

Research LO 3, 4 and Discussion Case



11–39. Your firm audits Metropolitan Power Supply (MPS). The issue under consideration is the treatment in the company's financial statements of \$700 million in capitalized construction costs relating to Eagle Mountain, a partially completed nuclear power plant.

Seven years ago, MPS began construction of Eagle Mountain, with an original cost estimate of \$400 million and completion expected within five years. Cost overruns were enormous, and construction has been repeatedly delayed by litigation initiated by the antinuclear lobby. At present, the project is little more than 50 percent complete, and construction has been halted because MPS does not have the funds to continue.

If Eagle Mountain is ultimately completed, the state utilities commission will determine the extent to which MPS may recover its construction costs through its rate structure. The commission's rulings are difficult to predict, but it is quite possible that the commission will not allow MPS to include all of the Eagle Mountain construction costs in its "rate base." If Eagle Mountain were abandoned today, none of the construction costs would be recoverable. The related write-off would amount to over 70 percent of MPS's stockholders' equity, but the company would survive.

MPS's management, however, remains committed to the completion of the Eagle Mountain facility. Management has obtained authorization from the company's stockholders to issue \$500 million in bonds and additional shares of common stock to finance completion of the project. If MPS incurs this additional debt and is still not able to make Eagle Mountain fully operational, it is doubtful that the company can avoid bankruptcy. In short, management has elected to gamble—all its chips are riding on Eagle Mountain.

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Required:

- a. Discuss the arguments for and against the auditors insisting that MPS begin expensing some portion of the construction costs rather than continuing to accumulate an ever-increasing asset. Indicate the position you would take as the auditor.
- b. Discuss whether the auditors should modify their report because of uncertainty about whether or not MPS can remain a going concern. Indicate the type of opinion that you would issue. (You need not limit yourself to a "going-concern" modification.)

Part a:

FASB Accounting Standards Codification sections 360-10 and 450-20-25-2.

Part b:

AICPA AU sections 570 and 700–706; PCAOB sections 341 and 508.