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AUDIT RISK ALERTS

Credit Union Industry Developments—1990

Update to AICPA Audit and Accounting Guide *Audits of Credit Unions*

Includes *Audit Risk Alert—1990*

Issued by the
Auditing Standards Division

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This document, which contains *Credit Union Industry Developments—1990* and *Audit Risk Alert—1990,* is intended to provide auditors of financial statements of credit unions with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Credit Union Industry Developments—1990

Industry and Economic Developments

During the 1980s, credit unions experienced unprecedented growth in both assets and member shares. Along with this growth came more diversity in the services and products offered by credit unions. Successful expansion into new lending areas has required additional management expertise, close attention to underwriting practices, and strengthened internal control structure policies and procedures.

As credit unions expand into areas such as mortgage lending; acquisition, development, and construction (ADC) and commercial real estate lending; and mortgage banking activities, they are exposed to new risks. In addition, the currently weakening economy makes it increasingly difficult for credit union managements to manage interest rate risk and to maintain liquidity and asset quality. The cyclical nature of the real estate market could cause large losses for credit unions that make undercollateralized loans or loans in anticipation of continued real estate appreciation, or that engage in other unsound credit extension practices. The weakening economy creates further potential for losses on consumer loans, which typically are unsecured, or are secured by vehicles and other depreciable assets.

An important factor cited in the failure of many financial institutions has been insider abuse. In general, insider abuse refers to actions by officers, directors, or employees that are intended to benefit themselves or related parties regardless of the effect of the actions on the soundness of the institution. Insider abuse may involve unsound loans to insiders or related parties, or embezzlement of an institution's funds. Embezzlement losses have increased in both frequency and severity in credit unions in recent years. Auditors should be aware of the various types of insider abuse that are being perpetrated and should be alert to any indications of insider abuse in the credit unions they audit.

Supervisory committees play an important role in developing and maintaining strong operational and financial management at credit unions. With the increase in credit union activities, it is essential that supervisory committees meet regularly and carefully review operational and financial goals, internal control structure policies and procedures, financial statements, and examiner and auditor reports. Lack of supervi-

sory committee involvement in credit union operations may be an early indicator of potential problems.

AICPA Statement on Auditing Standards (SAS) No. 61, *Communication With Audit Committees,* establishes a requirement for auditors to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process. In the credit union environment, it is generally the supervisory committee that has that responsibility.

Regulatory and Legislative Developments

General Accounting Office Study

As mandated by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), the General Accounting Office (GAO) is currently conducting a study of the nation's credit union system. Areas under study include—

- Credit unions' present and future role in the financial marketplace.
- The financial condition of credit unions.
- Credit union capital.
- Credit union regulation and supervision on both the federal and state levels.
- The comparability, in terms of frequency and quality, of National Credit Union Administration (NCUA) examinations of credit unions to supervisory examinations of insured banks and savings associations.
- The structure and financial condition of the National Credit Union Share Insurance Fund (NCUSIF), including consideration of whether supervision of the NCUSIF should be separated from other functions of the National Credit Union Administration Board.
- The ability of the common bond rules regarding credit union membership to continue to serve their original purpose.

The results of the GAO study are expected to be presented to Congress in March 1991 for legislative consideration.

U.S. Treasury Study

FIRREA also mandated a study of the federal deposit insurance system by the secretary of the Treasury. The study encompasses several issues related to all depository institutions, including the goals of the

federal deposit insurance system; the related success of the current insurance system in meeting those goals; methods of monitoring and measuring the risks inherent in the insurance system, including a closer relationship between depository institution auditors and regulators; and the adoption of risk-management and -control techniques, such as special regulatory examinations and changes in the scope of insurance coverage. The study also addresses certain issues specific to credit unions including—

- Whether insured credit union capital levels are adequate and whether the NCUSIF is adequately capitalized.
- How the arrangement of accounting for share insurance deposits by both credit unions and the NCUSIF is likely to work in a crisis affecting a number of credit unions or the credit union industry as a whole.
- Whether the regulatory and insurance functions, currently performed by the NCUA, should be separated within the credit union regulatory structure.

The results of this study are expected to be presented to Congress in March 1991 for legislative consideration.

New Appraisal Guidelines

To comply with FIRREA and to improve the safety and soundness of all federally insured credit unions, the NCUA has adopted a regulation that identifies those real estate transactions requiring an appraiser, sets forth minimum standards for performing appraisals, and distinguishes those appraisals requiring the services of a state-certified appraiser from those requiring a state-licensed appraiser. The NCUA Board has required state-certified or -licensed appraisers to be used for all real-estate-related financial transactions, except those transactions in which—

- A lien is placed on real property solely through an abundance of caution.
- The transaction value (as defined in the proposed regulation) is less than or equal to $50,000.
- A lease that is not the economic equivalent of a purchase or sale is involved.
- There is a renewal of an extension of credit under certain circumstances.
- The credit union is acquiring interests in loans that complied with this regulation when originated.

This new regulation is especially important in auditors' consideration of the qualifications, reputation, and professional standing of appraisers as required by paragraph 5 of SAS No. 11, *Using the Work of a Specialist*.

Contingency Planning

During 1990, the Federal Financial Institutions Examination Council issued an interagency policy on contingency planning for financial institutions. Its purpose was to alert boards of directors and management of financial institutions to the need for contingency planning and for information systems and services in their institutions. The policy states that the boards of directors and senior managements of financial institutions are responsible for establishing policies, procedures, and responsibilities for comprehensive contingency planning; reviewing and approving the institution's contingency plans annually; and documenting such reviews in board minutes. If the institution receives information processing services from a service bureau, management must also evaluate the adequacy of contingency plans for its service bureau and ensure that the institution's contingency plan is compatible with its service bureau's plan.

The policy stresses that each financial institution should assess its own risks and develop strategies accordingly. The planning process needs to address each critical system and operation, whether performed on site, at a user location, or by a service bureau.

Audit and Accounting Developments

Audit Issues

AICPA Statement of Position (SOP) 90-5, *Inquiries of Representatives of Financial Institution Regulatory Agencies*, amends chapter 2 of the AICPA Audit and Accounting Guide *Audits of Credit Unions* with respect to communications between independent auditors and examiners. The SOP states that the independent auditor should—

- Request that management provide access to all reports of examinations and related correspondence.
- Review reports of significant examinations and related correspondence between examiners and the financial institution during the period under audit through the date of the independent auditor's report.
- Communicate with the examiners, with the prior approval of the financial institution, when their examination of the financial institution is in process or a report on an examination has not been received by the financial institution.

A refusal by management or the examiner to allow the independent auditor to review communications from, or to communicate with, the examiner would ordinarily be a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

The SOP also encourages auditors to attend, as observers, with the prior approval of the financial institution, the exit conference between the examiner and the financial institution representatives. Further, if the examiners request permission to attend the meeting between the independent auditor and the financial institution representatives to review the audit report, and if management concurs, the SOP encourages the independent auditor to endeavor to be responsive to that request.

The SOP should apply to audits of financial statements for periods ending on or after September 30, 1990.

Accounting Issues

Statement of Cash Flows. Financial Accounting Standards Board (FASB) Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions,* which is effective for fiscal years ending after June 15, 1990, amends FASB Statement No. 95, *Statement of Cash Flows,* to permit financial institutions, including credit unions, to report in a statement of cash flows certain net cash receipts and cash payments for (a) deposits placed with other financial institutions and withdrawals of deposits, (b) time deposits accepted and repayments of deposits, and (c) loans made to customers and principal collections of loans. The statement also amends FASB Statement No. 95 to permit cash flows resulting from futures contracts, forward contracts, option contracts, or swap contracts that are accounted for as hedges of identifiable transactions or events to be classified in the same category as the cash flows from the items being hedged, provided that accounting policy is disclosed.

Debt Securities Held As Assets. An exposure draft of a proposed SOP, *Reporting by Financial Institutions of Debt Securities Held as Assets,* was issued for comment in May 1990 to provide guidance on applying GAAP in reporting debt securities held as assets by financial institutions, including credit unions. In September 1990, the AICPA Accounting Standards Executive Committee (AcSEC) agreed to issue an SOP recommending expanded disclosures and to study further the recognition and measurement issues.

The "disclosure" SOP, 90-11, *Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets,* is effective for financial statements for fiscal years ending after December 15, 1990. SOP 90-11 requires financial institutions to include an explanation of accounting policies for debt securities held, including the basis for clas-

sification into balance-sheet captions, such as investment or trading, in the notes to the financial statements. In addition, financial institutions must disclose the following in the notes to the financial statements for debt securities carried at either historical cost or the lower of cost or market:

- For each balance sheet presented, the amortized cost, estimated market values, gross unrealized gains, and gross unrealized losses on pertinent categories of securities
- For the most recent balance sheet, the amortized cost and estimated market values of debt securities due:
  - In one year or less
  - After one year and through five years
  - After five years and through ten years
  - After ten years
- For each period for which results of operations are presented, the proceeds from sales of such debt securities and gross realized gains and gross realized losses on such sales

With respect to the recognition and measurement issues, AcSEC sent a letter to the FASB on October 31, 1990, recommending that the FASB add a limited-scope project to its agenda on recognition and measurement of debt securities held as assets by financial institutions. On November 14, 1990, the FASB agreed to consider accelerating a portion of its financial instruments project to address this issue. However, the scope of such a project has not yet been defined.

The AICPA Audit and Accounting Guide *Audits of Credit Unions* states that if a credit union has the ability to hold its debt securities until maturity and also intends to hold them for the foreseeable future, the debt securities should be recorded at cost. In practice, however, it is difficult to assess intent to hold debt securities. Consequently, many financial institutions report such securities as investments simply when they have no intent to sell them.

Definition of Substantially the Same. SOP 90-3, *Definition of the Term* Substantially the Same *for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position,* provides guidance on whether two debt instruments that are exchanged are substantially the same for the purpose of determining whether a transaction involving a sale and a purchase or an exchange of debt instruments should be accounted for as a sale or as a financing. If such securities are substantially the same, the sale and purchase should be accounted for as a financing. It establishes the following six criteria, all of which must be met, for two debt instruments to be considered substantially the same:

1. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, cen-

tral bank, government-sponsored enterprise, or agency thereof, in which case the guarantor and terms of the guarantee must be the same.

2. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.
3. The debt instruments must bear the identical contractual interest rate.
4. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities, for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.
5. Mortgage-backed pass-through and pay-through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
6. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, for which the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard for the type of mortgage-backed security involved.

SOP 90-3 applies to transactions entered into after March 31, 1990.

Accounting for Foreclosed Assets. In December 1990, AcSEC issued an exposure draft of a proposed SOP, *Accounting for Foreclosed Assets.* Under the proposed SOP, there is a presumption that foreclosed assets are held for sale and not for the production of income. As a result, the proposed SOP would require foreclosed assets to be classified in the balance sheet as assets held for sale and reported at the lower of cost (including the estimated cost to sell the asset) or fair value. In addition, except for cash payments for capital additions, improvements, or both, and any related capitalized interest, net cash payments related to a foreclosed asset should be charged to income for each reporting period as a loss on holding the asset. Net cash receipts during each reporting period should reduce the carrying amount of the asset. No depreciation or amortization expense should be recognized.

The exposure period for the proposed SOP ends in March 1991. Shortly thereafter, AcSEC expects to issue a final SOP that would apply to foreclosed assets held by enterprises on or after the date the final SOP is issued.

In-Substance Foreclosures. AICPA Practice Bulletin No. 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed,*

issued in April 1990, establishes the following criteria for evaluating whether collateral for a loan has been in-substance foreclosed:

- The debtor has little or no equity in the collateral, considering the current fair value of the collateral.
- Proceeds for repayment of the loan can be expected to come only from the operation or sale of the collateral.
- The debtor has either (a) formally or effectively abandoned control of the collateral to the creditor, or (b) retained control of the collateral, but because of the current financial condition of the debtor, or the economic prospects for the debtor, the collateral, or both in the foreseeable future, it is doubtful that the debtor will be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future.

It also addresses the reporting by creditors for collateral for a loan that is in-substance foreclosed. If the criteria are met, paragraph 34 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* should be followed. That is, the loan should be reclassified to the category or categories of the collateral, and the recorded investment in the loan should be reduced to the fair value of the collateral, which establishes a new cost basis in the same manner as a legal foreclosure. The excess of the recorded investment in the receivable over the fair value of the collateral should be recognized as a loan loss in the current period to the extent that it is not offset against a previously established allowance.

ADC Arrangements and Similar Arrangements That are Classified as Real Estate Investments or Joint Ventures. A proposed Practice Bulletin, *ADC Arrangements and Similar Arrangements That are Classified as Real Estate Investments or Joint Ventures,* is being developed to provide implementation guidance on accounting for ADC arrangements and similar arrangements classified as investments in real estate or real estate joint ventures under the February 10, 1986, "Notice to Practitioners on ADC Arrangements." In particular, the proposed practice bulletin is expected to address the following issues:

- Reporting by lenders their proportionate shares of income or losses on ADC projects
- The relationship between a lender's proportionate share of income or losses and its "expected residual profit," as described in the ADC Notice
- Including depreciation in determining the income or loss to be recognized
- Reporting by lenders of interest receipts

- Circumstances in which unrealized appreciation of the property can be considered in determining income or loss to be recognized by the lender

Financial Reporting of Interest Income on Troubled or Past Due Loans by Financial Institutions. A proposed Issues Paper, *Financial Reporting of Interest Income on Troubled or Past Due Loans by Financial Institutions,* is being developed by an AcSEC task force regarding the financial reporting of interest income on troubled or past due loans by financial institutions. Among the questions the task force is addressing are the following:

- When should lenders cease accruing interest on troubled loans?
- How should lenders account for accrued but uncollected interest?
- What disclosures are appropriate for cash payments received on nonaccrual loans?

The status of the project is expected to be discussed by AcSEC's Planning Subcommittee in December 1990.

Revision of AICPA Audit and Accounting Guide Audits of Credit Unions

The AICPA Credit Unions Committee is currently revising the 1986 AICPA Audit and Accounting Guide *Audits of Credit Unions.* The proposed guide, which will supersede the 1986 guide, is expected to be exposed for public comment in mid-1991. The guide is intended to help auditors audit and report on the financial statements of credit unions, and, therefore, the discussion of accounting and financial reporting matters is intended to describe current practices, rather than prescribe new ones. The guide will incorporate applicable accounting and auditing pronouncements that have been issued subsequent to the publication of the 1986 guide.

* * * *

Copies of AICPA authoritative guidance may be obtained by calling the AICPA Order Department at (800) 334-6961 (USA) or (800) 248-0445 (NY). Copies of FASB authoritative guidance may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

Audit Risk Alert—1990*

General Update on Economic, Industry, Regulatory, and Accounting and Auditing Matters

Introduction

This alert is intended to help auditors in finalizing their planning for 1990 year-end audits. Successful audits are a result of a number of factors, including acceptance of clients with integrity, adequate partner involvement in planning and performing audits, an appropriate level of professional skepticism, and the allocation of sufficient audit resources to high-risk areas. Addressing these factors in each audit engagement requires substantial professional judgment based, in part, on a knowledge of professional standards and current developments in business and government.

It is important to make sure that written audit programs are *adequately tailored* to reflect *each client's circumstances,* including areas of greater *audit risk*. This alert identifies areas that, based on current information and trends, may be relevant to many 1990 year-end audits. Although it does not provide a complete list of risk factors to be considered, and the items discussed do not affect risk in every audit, this alert can be used as a planning tool for considering matters that may be especially significant for 1990 audits.

Economic Developments

The Current Economic Downturn

Dramatic events in the Persian Gulf and around the world have raised many questions and concerns for American companies. Rising oil prices, lower consumer demand, and reduced availability of capital are just *some* of the factors affecting companies in all industries. Auditors should take these economic factors into consideration and be aware of the ways in which clients have been affected by them as well as of the potential, if any, of a going-concern problem.

*This Audit Risk Alert was published in the December 1990 issue of the AICPA's *CPA Letter.*

Business Failures on the Rise

The current illiquidity in the junk-bond market, coupled with the continuing tightening of credit by lenders throughout the country, have made it substantially more difficult for prospective borrowers to obtain financing, particularly for highly leveraged companies. A recent article in the *Wall Street Journal* called attention to increases in bankruptcy filings, particularly in the real estate, apparel, retailing, and construction industries, due in large part to the weakening cash flow of many businesses as well as the more cautious credit environment. Some industries are becoming very risky undertakings. For example, in 1990, the number of restaurant closings exceeded the number of openings; increased competition has made it nearly impossible to raise menu prices, while costs have continued to increase, especially those for energy, insurance, and wages.

The effects of the economic slowdown will vary across geographic regions and industries, and among companies even within the same industry. Therefore, auditors need to focus specifically on the environment of each client and address each client's particular issues accordingly. Nevertheless, many companies will be unable to pass on increased costs (particularly increased oil prices and medical expenses) due, in part, to increasing competition and softening demand for their products. This could make it difficult for companies to report favorable operating results for the year. With this in mind, auditors should be even more sensitive this year to ongoing issues that affect operating results, such as the collectibility of receivables and the potential obsolescence and realizability of inventories.

Highly leveraged companies are particularly vulnerable to a downturn in business activity and the other factors discussed above. Auditors should consider these circumstances when evaluating the ability of highly leveraged clients to continue as going concerns.

Economic Considerations Relating to Debt

Adverse developments in the economy in general, or in a particular financial institution, may cause an institution to refuse to renew loans, to exercise demand clauses (such as the due-on-demand clause), or to decline to waive covenant violations. In addition, these developments may make it more difficult for companies to obtain alternate sources of financing than in the past. In these cases, the auditor should consider the borrower's classification of the liability, potential going-concern issues, management's plans (such as those for alternate financing or asset disposition), and the adequacy of disclosures in the borrower's financial statements. Securities and Exchange Commission (SEC) rules

contain specific disclosure requirements in Management's Discussion and Analysis (MD & A) about liquidity and material uncertainties.

Regulatory and Legislative Developments

Environmental Liabilities

The Environmental Protection Agency is empowered by law (through the Superfund legislation) to seek recovery from anyone who ever owned or operated a particular contaminated site, or anyone who ever generated or transported hazardous materials to a site (these parties are commonly referred to as potentially responsible parties, or PRPs). Potentially, the liability can extend to subsequent owners or to the parent company of a PRP.

In connection with audit planning, the auditor should consider making inquiries of management about whether a client (or any of its subsidiaries) has been designated as a PRP or otherwise has a high risk of exposure to environmental liabilities. If a client has been designated as a PRP, the auditor should consider whether any amount should be accrued for cleanup costs and assess the need for disclosure and, possibly, for the inclusion of an explanatory fourth paragraph in the audit report citing the uncertainty, if management is unable to make reasonable estimates of the costs. In addition, for public entities, disclosure should be made in MD&A of estimates of cleanup costs or the reasons why the matter will not have a material effect.

Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*, and Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, provide guidance for the accounting and disclosure of loss contingencies, including those related to environmental issues. The FASB's Emerging Issues Task Force (EITF) reached a consensus in Issue 90-8, *Capitalization of Costs to Treat Environmental Contamination*, that, generally, the costs incurred to treat environmental contamination should be expensed and may be capitalized only if specific criteria are met.

Notification of Termination of Auditor-Client Relationship

The SEC staff has observed instances in which CPA firms have not notified the SEC's Chief Accountant when an auditor-client relationship ends. Under a rule effective May 1, 1989, member firms of the SEC Practice Section of the AICPA Division for Firms must notify the SEC directly by letter *within five business days* after the auditor resigns, declines to stand for reelection, or is dismissed.

New Auditing Pronouncements

Implementing SAS No. 55 on Internal Control

AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, is effective for audit periods beginning on or after January 1, 1990. Auditors who did not apply its provisions early are faced with implementation for December 31, 1990, year-end audits.

To help auditors with questions that may arise, the Auditing Standards Board (ASB) issued the Audit Guide *Consideration of the Internal Control Structure in a Financial Statement Audit*. The guide presents two preliminary audit strategies for assessing control risk and uses three hypothetical companies ranging from a small, owner-managed business to a large public company to illustrate how the strategies affect the nature, timing, and extent of procedures. Particularly helpful is a series of exhibits that includes sample workpapers documenting the hypothetical companies' compliance with SAS No. 55. A copy of the guide (product number 012450) may be obtained by calling the AICPA Order Department at (800) 334-6961 (USA) or at (800) 248-0445 (NY).

New Financial Institutions Confirmation Form

The AICPA will replace the existing 1966 Standard Bank Confirmation Inquiry. The new form will provide only confirmation of *deposit* and *loan* balances. To confirm other transactions and arrangements, auditors will have to send a separate letter, signed by the client, to a financial institution official responsible for the financial institution's relationship with the client or knowledgeable about the transactions or arrangements. Anyone ordering the new standard form from the AICPA Order Department will receive a copy of a notice to practitioners, which describes the revisions to the process of confirming information with financial institutions, and illustrative letters for confirming some of these types of transactions or arrangements. The new form should be used for confirmations mailed on or after March 31, 1991. Practitioners should neither use the new form before March 31, 1991, nor use the old form on or after that date.

New SAS on Internal Auditing

In January 1991, the ASB will issue a new SAS, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, that will provide practitioners with expanded guidance when considering the work of internal auditors. Many internal audit activities are relevant to an audit of financial statements because they provide evidence about

the design and effectiveness of internal control structure policies and procedures or provide direct evidence about misstatements of financial data contained in financial statements. The SAS is effective for audits of financial statements for periods beginning on or after January 1, 1991, and will include guidance to assist auditors in obtaining an understanding of the internal audit function, assessing the competence and objectivity of internal auditors, and determining the extent to which they may consider work performed by internal auditors. The SAS supersedes SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit,* and incorporates the terminology and concepts of more recent SASs, particularly SAS No. 55.

Forthcoming Guidance on Circular A-133

On March 8, 1990, the Office of Management and Budget (OMB) issued Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* The purpose of Circular A-133 is to establish audit requirements and to define federal responsibilities for implementing and monitoring audit requirements for institutions of higher education and other nonprofit institutions receiving federal awards. Institutions covered by Circular A-133 generally include colleges and universities (and their affiliated hospitals) and other not-for-profit organizations, such as voluntary health and welfare organizations and other civic organizations.

The circular applies to nonprofit institutions that receive $100,000 or more in federal awards. (Circular A-133's definition of *financial awards* is broader than the term *financial assistance* used in SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance.*) Nonprofit institutions that receive at least $25,000 but less than $100,000 in federal financial assistance have the option of applying either the requirements of Circular A-133 or separate program audit requirements. For institutions receiving less than $25,000, records must be kept and made available for review, if requested, but the provisions of the circular do not apply.

In the first quarter of 1991, the AICPA's Auditing Standards Division plans to expose a statement of position, prepared by a subcommittee of the AICPA Not-for-Profit Organizations Committee, that will provide guidance about compliance-auditing requirements in Circular A-133. Circular A-133 is effective for audits of fiscal years beginning on or after January 1, 1990. Since the circular permits biennial audits, some institutions may not be required to follow its requirements until the audit of their financial statements for the fiscal year ending June 30, 1992.

Audit Reporting and Communication Issues

Reporting on Uncertainties

Some auditors have issued an unqualified report with an additional paragraph about the existence of an uncertainty in situations when a qualified or adverse opinion should have been issued.

SAS No. 58, *Reports on Audited Financial Statements,* requires an auditor to add an explanatory paragraph (after the opinion paragraph) to the standard report when a matter is expected to be resolved at some future date, at which time sufficient evidence about its outcome is likely to be available. Examples of such uncertainties include lawsuits against the entity and tax claims by tax authorities when precedents are not clear. Because its resolution is prospective, sometimes management cannot estimate the effect of the uncertainty on the entity's financial statements. However, those uncertainties have, in some cases, been confused with other situations in which management asserts that it is unable to estimate certain financial statement elements, accounts, or items.

Generally, matters whose outcomes depend on the actions of management and relate to typical business operations are susceptible to reasonable estimation and, therefore, are estimates inherent in the accounting process, not uncertainties. Management's inability to estimate in these situations should raise concerns about the possible use of inappropriate accounting principles or scope limitations. If the auditor believes that financial statements are materially misstated because of the use of inappropriate accounting principles, a qualified or adverse opinion is required due to the GAAP departure. A scope limitation should result in a qualified opinion or a disclaimer of opinion.

Going-Concern Matters

When an auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern, SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* requires the auditor to include an explanatory paragraph (following the opinion paragraph) in the report to reflect that conclusion. Auditors have issued reports in which it is unclear whether they are expressing a conclusion that there is substantial doubt about an entity's ability to continue as a going concern.

For situations in which the auditor expresses such a conclusion, the ASB recently amended SAS No. 59 to require the use of the phrase "substantial doubt about the entity's ability to continue as a going concern" (or similar wording that includes the terms *substantial doubt* and *going concern*) in the required explanatory paragraph.

Required Communications to Audit Committees and Others Having Oversight Responsibility

Instances have been noted in which auditors have overlooked the communication requirements of SAS No. 61, *Communication With Audit Committees*. This statement requires auditors to ensure that certain matters are communicated to audit committees or other groups with responsibility for oversight of the financial reporting process. SAS No. 61 applies to—

- Entities that have an audit committee or a formally designated group having oversight responsibility for financial reporting (for example, a finance or budget committee).
- All SEC engagements as defined in note 1 of the statement.

In considering the communications required by SAS No. 61, the auditor should also not overlook the communications required by the following:

- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*
- SAS No. 54, *Illegal Acts by Clients* (see discussion below)
- SAS No. 60, *Communications of Internal Control Structure Related Matters Noted in an Audit*

Illegal Acts

SAS No. 54 provides guidance for communications with clients of possible illegal acts. The auditor has a responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on financial statement line-item amounts. Auditors may also become aware of other illegal acts that have, or are likely to have, occurred and that may not have a direct and material effect on financial statement amounts.

Auditors should assure themselves that all illegal acts that have come to their attention, unless clearly inconsequential, have been communicated to the audit committee or its equivalent (the board of trustees or an owner-manager) in accordance with SAS No. 54.

Recurring Audit Problems

Questionable Accounting Practices

Managements of companies—public or private—might feel pressure to report favorable results—for example, to maintain a trend of growth in earnings, support or improve the price of the company's stock,

obtain or maintain essential financing, or comply with debt covenants. This pressure is most likely to affect public companies, but auditors should not underestimate the pressures on nonpublic companies to "stretch" earnings or report a favorable financial condition—particularly in light of the current credit crunch. In most cases, the actions taken are well-intentioned and believed to be appropriate by the company. However, in certain cases, the result is an inappropriate accounting practice.

The downturn in the economy may have an effect on the way a client conducts its business and carries out its revenue recognition policies. Auditors should be alert to facts and circumstances relating to revenue recognition policies that may not be appropriate, such as—

- Changes in standard sales contracts permitting, for example, continuation of cancellation privileges.
- Situations in which the seller has significant continuing involvement or the buyer has not made a sufficient financial commitment to demonstrate an intent or ability to pay.
- Certain sales with a "bill and hold" agreement.

Revenue should not be recorded until it is realized or clearly realizable, the earnings process is complete, and its collection is reasonably assured.

The following are some other accounting practices that distort operating results or financial position:

- Improperly deferring typical period costs and expenses (for example, personnel, training, and moving costs) or costs for which a specific quantifiable future benefit has not been determined
- Adjusting reserves without adequate support
- Nonaccrual of losses (for example, environmental liabilities) or inadequate disclosure in accordance with FASB Statement No. 5, *Accounting for Contingencies*
- Inadequate recognition of uninsured losses (for example, increased deductibles for workers' compensation or medical care)
- Using improper LIFO accounting practices, including inappropriate pools and intercompany transactions

Competent and sufficient audit evidence continues to be the foundation for the auditor's opinion. Insufficient professional skepticism, illustrated by "auditing by conversation," or failing to obtain solid evidence to back up management's representations, can lead to audit problems. In the final analysis, auditors need to step back and ask one of auditing's most fundamental questions: Does it make sense?

Problems also can occur due to errors in recording relatively straight-

forward transactions, particularly in those situations where cost-reduction and restructuring programs have reduced the number and quality of accounting personnel. The importance of principal audit procedures (for example, sales and inventory cut-off tests, searches for unrecorded liabilities, and follow-up on errors noted during tests) cannot be overemphasized. These types of procedures are fundamental and critical to the audit process.

Although clients may impose fee pressures or tight deadlines on auditors, these pressures do not change the professional responsibility to understand and audit the facts and situations carefully and to make professional, knowledgeable decisions.

Communications Between Predecessor and Successor Auditors

SAS No. 7, *Communications Between Predecessor and Successor Auditors*, establishes requirements for communications between predecessor and successor auditors when a change of auditors has taken place or is in process. It has been observed that the guidance provided by SAS No. 7 is sometimes not followed. It is essential that both predecessor and successor auditors are aware of, and adhere to, the requirements of SAS No. 7. For example, the predecessor auditor should respond promptly and fully to the successor's reasonable inquiries unless he or she indicates that the response is limited.

Part of Audit Performed by Other Independent Auditors

In accordance with SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 543), in no circumstances should an auditor state or imply that an audit report making reference to another auditor is inferior in professional standing to a report without such a reference. When a principal auditor decides not to make reference to the work of another auditor, the extent of additional procedures to be performed by the principal auditor may be affected by the other auditor's quality-control policies and procedures (see auditing interpretation "Part of Audit Performed by Other Auditors: Auditing Interpretations of AU Section 543" [AICPA, *Professional Standards*, vol. 1, AU sec. 9543.18]).

Attorney's Responses

A letter of audit inquiry to the client's lawyer is the auditor's primary means of corroborating information furnished by management concerning litigation, claims, and assessments. Auditors should carefully read all letters from attorneys and ensure that all matters discussed are understood. Ambiguous and incomplete responses should be appropriately resolved with client management and attorneys, and

conclusions should be properly documented. An auditing interpretation of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, presented in the AICPA's *Professional Standards*, vol. 1, AU sec. 9337.18, discusses what constitutes an acceptable reply. Additional inquiries may be needed if replies are not dated sufficiently close to the date of the audit report.

Pitfalls for Auditors

Each year-end seems to abound with pitfalls for auditors. The following reminders are intended to alert auditors to some of these pitfalls.

- Watch out for large, unusual, one-time transactions, especially at or near year-end, that may be designed to ease short-term profit and cash flow pressures. Scrutinize each transaction to ensure validity of business purpose, timing of revenue or profit recognition, and adequacy of disclosure.
- In performing analytical procedures (for example, analyzing accounts, changes from period to period, and differences from expectations), maintain an attitude of objectivity and professional skepticism. Do not assume that the accounts or client explanations are right. Rather, question, challenge, and compare new information with what is already known about the client and of business in general.
- Make sure that receivables that are supported by real estate as collateral reflect the softening of the market. Increases in the allowance for uncollectibles may be needed. Recognize that assets acquired through foreclosure may be overvalued and difficult to sell.
- Pay special attention to the collectibility of significant receivables from debtors that have recently gone through a leveraged buyout (LBO). A company is not the same entity that it was before an LBO.

Accounting Developments

Financial Instruments Disclosure

In March 1990, the FASB issued Statement No. 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, effective for fiscal years ending after June 25, 1990. It applies to all entities, including small businesses (due to its requirement to disclose significant concentrations of credit risk arising from all financial instruments, including trade accounts receivable).

The statement applies to all financial instruments with off-balance-sheet risk of accounting loss and all financial instruments with concentrations of credit risk, with some exceptions that are detailed in paragraphs 14 and 15 of the statement. It requires all entities with financial instruments that have off-balance-sheet risk to disclose the face, contract, or underlying principal involved; the nature and terms of the financial instrument; the accounting loss that could occur; and the entity's policy regarding collateral or other security and a description of the collateral.

Postretirement Benefits Other Than Pensions

The FASB is expected to issue the final statement on postretirement benefits other than pensions in December 1990. The proposed statement would significantly change the prevalent current practice of accounting for postretirement benefits on the "pay as you go" (cash) basis by requiring accrual, during the years that employees render services, of the expected cost of providing those benefits to employees and their beneficiaries and covered dependents. This statement would be effective for calendar-year 1993 financial statements. An additional two-year delay would be provided for plans of non-U.S. companies and certain small employers.

In the SEC Staff Accounting Bulletin (SAB) No. 74, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period*, the SEC staff expressed its belief that disclosure of *impending* accounting changes is necessary to inform readers about expected effects on financial information to be reported in the future and should be made in accordance with existing MD&A requirements. The SEC staff provided supplemental guidance regarding SAB No. 74 in the November 1990 EITF minutes.

Reporting When in Bankruptcy

Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*, provides guidance for entities that have filed petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11.

The SOP recommends that all such entities report the same way while reorganizing under Chapter 11, with the objective of reflecting their financial evolution. To do that, their financial statements should distinguish transactions and events that are directly associated with the reorganization from the operations of the ongoing business as it evolves.

The SOP generally becomes effective for financial statements of enterprises that have filed petitions under the Bankruptcy Code after December 31, 1990.

Audit Risk Alerts

The Auditing Standards Division is issuing Audit Risk Alerts to advise auditors of current economic, industry, regulatory, and professional developments that they should be aware of as they perform year-end audits. The following industries are covered:

- Airlines (022071)
- Agricultural producers and agricultural cooperatives (022073)
- Banking (022063)
- Casinos (022070)
- Construction contractors (022066)
- Credit unions (022061)
- Employee benefit plans (022055)
- Federal government contractors (022068)
- Finance companies (022060)
- Investment companies (022059)
- Life and health insurance companies (022058)
- Nonprofit organizations, including colleges and universities and voluntary health and welfare organizations (expected to be available in March 1991) (022074)
- Oil and gas producers (022069)
- Property and liability insurance companies (022072)
- Providers of health care services (022067)
- Savings and loan institutions (022076)
- Securities (022062)
- State and local governmental units (022056)

Copies of these industry updates may be purchased from the AICPA Order Department. They will also be included in the new loose-leaf service for audit and accounting guides.

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Ethics Division

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(212) 575-6217
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