measurements are reliable and more certain.

The Above Type Contracts With Incentive Provisions. All the contract types can have provisions for incentives. The auditing of contracts that include incentive provisions should consist of but are not limited to the following procedures: (1) an examination of the contract terms to determine the conditions for incentive achievement, (2) a testing to see if the conditions for achievement have been met, (3) confirmation of incentive earnings, (4) subsequent billing and collection of incentive revenues, (5) analysis of whether incentive provisions can be earned incrementally or are under "all or none" terms, and/or (6) a determination whether the incentive should be considered a gain contingency properly accounted for under FASB Statement No. 5, *Accounting for Contingencies*.

> **Help Desk**—Marshall and Swift is a consulting firm that provides comprehensive cost data for the construction industry. Included on its Web site is a cost estimator that allows the user to estimate the cost of a project based on current costs in any geographic area. You may find these estimates helpful in performing analytical procedures on client estimates. You can access the cost estimator at www.construction.com.

Affiliated Entities

In the construction industry, contractors frequently participate in joint ventures or have a direct or indirect affiliation with other entities. The prevalence of such arrangements in the industry can be attributed to factors such as legal liability, taxation, competition, ownership and operating arrangements, labor and labor union considerations, and regulatory requirements. As a result of these types of relationships among entities, construction firms are frequently involved in *related-party transactions*, as that term is defined in FASB Statement No. 57, *Related Party Disclosures*.

Participation in Joint Ventures

You should review a contractor's participation in joint ventures to evaluate whether investments in joint ventures are reported properly. The following are among the factors you should consider:

- The method or methods of reporting joint venture investments. Different methods of reporting joint venture investments can result in different financial statement presentation on the books of the construction joint venturer.

- The nature of capital contributions and the methods of recording capital contributions.
- The timeliness of the available financial statements of joint ventures in relation to those of the reporting investor.
- The appropriateness of the accounting for joint venture losses that exceed a contractor's loans and investments.
- The adequacy of joint-venture-related disclosures in the contractor's financial statements.

You should also review joint venture agreements and document your client's participation.

Participation in Partnerships

The audit considerations for a contractor's participation in a partnership (for example, in a real estate tax shelter partnership) are similar to those for participation in corporate joint ventures. They may differ primarily in relation to the contractor's unlimited liability as a general partner for partnership obligations.

You should also assess the economic and tax incentives underlying the creation of the partnership, the events requiring capital contribution installments by limited partners, and temporary and permanent financing arrangements and related costs. In addition, you should assess the extent of actual and contingent obligations that arise from the contractor's role as a general partner. To that end, you should review the financial condition of the other general partners and their ability to participate in the funding of required capital contributions, partnership obligations, and partnership losses, if any. The inability of other general partners to provide their share of such funding may require your client to recognize additional obligations based on its legal liability as a general partner for all partnership obligations.

For any type of venture, remember to consider the nature of the venture, the scope of its operations, and the extent of involvement of each participant.

Using the Work of a Specialist

It may be necessary to use a specialist (such as construction engineer) to perform or assist in job site visits or other audit procedures. The specialist may help you gain assurance as to percent complete, identify problems on the job, and identify possible uninstalled materials or inventoriable items. In addition, the specialist will generally be able to "talk shop" with your client's job site personnel.

Engaging a specialist for gaining an understanding of internal controls, tests of controls, substantive tests, and analytical procedures requires awareness of guidelines available in the authoritative literature. According to paragraph .06 of AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), specialized assistance is advisable for auditors who:

> . . . may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skills or knowledge and in the auditor's judgment require using the work of a specialist to obtain competent evidential matter.

The use of an outside specialist[2] does not absolve the auditor from a certain level of understanding about the construction contractor. Audit planning comes into play because of the lead time necessary to contract for a specialist's services and the time required for the auditor to obtain the minimum knowledge necessary to supervise the specialist. According to paragraph .10 of AU section 311:

> If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who may be either on the auditor's staff or an outside professional. If the use of such a professional is planned, the auditor should have suf-

2. Note that AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1) does not apply to specialists who are employed by the firm and are part of the engagement team. AU section 336 indicates that the auditor uses the work of the specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions. The specialist does not, however, perform the substantive tests or analytical procedures.

> ficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditor's objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures. The auditor's responsibilities with respect to using such a professional are equivalent to those for other assistants.

The use of a specialist is an excellent way to learn the construction contractor's business and can be helpful from initial planning through site visits and fieldwork.

Important Information for Review Engagements

The majority of CPA practitioners serving construction contractors perform a higher number of reviews than audits. Readers interested in guidance for review engagements should refer to the AICPA *Compilation and Review Alert—2005/06* (product number 022306kk). However, a brief overview of Statement on Standards for Accounting and Review Services (SSARS) No. 10, *Performance of Review Engagements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100) is provided in this Alert due to its significant impact on review engagements.

SSARS No. 10, *Performance of Review Engagements*

Since SSARS No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100), was issued in 1978, there had been no substantial change to the requirements for a review engagement. Over time, as a result of feedback from the peer review process, the AICPA Accounting and Review Services Committee (ARSC) became aware of the need to update and expand the guidance related to inquiries and analytics in review engagements. In order to update the guidance for reviews and make other changes, in May 2004 ARSC issued SSARS No. 10, which amended SSARS No. 1.

A review of financial statements under SSARS No. 1 consists of two phases. First, through inquiry and analytical procedures, you gather information to determine whether a client's financial statements are presented in accordance with GAAP or a comprehensive basis of accounting other than GAAP, such as cash or tax basis. Second, based on the results of the inquiries and analytical procedures, you express limited assurance on the financial statements. That limited assurance states that you “are not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with GAAP.”

The fundamental steps in the review engagement are as follows:

- Establish an understanding of the engagement with the client, preferably in writing.
- Develop an understanding of the accounting principles and practices used in the client’s industry.
- Develop a general understanding of the client’s organization; its operating characteristics; and the nature of its assets, liabilities, revenues, and expenses.
- Make appropriate inquiries of the client.
- Perform appropriate analytical procedures.
- Read the client’s financial statements.

SSARS No. 1 has always provided guidance on analytical procedures, inquiries, and other procedures applicable to a review of financial statements. However, SSARS No. 10 amended SSARS No. 1 by providing:

- New and expanded guidance on analytical procedures, including specific guidance on developing expectations
- New and expanded guidance on inquiries, including specific new inquiries to be directed to management
- New inquiries regarding fraud in a review engagement
- New written representations regarding fraud in the management representation letter
- Clarification of guidance regarding working paper documentation in a review engagement, including a requirement to document expectations developed in performing analytical procedures whereby significant expectations are not otherwise readily determinable

Since a review engagement provides limited assurance that no material modifications need to be made to the financial statements for them to be in conformity with GAAP, and because financial statement misstatements could be intentional (fraud) or unintentional (error), ARSC felt that CPAs should make inquiries related to fraud in a review engagement.

Given the conclusion related to the required inquiry about fraud, ARSC also concluded that there should be written representations about fraud in the management representation letter.

In July 2005, ARSC issued SSARS No. 12, *Omnibus Statement on Standards for Accounting and Review Services—2005*. SSARS No. 12 includes revisions to existing SSARSs that have been accumulated over a period of time and addresses a number of issues, including the accountant's consideration of fraud and illegal acts in a compilation or review engagement. This amendment is effective for compilations and reviews of financial statements for periods ending after December 15, 2005. Early application is permitted. Please refer to the AICPA *Compilation and Review Alert—2005/06* for an in-depth discussion of SSARS No. 12.

ARSC also determined that there were questions about documentation related to review engagements, partly due to the fact that the SSARS do not provide enough specific documentation guidance for practitioners to use related to this issue.

The expanded illustrative inquiries (in Appendix B, "Review of Financial Statements—Illustrative Inquiries," of SSARS No. 1) relate to the fact that the illustrative inquiries had not been updated since 1978. Many of the illustrative inquiries had become dated and, primarily because of new technical literature, there was a need to provide more comprehensive guidance related to these inquiries.

SSARS No. 10 is effective for reviews of financial statements for periods ending on or after December 15, 2004.

Additional Guidance

The AICPA issued the following implementation guidance on SSARS No. 10 in order to enhance the CPA's understanding of this standard:

- *ARSC Issues Paper.* ARSC published an Issues Paper entitled "Analytical Procedures in a Review Engagement" to provide accountants with information that may help them understand certain requirements related to the use of analytical procedures in review engagements and how the use of analytical procedures should be documented in those engagements. A copy of this issues paper can be found on the AICPA Web site at www.aicpa.org/members/div/auditstd/issupap_2004_05_ssars10.htm.
- *Practice Aid.* The AICPA published a Practice Aid entitled *Review Engagements—New and Expanded Guidance on Analytical Procedures, Inquiries, and Other Procedures*, to help practitioners perform more effective review engagements and implement SSARS No. 10. You can obtain this practice aid (product no. 006618kk) by calling AICPA Service Center Operations at (888) 777-7077 or going online at www.cpa2biz. com.

Recent Auditing and Attestation Pronouncements, and Related Guidance

Presented below is a list of auditing, attestation, and quality control pronouncements and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards, quality control standards, and other guidance that may have been issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm and the PCAOB Web site at www.pcaobus.org (public company audits only). You may also look for announcements of newly issued standards in the *CPA Letter, Journal of Accountancy*, and the quarterly electronic newsletter, "In Our Opinion," issued by the AICPA's Auditing

Standards team and available at www.aicpa.org/members/div/auditstd/opinion/index.htm.

AICPA Auditing Interpretation No. 1 of AU section 328, *Auditing Fair Value Measurements and Disclosures* AICPA Auditing Interpretation No. 1 of AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (July 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	"Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value" "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist" These Interpretations clarify that simply receiving a confirmation from a third party (including a trustee) does not in and of itself constitute adequate audit evidence with respect to the valuation assertion of interests in trusts or investments in securities. The Interpretations also reiterate the responsibility of management to institute accounting and financial reporting processes for the determination of fair value measurements. According to the Interpretations, if the auditor is unable to audit the existence or measurement of interests in investments in securities at the financial statement date, the auditor should consider whether that scope limitation requires the auditor to qualify his or her opinion or disclaim an opinion.
AICPA Auditing Interpretation No. 1 of AU section 625, *Reports on the Application of Accounting Principles* (January 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	"Requirement to Consult With the Continuing Accountant" This Interpretation provides guidance on when it is acceptable to not seek a "second opinion" from a continuing accountant.
AICPA Auditing Interpretation No. 14 of AU section 623, *Special Reports* (amended January 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	"Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)" This Interpretation provides guidance on necessary disclosures for financial statements prepared on an other comprehensive basis of accounting.

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AICPA Auditing Interpretation No. 15 of AU section 623, *Special Reports* (January 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	"Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request" This Interpretation provides illustrative language for an auditor's report prepared on a regulatory basis of accounting prescribed by a regulatory agency, where the financial statements are not prepared solely for filing with that agency.
AICPA Attest Interpretation No. 6 of AT section 101, *Attest Engagements* (December 2004) (Not applicable to audits conducted in accordance with PCAOB standards)	"Reporting on Attestation Engagements Performed in Accordance With Government Auditing Standards" This Interpretation provides illustrative language for an attestation report for engagements performed pursuant to generally accepted government auditing standards.
AICPA Technical Practice Aid 9070.05 (August 2005) (nonauthoritative)	"Consideration of Impact of Losses From Natural Disasters Occurring After Completion of Audit Field Work and Signing of the Auditor's Report But Before Issuance of the Auditor's Report and Related Financial Statements"
AICPA Technical Practice Aid 8345.01 (September 2005) (nonauthoritative)	"Audit Considerations When Client Evidence and Corroborating Evidence in Support of the Financial Statements Has Been Destroyed by Fire, Flood, or Natural Disaster"
AICPA Technical Practice Aid 8345.02 (September 2005) (nonauthoritative)	"Considerations When Audit Documentation Has Been Destroyed by Fire, Flood, or Natural Disaster"
AICPA Practice Alert 2005-01 (September 2005) (nonauthoritative)	"Auditing Procedures With Respect to Variable Interest Entities" The purpose of this Practice Alert is to provide guidance to auditors in planning and performing auditing procedures with respect to variable interest entities.

PCAOB Auditing Standard No. 4 (Issued as a final standard by the PCAOB, awaiting SEC approval) (Applicable to audits conducted in accordance with PCAOB standards only)	*Reporting on Whether a Previously Reported Material Weakness Continues to Exist* This standard applies if auditors report on the elimination of a material weakness in a company's internal control over financial reporting. The standard establishes a voluntary engagement that would be performed at the election of the company.
PCAOB Conforming Amendment (Issued as a final standard by the PCAOB, awaiting SEC approval) (Applicable to audits conducted in accordance with PCAOB standards only)	Conforming Amendment to PCAOB Related Auditing and Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4
PCAOB Rules (Issued as a final standard by the PCAOB, awaiting SEC approval) (Applicable to audits conducted in accordance with PCAOB standards only)	Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees See the AICPA *Independence and Ethics Alert—2005/06* for further information.
PCAOB Staff Questions and Answers (Various dates) (Applicable to audits conducted in accordance with PCAOB standards only)	1. Auditing Internal Control over Reporting. The PCAOB has issued two sets of questions and answers in 2005 relating to the issuance of PCAOB No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements:* question 37, and questions 38 through 55 2. *Attest Engagements Regarding XBRL Financial Information Furnished Under the XBRL Voluntary Financial Reporting Program on the Edgar System*
AICPA Audit and Accounting Practice Aid (nonauthoritative)	*The Auditor's Guide to Understanding PCAOB Auditing Standard No. 2* This publication walks an auditor through all the key requirements of PCAOB Auditing Standard No. 2 and provides insight and analysis on what those requirements mean.

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AICPA Audit and Accounting Practice Aid (nonauthoritative)	*SAS No. 70 Reports and Employee Benefit Plans* This publication provides guidance on the use of Statement on Auditing Standards (SAS) No. 70 reports in audits performed in accordance with generally accepted auditing standards (GAAS). In addition, this publication includes checklists and forms to help implement the guidance.
AICPA Audit and Accounting Practice Aid (nonauthoritative)	*Illustrative Disclosures on Derivative Loan Commitments* This Practice Aid provides illustrations of disclosures of derivative loan commitments in accordance with the reporting and disclosure guidance cited in Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 105, *Application of Accounting Principles to Loan Commitments*.
AICPA Audit and Accounting Practice Aid (nonauthoritative)	*Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133*, third edition This new edition covers the 2003 revision to Government Auditing Standards. It includes a CD-ROM containing detailed programs and checklists to assist in the audits of entities that receive federal assistance.
Accounting Trends & Techniques (nonauthoritative)	*Employee Benefit Plans* This publication provides extensive illustrative financial statements and note disclosures for employee benefit plans.
Guidance on Management Override of Internal Controls (nonauthoritative)	*Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention—The Audit Committee and Oversight of Financial Reporting* This guidance is available through the AICPA Audit Committee Effectiveness Center at www.aicpa.org/audcommctr (go to "Spotlight Area").

SSARS No. 12	*Omnibus Statement on Standards for Accounting and Review Services—2005* SSARS No. 12 amends SSARS No. 1 by: 1. Requiring the accountant to establish an understanding with the client, preferably in writing, that the accountant will report to the appropriate level of management any evidence or information that comes to the accountant's attention during the performance of compilation or review procedures that fraud or an illegal act may have occurred. 2. Providing guidance on when an accountant should obtain an updated representation letter from management. 3. Providing guidance to the accountant on restricting the use of reports issued pursuant to SSARS. SSARS No. 12 also amends SSARS No. 2 to enable a successor accountant to report on a restatement adjustment of prior-period financial statements and indicate that a predecessor accountant reported on the financial statements of the prior period before the restatement.
SSARS No. 13	*Compilation of Specified Elements, Accounts, or Items of a Financial Statement* SSARS No. 13 expands the applicability of SSARS to situations in which an accountant is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement.
SSARS No. 14	*Compilation of Pro Forma Financial Information* SSARS No. 14 expands the applicability of SSARS to situations in which an accountant is engaged to compile or issues a compilation report on pro forma financial information.

The summaries provided above are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards and other guidance. You should visit the applicable Web site for complete information.

The standards and interpretations promulgated by the AICPA Auditing Standards Board (ASB) are now available free of charge by visiting the AICPA's Audit and Attest Standards Team's page at www.aicpa.org/members/div/auditstd/Auth_Lit_for_Non Issuers.htm. Members and nonmembers alike can download the auditing, attestation, and quality control standards by either choosing a section of the codification or an individual statement number. You can also obtain copies of AICPA standards and other guidance by contacting the Service Operations Center at (888) 777-7077 or online at www.cpa2biz.com.

Recent AICPA Independence and Ethics Pronouncements

The AICPA *Independence and Ethics Alert—2005/06* (product no. 022476kk) contains a complete update on new independence and ethics pronouncements. This Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain that Alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

Presented below is a list of recently issued accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the publication of this Alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and the *Journal of Accountancy*.

FASB Statement No. 152 (December 2004)	*Accounting for Real Estate Time-Sharing Transactions—an amendment of FASB Statements No. 66 and 67* This Statement amends FASB Statement No. 66, *Accounting for Sales of Real Estate*, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in

	AICPA SOP 04-2, *Accounting for Real Estate Time-Sharing Transactions*. This Statement also amends FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to state that the guidance for (1) incidental operations and (2) costs incurred to sell real estate projects does not apply to real estate time-sharing transactions. The accounting for those operations and costs is subject to the guidance in SOP 04-2.
FASB Statement No. 153 (December 2004)	*Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29* This Statement amends APB Opinion 29, *Accounting for Nonmonetary Transactions*, to eliminate the exception for nonmonetary exchanges of similar productive assets, and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange.
FASB Statement No. 123(R) (December 2004)	*Share-Based Payment* This Statement is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*; it supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. It establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments.

(continued)

FASB Statement No. 154 (May 2005)	*Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3* This Statement replaces APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements,* and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions.
FASB Interpretation No. 47 (March 2005)	*Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143* This Interpretation clarifies that conditional asset retirement obligations describes a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may not be under the entity's control.
FASB EITF Issues (Various dates)	Go to www.fasb.org/eitf/ for a complete list of EITF Issues.
FASB Staff Positions (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FASB Staff Positions (FSPs). Some of the recently issued FSPs address issues relating to FASB Statements No. 143 and No. 150, among others; and FASB Interpretation No. 46(R).
AICPA SOP 05-1	*Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*
AICPA Technical Practice Aid 1200.06–1200.15 (February 2005) (nonauthoritative)	"Accounting by Noninsurance Enterprises for Property and Casualty Insurance Arrangements That Limit Insurance Risk"

AICPA Technical Practice Aid 5400.05 (September 2005) (nonauthoritative)	"Accounting and Disclosure Guidance for Losses from Natural Disasters—Nongovernmental Entities"
AICPA Technical Practice Aid 6930.09 (August 2005) (nonauthoritative)	"Accounting and Disclosure Requirements for Single-Employer Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003"
AICPA Technical Practice Aid 6930.10 (August 2005) (nonauthoritative)	"Accounting and Disclosure Requirements for Multiemployer Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003"

The summaries provided above are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standards and other guidance. You should visit the applicable Web site for complete information. You can obtain copies of AICPA standards and other guidance by contacting the Service Operations Center at (888) 777-7077 or online at www.cpa2biz.com.

Some of the pronouncements listed above are already discussed in more detail in this Alert. Below is a brief discussion of two recently issued FSPs that may have an impact on construction contractors.

FSP No. SOP 78-9-1, *Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5*

This FASB Staff Position, issued in July 2005, amends SOP 78-9, *Accounting for Investments in Real Estate Ventures*.

At its June 15-16, 2005 meeting, the EITF reached a consensus on EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights" (Issue 04-5). The consensus provides a framework for addressing when a general partner, or general partners as a group, controls a limited partnership or similar entity. The

EITF acknowledged that the consensus in Issue 04-5 conflicts with certain aspects of SOP 78-9. The EITF agreed that the assessment of whether a general partner, or the general partners as a group, controls a limited partnership should be consistent for all limited partnerships, irrespective of the industry within which the limited partnership operates. Accordingly, the EITF requested and the FASB agreed to amend the guidance in SOP 78-9 to be consistent with the consensus in Issue 04-5.

This FSP eliminates the concept of "important rights" in paragraph .09 of SOP 78-9 and replaces it with the concepts of "kick-out rights" and "substantive participating rights" as defined in Issue 04-5. This FSP also amends paragraph .07 of SOP 78-9 to be consistent with revised paragraph .09. The FASB believes that the effect of the rights held by minority partners on the assessment of control, and therefore consolidation, of a general partnership should be the same as the evaluation of limited partners' rights in a limited partnership.

For general partners of all new partnerships formed and for existing partnerships for which the partnership agreements are modified, the guidance in this FSP is effective after June 29, 2005. For general partners in all other partnerships, the guidance in this FSP is effective no later than the beginning of the first reporting period in fiscal years beginning after December 15, 2005, and the application of either Transition Method A or Transition Method B, described in this FSP, is permitted.

FSP No. FAS 13-1, *Accounting for Rental Costs Incurred during a Construction Period*

This FSP, issued in October 2005, addresses the accounting for rental costs associated with operating leases that are incurred during a construction period. This FSP does not address rental costs other than those associated with building and ground operating leases. This FSP also does not address whether a lessee that accounts for the sale or rental of real estate projects under FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, should capitalize rental costs associated with ground and building operating leases.

This FSP provides that rental costs associated with ground or building operating leases that are incurred during a construction period shall be recognized as rental expense. The rental costs shall be included in income from continuing operations. A lessee shall follow the guidance in FASB Statement No. 13, *Accounting for Leases*, and FASB Technical Bulletin No. 85-3, *Accounting for Operating Leases with Scheduled Rent Increases*, in determining how to allocate rental costs over the lease term. This guidance does not change application of the maximum guarantee test in EITF Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction*.

The guidance in this FSP shall be applied to the first reporting period beginning after December 15, 2005. Early adoption is permitted for financial statements or interim financial statements that have not yet been issued. A lessee shall cease capitalizing rental costs as of the effective date of this FSP for operating lease arrangements entered into prior to the effective date of this FSP. Retrospective application in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*, is permitted but not required.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. You should check the appropriate standard-setting Web sites (listed below) for a complete picture of all accounting and auditing projects in progress. Presented below is brief information about certain projects that are expected to result in final standards in the near future. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB) (Note that for audits of public, companies, the Public Company Accounting Oversight Board sets auditing standards.)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.fasb.org
Governmental Accounting Standards Board (GASB)	www.gasb.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Accounting Pipeline

FASB Project on Revenue Recognition

Revenue usually is the largest single item in financial statements, and issues involving revenue recognition are among the most important and difficult that standard setters and accountants face. Because no comprehensive standard on revenue recognition exists, there is a significant gap between the broad conceptual guidance in the FASB's Concepts Statements and the detailed guidance in the authoritative literature. Most of the authoritative literature provides industry or transaction-specific implementation guidance, and it has been developed largely on an ad hoc basis and issued in numerous pronouncements with differing degrees of authority. Those pronouncements include APB Opinions, FASB Statements, AICPA Audit and Accounting Guides, AICPA SOPs, FASB Interpretations, EITF Issues, SEC SABs, and the like. Each focuses on a specific practice problem and has a narrow scope, and the guidance is not always consistent across pronouncements.

The SEC sought to fill the gap in the accounting literature with SAB No. 101, *Revenue Recognition in Financial Statements*, which was issued in December 1999, and the companion document, *Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers*, which was issued in October 2000. SAB No. 101 was superseded by SAB No. 104, *Revenue Recognition*, in December 2003. SAB No. 104 states that if a transaction falls within the scope of specific authoritative literature on revenue recognition, that guidance should be followed; in the absence of such guidance, the revenue recognition criteria in Concepts Statement 5 (namely, that revenue should not be recognized until it is (1) *realized or realizable* and (2) *earned*), should be followed. However, SAB No. 104 is more specific, stating additional requirements for meeting those criteria, and reflects the SEC staff's view that the four basic criteria for revenue recognition in AICPA SOP 97-2, *Software Revenue Recognition*, should be a foundation for all basic revenue recognition principles. Those criteria are:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred.
- The vendor's fee is fixed or determinable.
- Collectibility is probable.

Some criticized SAB No. 101 on the basis that the criteria in SOP 97-2 were developed for a particular industry and that broader application of those criteria was neither contemplated nor intended. They asserted that that guidance may not be appropriate for certain recognition issues, including some that the EITF has considered. Others noted that a SAB is designed to provide the SEC staff's interpretive responses and not to change GAAP. For that reason, SABs are issued without an invitation for comment. Critics argued that SAB No. 101 had in fact changed GAAP by promulgating changes in industry practice without the full due process and deliberation that characterize the FASB's decision-making process. Even though the SEC guidance for revenue recognition applies only to SEC registrants, the work done in developing and implementing SAB No. 101 has focused attention on revenue recognition issues and will be very useful in this project.

In response to these issues, the FASB has undertaken a project to develop a comprehensive statement on revenue recognition that is conceptually based and framed in terms of principles. The FASB is partnering with the International Accounting Standards Board (IASB) on this project.

The planned comprehensive revenue recognition Statement will (1) eliminate the inconsistencies in the existing authoritative literature and accepted practices, (2) fill the voids that have emerged in revenue recognition guidance in recent years, and (3) provide a conceptual basis for addressing issues that arise in the future.

Proposed FASB Statements and Interpretation

The FASB has issued a number of exposure drafts of proposed statements and an interpretation. Readers should visit the FASB Web site at www.fasb.org/draft/for complete information.

Proposed FASB EITF Issues

Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

Proposed FASB Staff Positions

The FASB has a number of proposed FASB Staff Positions on its agenda. Readers should visit the FASB Web site at www.fasb. org/fasb_staff_positions/proposed_fsp.shtml for complete information.

Proposed Eight SASs Related to Audit Risk

The AICPA's Auditing Standards Board (ASB) has issued an exposure draft of eight proposed Statements on Auditing Standards (SASs). These proposed SASs were originally exposed on December 2, 2002 (except for the amendment to SAS No. 1, *Codification of Auditing Standards and Procedures* [AICPA, *Professional Standards*, vol. 1, AU sec. 230, "Due Professional Care in the Performance of Work"] which was approved for exposure by the ASB on April 28, 2005). The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model in practice by requiring:

- More in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.
- More rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

The exposure draft consists of the following proposed SASs:

- *Amendment to "Due Professional Care in the Performance of Work" of Statement on Auditing Standards No. 1*, Codification of Auditing Standards and Procedures
- *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards
- *Audit Evidence*
- *Audit Risk and Materiality in Conducting an Audit*

- *Planning and Supervision*
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling

The proposed SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the proposed SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. Readers should be alert for the issuance of final standards in the fourth quarter of 2005.

Proposed SAS, *Communication of Internal Control Related Matters Noted in an Audit*

This proposed SAS will supersede SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), and significantly strengthen the quality of auditor communications of such matters in audits of nonpublic companies. Readers should be alert for the issuance of a final standard in the first quarter of 2006.

Proposed SAS, *Audit Documentation*

This proposed SAS will supercede SAS No. 96 of the same name (AICPA, *Professional Standards*, vol. 1, AU sec. 339) and establish standards and provide guidance to an auditor of a nonissuer on audit documentation for audits of financial statements or other financial information being reported on. In developing this exposure draft, the ASB considered the documentation requirements of the PCAOB's Auditing Standard No. 3, *Audit Documentation*;

the International Auditing and Assurance Standards Board's exposure draft, ISA 230, *Audit Documentation*, issued in September 2004; suggestions received from the National Association of State Boards of Accountancy; and Government Auditing Standards issued by the Comptroller General of the United States.

In addition to the proposed SAS, the exposure draft includes proposed amendments to paragraphs .01 and .05 of SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 530, "Dating of the Independent Auditor's Report"). The proposed amendment requires that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient competent audit evidence to support the opinion on the financial statements. It also proposes an amendment to SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150.05). The amendment adds a requirement for the auditor to document his or her justification for a departure from the SASs in the working papers. Readers should be alert for the issuance of a final standard in the fourth quarter of 2005.

Proposed SAS, *Defining Professional Requirements in Statements on Auditing Standards*, and Proposed Statement on Standards for Attestation Engagements, *Defining Professional Requirements in Statements on Standards for Attestation Engagements*

The ASB has issued an exposure draft of a proposed SAS entitled *Defining Professional Requirements in Statements on Auditing Standards* and a proposed Statement on Standards for Attestation Engagements (SSAE) entitled *Defining Professional Requirements in Statements on Standards for Attestation Engagements*. The proposed SAS and SSAE define the terminology the ASB will use to describe the degrees of responsibility that the requirements impose on the auditor or the practitioner. The final SAS and SSAE are expected to be issued in the fourth quarter of 2005.

Proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Over Financial Reporting*

This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). Specifically, guidance is provided regarding the following:

- Conditions that must be met for a practitioner to accept an engagement to examine the effectiveness of an entity's internal control and the prohibition of acceptance of an engagement to review such subject matter
- Engagements to examine the design and operating effectiveness of an entity's internal control
- Engagements to examine the design and operating effectiveness of a portion of an entity's internal control (for example, internal control over financial reporting of an entity's operating division or its accounts receivable)
- Engagements to examine only the suitability of design of an entity's internal control (no assertion is made about the operating effectiveness of internal control)
- Engagements to examine the design and operating effectiveness of an entity's internal control based on criteria established by a regulatory agency

Readers should be alert for the issuance of a final standard in the fourth quarter of 2005.

Proposed SAS, *Amendment to Statement on Auditing Standards No. 69*, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles, for Nongovernmental Entities

The ASB has issued an exposure draft introducing a proposed SAS entitled *Amendment to Statement on Auditing Standards No. 69*, The Meaning of *Present Fairly in Conformity With Generally*

Accepted Accounting Principles, for Nongovernmental Entities. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement entitled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 [AICPA. *Professional Standards*, vol. 1, AU sec. 411]) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the FASB proposed statement, which can be obtained at www.fasb.org.

AICPA Resource Central

The following publications deliver valuable guidance and practical assistance as potent tools to be used on your construction engagements.

- Audit and Accounting Guide *Construction Contractors* (product no. 012585kk). The Audit and Accounting Guide as of May 1, 2005 summarizes applicable practices and delivers "how to" advice for handling almost every type of financial statement. It describes relevant matters, conditions, and procedures unique to the construction industry, and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems. This Audit and Accounting Guide is available now as a CD-ROM or online subscription.
- Checklist Supplement and Illustrative Financial Statements *Construction Contractors* (product no. 008925kk). Developed by AICPA's Accounting and Auditing Publications staff as a supplement to *Corporations Checklists and Illustrative Financial Statements* (product no. 008935kk), this practice aid is invaluable to anyone who prepares financial statements and reports for construction contractors.

- *CPA's Guide to Accounting, Auditing and Tax for Construction Contractors* (2004 paperback) (product no. 091014kk). Here's the definitive resource—complete with information on the specialized requirements that affect contractors—that is perfect for CPAs in public practice and in the construction industry. Based on the AICPA's best-selling CPE self-study course, this newly revised guide covers everything from GAAP accounting methods to auditing and review services performed by outside CPAs and important tax rules for contractors.

- *Accounting Trends & Techniques—2005* (product no. 009897kk). It is the must-have resource for any CPA who frequently creates or uses financial reports. Filled with current reporting techniques and methods used by the nation's top organizations, this 650-page AICPA bestseller will provide guidance you need to improve your accounting preparation and procedures.

- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk). Authoritative guidance on cash- and tax-basis financial statements is rather vague and leaves a great deal to professional judgment. Section One of this publication provides nonauthoritative, practical guidance on preparing and reporting on cash- and tax-basis financial statements. Section Two includes example financial statements, disclosures, and other engagement practice aids. The appendix provides an example checklist to be used for cash- and tax-basis financial statements.

- Audit and Accounting Guide *Auditing Derivative Instruments, Hedging Activities and Investments in Securities* (product no. 012523kk). The first new edition since the guide was originally released in 2001, the guide as of May 1, 2005 has been upgraded to reflect all the latest accounting literature issued since FASB Statement No. 133, as well as new auditing requirements, including SAS No. 101 on auditing fair value.

- Audit and Accounting Guide *Auditing Revenue in Certain Industries* (product no. 012515kk). This publication—as of May 1, 2005—assists auditors in fulfilling their professional responsibilities with regard to auditing assertions about revenue.
- Audit and Accounting Guide *Audit Sampling* (product no. 012530kk). This revised guide (as of April 1, 2001) provides guidance to help auditors apply audit sampling in accordance with AU section 350, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1). The revisions incorporate SASs issued since the guide was originally published, and it also includes increased coverage of nonstatistical audit sampling. This guide may be used both as a reference source for those who are knowledgeable about audit sampling and as initial background for those who are new to this area.
- Audit and Accounting Guide *Analytical Procedures* (product no. 012555kk). Receive guidance on the effective use of analytical procedures with an emphasis on analytical procedures as substantive tests. This guide—revised as of May 1, 2005—includes: AU section 329 (*Analytical Procedures*, AICPA, *Professional Standards*, vol. 1), concepts and definitions; a questions and answers section; an illustrative case study; and a new appendix that includes useful financial ratios.
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk). This book provides practical guidance for handling the audit problems related to the audit of soft accounting information, illustrating how AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), may be applied by practicing auditors.

Audit and Accounting Manual

The *Audit and Accounting Manual* (product no. 005135kk) is developed exclusively for small- and medium-size CPA practices. This unique manual explains and demonstrates useful techniques and procedures for conducting compilation, review, and audit engagements—from planning to internal control to accountants' reports.

AICPA reSOURCE: Online Accounting and Auditing Literature

AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library—that's available too! Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, Technical Practice Aids, Audit and Accounting Guides (more than 20!), Audit Risk Alerts (more than 15!), and *Accounting Trends & Techniques*. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Educational Courses

The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the construction industry. Those courses include:

- *Construction Contractors: Accounting, Auditing and Tax* (product no. 736429kk). Master the fundamentals of the construction industry with this highly effective course. An outstanding value, it provides a thorough industry overview and includes AICPA authoritative publications. Content is tailored to the needs of both practitioners and industry financial professionals.

- *Construction Contractors Advanced Issues* (product no. 731991kk). Delve beyond the basics of many issues the construction industry brings to the accounting profession. Get hands-on advice on the accounting, audit, and tax issues that make construction industry clients high-risk. Address difficult issues such as look-back calculations, measuring progress of construction contracts, and overhead allocations. Enhance your skills today to reduce the risk of your next construction engagement.

- *Construction Contractors Strategic Briefing* (CD-ROM of Webcast originally presented on November 4, 2004) (product no. 780034kk). This course provides a strategic look at what's important in the area of construction contractors. The program addresses the current economic and industry environment, the regulatory environment, current accounting developments, current auditing developments, and what's on the horizon that could affect this industry segment.
- *Real Estate Accounting and Auditing* (product no. 730604kk). This course provides an in-depth study of the unique requirements that apply at each stage of the real estate life cycle. It gives practical, how-to-do-it coverage of accounting considerations related to the development, ownership, and operation of real estate assets.

Accountants in the construction industry, as well as in other industries, may also find the following courses helpful:

- *FASB Review for Industry* (2005-2006 edition) (product no. 730562kk). Comprehensive coverage of recent FASB, AcSEC, IASB, and EITF pronouncements is provided in this course geared to the specific interests of the CPA in corporate management.
- *Accounting Update: A Review of Recent Activities* (2005 edition) (732761kk). This course keeps you current and shows you how to apply the most recent financial accounting and reporting standards. Highlights include FASB Interpretation No. 46 on variable interest entities, fair value concepts and measurements, and the revised FASB Statement No. 123 on share-based payment.
- *AICPA's Annual Accounting and Auditing Update Workshop* (2005 edition) (product no. 736181kk, text; also available in video and DVD formats with a manual). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.

- *Accounting for Income Taxes: Applying SFAS No. 109* (product no. 732790kk). No other area in accounting is as far reaching, and requires knowledge of a vast number of topics in financial and tax accounting, as accounting for deferred taxes. This course addresses the application of this complex standard to many common differences between financial accounting and tax compliance. You will gain a sound knowledge of the theory of deferred taxes and how this theory can be applied to practical situations. Many practical examples are included to illustrate the theory, and the information is presented so you will be able to apply this theory to any other situation that you may encounter.
- *The AICPA's Guide to Consolidations and Business Combinations* (product no. 735129kk). Learn how FASB Statements No. 141 and No. 142 have changed the rules for business combinations and goodwill accounting. Develop standards for applying purchase accounting and how to allocate the acquired entity now that it's the only game in town under FASB Statement No. 141. Identify variable interest entities' impact under FASB Interpretation No. 46(R). Learn how FASB Statement No. 142 deals with goodwill from initial recognition to the annual impairment review requirements.

For a listing of additional courses available, please download the *Fall/Winter 2005 AICPA CPE Catalog* at https://media.cpa2biz.com/Publication/05_fall_winter_FINAL.pdf. You can also check at www.cpa2biz.com/CPE/default.htm for availability of a more recent catalog.

Online CPE

AICPA InfoBytes, offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. Selected as one of *Accounting Today's* top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to

30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com/infobytes.

Webcasts

Stay plugged in to what's happening and earn CPE credit right from your desktop. AICPA Webcasts are high-quality two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in on the discussion. If you can't make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

The CFO Roundtable Webcast Series—brought to you each calendar quarter—covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting, to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

The SEC Quarterly Update Webcast Series—brought to you each calendar quarter—showcases the profession's leading experts on what's "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and CorpFin activities, these hard-hitting sessions will keep you "plugged in" to what's important. A must for both preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Satisfaction Center

To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Technical Hotline and Ethics Hotline

Do you have a complex technical question about GAAP, other comprehensive bases of accounting (OCBOA), or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. You can reach the Technical Hotline at (888) 777-7077.

In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

Conferences

Among the many interesting conferences the AICPA offers, there is one that might interest you. Held late each fall, the AICPA National Construction Industry Conference presents a comprehensive program revealing latest trends and developments in the construction industry. The conference offers a national perspective and addresses the newest trends in conducting business, among other topics.

For additional information, contact CPA2biz at its Web site, www.cpa2biz.com.

Web Sites[3]

AICPA Online and CPA2biz

Here is a unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online, at aicpa.org, informs you of

3. Additional helpful Web sites are presented in the Appendix.

developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, cpa2biz.com offers you all the latest AICPA products, including more than 15 Audit Risk Alerts, more than 20 Audit and Accounting Guides, the professional standards, and CPE courses.

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This Audit Risk Alert replaces *Construction Contractors Industry Developments—2004/05*. Construction Contractors Industry Developments is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to ymishkevich@aicpa.org or write to:

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APPENDIX

Helpful Web Sites

Here are some useful Web sites that may provide valuable information as you plan your client engagements. In addition to these Web sites, be sure to review those listed in the "On the Horizon" section of this Alert.

General Web Sites of Interest

Name of Site	*Content*	*Internet Address*
American Institute of CPAs	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
AuditNet	Electronic communications among audit professionals	www.auditnet.org
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com/
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com/
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
Cybersolve	Online financial calculators, such as ratio and breakeven analysis	www.cybersolve.com/tools1.html
FedWorld. Gov	U.S. Department of Commerce-sponsored site providing access to government publications	www.fedworld.gov
Hoovers Online	Online information on various companies and industries	www.hoovers.com

(continued)

Name of Site	*Content*	*Internet Address*
Ask Jeeves	Search engine that uses a user-friendly question format and provides simultaneous search results from other search engines (for example., Excite, Yahoo, AltaVista)	www.askjeeves.com
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
Society of Industrial and Office Realtors	Industrial and office real estate information	www.sior.com
Engineering News Record	Source of important information for owners, contractors, and design and engineering professionals	www.enr.com
Construction.com	A McGraw-Hill company that unifies the resources of Dodge, Sweets, *Architectural Record*, ENR, and Regional Publications and includes market analysis and forecasting, industry trends, and insights	www.construction.com
Associated Builders and Contractors	A national association representing all specialties within the construction industry and primarily comprising firms that perform work in the industrial and commercial sectors of the industry	www.abc.org
Associated General Contractors of America	An organization of qualified construction contractors and industry-related companies	www.agc.org
Construction Financial Management Association	The only nonprofit organization dedicated to serving the construction financial professional	www.cfma.org

Name of Site	*Content*	*Internet Address*
Construction Industry Compliance Assistance Center	The source for plain language explanations of environmental rules for the construction industry	www.cicacenter.org
Construction Owners Association of America	A focal point and voice for the interests of owners in the construction industry	www.coaa.org
Contractor's License Reference Site	Information about state license requirements, with search functions to find out if a contractor is licensed in a particular state	http://contractors-license.org/index.html
Home Builders Institute	Dedicated to the advancement and enrichment of education and training programs serving the needs of the housing industry	www.hbi.org
National Association of Home Builders	A trade association that helps promote the policies that make housing a national priority	www.nahb.org
National Association of the Remodeling Industry	Focusing on educating both trade professionals and remodeling-ready homeowners through a variety of formats including education, training, publications, and programs	www.nari.org
Disaster Contractors Network	Facilitating information sharing and resource matching among government, the construction community, and home and business owners before, during, and after disasters strike	www.dcnonline.org

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