RICHARD LAFFERTY, CPA

SAS 99 AND THE CONTRACTOR AUDIT

In November 2002 the Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 99, entitled, "Consideration of Fraud in a Financial Statement Audit." SAS 99 became effective for audits of financial statements for fiscal years beginning on or after December 15, 2002. Implementing SAS 99 is not a "'one audit fits all'" application. Because contractors offer a whole host of potential fraud factors and risks that are unique to their industry, this column will focus on considerations that should be given expressly with regard to SAS 99 and the audited financial statements of contractors.

About SAS 99

SAS 99 requires that the auditor consider the risks of fraud and design the audit to provide reasonable assurance of detecting fraud that could result in the financial statement's being materially misstated. The standard specifically requires the auditor to address fraud risks that relate to management's ability to override controls and the revenue recognition process.

Overriding controls

Management's ability to override controls is a risk that may exist in the audit of a contractor. Many contractors lack the size and organizational structure to prevent, or detect, such an override of controls. Small contractors who operate with only a controller who handles not only the reporting function but purchasing and payroll responsibilities as well are problematic in regard to the lack of segregation of duties.

Inquiries of management and those who report directly to management that are involved in the financial reporting process through interviews can be a highly effective and efficient way to identify risks of material misstatement due to fraud. To further address the risk of management overriding controls, SAS 99 requires the auditor to: (1) examine journal entries and other adjustments; (2) review accounting estimates for biases; and (3) evaluate the business rationale for significant unusual transactions. In addition, auditors should be aware of the nature, timing, and control of journal entries and other adjustments made to the general ledger when assessing risk of misstatement.

Revenue recognition

The second mandatory fraud risk assessment that SAS 99 requires the auditor to consider is revenue recognition. Although there are other accounting methods that exist, the focus here will be on the percentage of completion method. It can be argued that a construction contractor's financial statements rely more on estimates than that of any other industry. Therefore, percentage of completion method, which recognizes revenue based on estimates of revenue that will be earned from contracts and costs to complete those, is very effective for contractors.

Profit fade analysis

The auditor utilizing a profit fade analysis test will be able to analyze profits recognized in prior periods and make comparisons to the current audit period. If the job is completed the auditor can then test the accuracy of the prior period estimate and

---

RICHARD LAFFERTY is a senior manager in the audit and accounting services area of Sobel & Co. He works with clients in the construction industry, leveraging his more than 20 years experience primarily with closely held businesses to help them remain successful and competitive in their market. Sobel & Co. is a full service public accounting and consulting firm serving the New Jersey middle market since it was founded in 1956. The firm specializes in working with clients in the construction industry.

inquire of management regarding any significant variances. The auditor will then have a better understanding of the company's ability to support estimates made in this area. The auditor should test to see that the contract price is correct, because contracts typically evolve and change over the life of a job.

Questions auditors should ask include: Have change orders been properly recorded? Are there any claims or other additions to the contract that have been made since inception? Are estimated gross profits reasonable compared to historical and current percentages of similar contracts? If not, there may be a problem with the estimate of job costs. In a cost-to-cost comparison under the percentage of completion, revenue is recognized as costs posted to a specific job. This could result in management posting costs improperly to a job to affect revenue recognition. The project manager could assign costs to the wrong job to make another job more profitable.

Conclusion

The auditor must be aware of management's style and, as important, its attitude toward the financial reporting process, especially when considering misstatement due to fraud. It is important to be ever alert because management may perpetrate a fraud for myriad reasons, such as:

- External pressures to present favorable numbers to increase or maintain bonding capacity;
- Financial covenants may have to be met;
- To defer taxes;
- For an estimator or project manager to obtain bonuses by jobs realizing certain profit expectations.

Auditors must be aware of certain risk factors of fraud in a construction audit under SAS 99. Proper planning and a heightened awareness throughout the engagement will improve the audit quality of the engagement. ■