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Risks of material misstatement: Construction contractors

Note: This practice aid is intended to help auditors identify risks of material misstatement (RMM) in accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. This publication is an *other auditing publication* as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, Professional Standards). Other auditing publications have no authoritative status; however, they may help you, as an auditor, understand and apply certain auditing standards.

In applying the auditing guidance included in an *other auditing publication*, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. This document has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA.

Instructions

AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires that the auditor identify and assess the risks of material misstatement (RMM) at the financial statement level and relevant assertion level for classes of transactions, individual account balances, and disclosures to provide a basis for performing further audit procedures. RMM includes both inherent risk and control risk.

To aid auditors in meeting this requirement, this document includes information that could be useful in assessing RMM in the construction industry. **These examples do not include all RMM that could apply or be relevant.**

Refer to the AICPA's *Construction Contractors: Audit and Accounting Guide* for further information on auditing clients in this industry.

Controls

When obtaining an understanding of controls that are relevant to the audit, the auditor should evaluate the design of those controls and determine whether they have been implemented by performing procedures in addition to inquiry of the entity's personnel. Areas of focus in the construction industry are:

- contract revenues
- costs
- gross profit or loss
- related contract receivables and payables

Chapter 8 of the AICPA's *Construction Contractors: Audit and Accounting Guide* presents a general discussion of some of the desirable control activities in the construction industry. Although not all the controls identified are found in every construction entity, their discussion can serve as guidance concerning what might be considered adequate controls for a contractor. This discussion considers aspects of controls in the following areas:

- Estimating and bidding
- Project administration and contract evaluation
- Job site accounting and controls
- Billing procedures (including determination of reimbursable costs under cost-plus contracts)

- Contract costs
- Contract revenues
- Construction equipment
- Claims, extras, and back charges
- Joint ventures
- Internal audit function

Increased audit risk

For audits of construction contractors, a major area of risks of misstatements is in the area of contracts. Contracts have a pervasive effect at the account balance, class of transactions, and disclosure level. Construction contract factors that normally indicate an increased audit risk include:

- Percent of contract complete – 10% to 90%
- Size of project – Relatively large job
- Type of project
  - Complex, one of a kind
  - Not within contractor's expertise
- Timing and scheduling
  - Long-term project
  - Work is falling behind schedule
  - Accelerated time frame
  - Significant penalties for late completion
- Location
  - New area
  - Remote area – materials and labor are not readily available
- Weather – High susceptibility to adverse weather
- Owner/investor
  - Very few previous contracts with contractor
  - Weak financial position
- Subcontractors
  - Small portion of work performed by subcontractors
  - Very few previous contracts with contractor
  - Weak financial position
  - Majority of significant subcontract agreements not finalized
- Big spread – Significant variances in bid amounts among competing contractors
- Profit fade – Significant profit fade
- Underbilling – Unusual/significant underbilling
- Type of contract
  - Fixed-price
  - Cost-type, difficult to determine reimbursable costs
- Claims – significant claims
- Material costs – High susceptibility to price escalations during performance of contract

Significant risks

As part of the assessment of the risks of material misstatement, the auditor should determine whether any of the risks identified are, in the auditor's professional judgment, a significant risk, those that require special audit consideration (such risks are defined as *significant risks*).

In the construction industry, auditors may find that a significant risk exists with regards to:

- the accuracy of management's estimates of costs to complete for contracts in progress
- contract revenues due to the possible effects of unsigned or unpriced change orders and claims

- the significant measurement uncertainty associated with the application of the percentage-of-completion method of accounting for contracts

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