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1990

## Oil and gas producers industry developments - 1990; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

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**AUDIT RISK  
ALERTS**

# **Oil and Gas Producers Industry Developments—1990**

**Update to AICPA Audit and Accounting Guide  
*Audits of Entities With Oil and Gas Producing Activities***

**Includes *Audit Risk Alert—1990***

**Issued by the  
Auditing Standards Division**

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**American Institute of Certified Public Accountants**

## NOTICE TO READERS

This document, which contains *Oil and Gas Producers Industry Developments—1990* and *Audit Risk Alert—1990*, is intended to provide auditors of financial statements of oil and gas producers 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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# Oil and Gas Producers Industry Developments—1990

## Industry and Economic Developments

The oil and gas producing industry began the year with inventories of oil and gas at high levels at a time when the economy and consumption were slowing down. During the first half of the year, prices declined and oil and gas producers were earning only moderate profits. By the end of the year, even though the economy continued to stall and inventories remained relatively high, the sharp increase in prices due to the events in the Middle East created a new (perhaps transient) boom for virtually all oil and gas producers.

### *The Oil Market*

The oil market has undergone a fundamental change in the last decade. Throughout the 1970s and 1980s, the market price of oil was influenced heavily by the Organization of Petroleum Exporting Countries (OPEC). However, overproduction and discord among OPEC members have created a market that now reacts quickly to anticipated near-term shortfalls or oversupply. Short-term price movements are not always indicative of the long-term price expectations of most oil producers or the longer-term markets. These volatile market trends were prevalent throughout 1990 and are expected to continue in the years to come.

### *The Natural Gas Market*

In contrast to the oil market, the natural gas market has been more susceptible to seasonal trends than to the influence of short-term aberrations. The method of marketing natural gas has changed since the adoption of Financial Accounting Standards Board (FASB) Statement No. 69, *Disclosures about Oil and Gas Producing Activities*, and of Rule 4-10 of Securities and Exchange Commission (SEC) Regulation S-X. The change was driven largely by the deregulation of natural gas pipelines, the "take or pay" contractual disputes, and the emergence of the "gas bubble" throughout the 1980s. These and other factors have led to the creation of a natural gas market that is open and fluctuates with seasonal demand and have replaced the previously existing market, which was characterized by long-term, fixed contracts. Consequently, natural gas prices generally rise in the fall and winter and decline in the spring and summer, and may be expected to continue to fluctuate seasonally.

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## **Regulatory and Legislative Developments**

### *Oil and Gas Pricing*

For several years, two issues concerning the “full cost” method of accounting have been raised by companies in the industry. The first issue centers on whether the full-cost ceiling must be applied annually or quarterly. The second centers on which price should be used in applying the ceiling test—current, average, or forecast.

For SEC registrants, Regulation S-X provides that an excess of unamortized capitalized costs within a certain cost center over the related cost ceiling must be charged to expense during the period in which the excess occurs. Because of practical considerations, SEC rules do not explicitly require registrants to obtain new geological and engineering surveys each quarter. However, should events or conditions become known to management that indicate that the full-cost ceiling is less than capitalized costs, a write-down (based on the estimated impact of the relevant events or conditions) may be necessary in the interim period in which the shortfall occurs. For example, management would be expected to utilize the data it has already derived (such as a roll-forward of year-end reserve reports based on subsequent production and proved-up reserves) in assessing whether capitalized costs exceed the full-cost ceiling tests, using the price at the end of the quarter. Once such a change is recorded, it should not be reinstated for subsequent increases in the cost center ceiling.

The development of a short-term, seasonal market for natural gas has led to a renewed interest in these issues. To date, the SEC staff has not changed its position.

## **Audit and Accounting Developments**

### *Gas Balancing*

At a meeting in November 1990, the Emerging Issues Task Force (EITF) of the FASB briefly considered whether the topic of gas balancing should be added to its agenda. The topic involves determining which method—entitlements or liftings—is preferable for oil and gas companies to use in accounting for revenue.

Under the entitlements method, each well owner records revenue based on his or her ownership interest in the production—regardless of the amount that the owner actually sells and for which he or she receives cash. Under the liftings method, each owner records his or her interest based on production actually taken and sold. Of major concern is the issue of valuation of the imbalance (usually gas) if one follows the entitlements method (that is, market versus cost).

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In the minutes of the November 1990 EITF meeting, the SEC staff observer stated that the SEC staff has not taken a position on which method is preferable. The SEC observer also stated that if the entitlements method is used, any receivable or liability recorded should be valued at the lower of the (1) price in effect at the time of production, (2) current market value, or (3) contract price, if a contract is in hand. Receivables should be presented net of selling expenses. SEC registrants should disclose their method of accounting, as well as the amount of any imbalance in terms of units and value, if the amount is significant.

SEC registrants should also disclose the effect of gas imbalances on operations, as well as on liquidity and capital resources, in the management's discussion and analysis (MD&A) section of their reports.

### *Price Changes After the Report Date*

Both FASB Statement No. 69 and the SEC rules require the use of year-end prices in presenting the standard measure of discounted future net cash flows relating to proved oil and gas reserves. However, to the extent that significant price changes occur subsequent to year-end, companies may show the impact of the subsequent price changes by providing a supplement to the required standardized measure disclosed.

### *Future Abandonment Costs*

To date, most producers still presume that salvage values will balance or compensate for the cost of abandoning onshore wells. This presumption should be carefully evaluated in light of increased environmental concerns and the related costs.

### *Improved Recovery*

Throughout the industry, uncertainty exists about whether certain reserves to be recovered by improved recovery techniques should be included in reports filed with the SEC. Such confusion stems from the fact that certain reserves to be recovered by improved recovery techniques may qualify as proved reserves under definitions established by the Society of Petroleum Engineers (SPE) that use a reservoir with similar rock and fluid properties located in the immediate area as an analogy. Rule 4-10(a)(4) of SEC Regulation S-X does not permit reserves to be recovered by improved recovery techniques to qualify as proved reserves unless a pilot project or an installed program is in place and has been tested to confirm that recovery will be enhanced. This difference in definition has existed for a number of years; SEC registrants are expected to comply with the SEC definition.

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### *Successful-Efforts Ceiling Test*

Generally accepted accounting principles (GAAP) require the application of the "ceiling test" for successful efforts under the general impairments rules. The SEC staff has maintained that, as a minimum test, total capitalized costs may not exceed future undiscounted net revenues on a worldwide basis. The SEC staff has taken this position in recognition that practice varies with respect to discounting for purposes of determining asset impairment. Companies may elect to use discounting techniques in testing impairment under the successful-efforts method.

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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.

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

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### ***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

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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.

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## **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

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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.

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## **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.

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## ***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,

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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-



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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

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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).

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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.

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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.

Call toll free: (800) 334-6961 (USA)  
(800) 248-0445 (NY)

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## **AICPA Services**

### ***Technical Hotline***

The AICPA Technical Information Service answers inquiries about specific audit or accounting problems.

Call toll free: (800) 223-4158 (USA)  
(800) 522-5430 (NY)

### ***Ethics Division***

The AICPA's Ethics Division answers inquiries about the application of the AICPA Code of Professional Conduct. Auditors may call at any of the following numbers:

(212) 575-6217  
(212) 575-6299  
(212) 575-6736

