Accounting and auditing update handbook

American Institute of Certified Public Accountants

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1990 ACCOUNTING AND AUDITING UPDATE HANDBOOK

BY

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The Accounting and Auditing Update Handbook is intended to be a convenient means of keeping up to date on developments in professional standards. It is a relatively compact reference guide to the authoritative pronouncements on accounting and auditing issued within the approximate two-year period before publication—pronouncements on topics that are not yet "mature" and present problems for implementation. It is intended to be a handy reference source for CPAs in both public and private practice.

Many CPA firms prepare internal updating materials for their staffs. This work can serve as your own firm's updating manual on significant professional developments.

We have monitored professional standards in the following areas:

- Accounting Standards
- Auditing Standards
- Compilation and Review Standards
- Attestation Standards

All major new pronouncements in these areas within the last two years as well as important projects under consideration are discussed in this book.

The discussion of pronouncements explains the basic requirements and attempts to anticipate the issues that will arise as the pronouncements are implemented. The raw material for this book is partially based on the two-day AICPA continuing professional education course—Accounting and Auditing Update Workshop
Foreword

(AAUW). AAUW is presented by state societies of CPAs around the country and attended by thousands of CPAs. We have attempted to incorporate the comments, suggestions, and practice issues raised by course participants into the book.

This edition of the Update Handbook covers the following topics:

Chapter 1: The Effects of SASs 53 to 61 on the Audit Process
- Audit planning and documentation
- Audit procedures and evaluation of results
- Communications between the auditor and users of audited financial statements

Chapter 2: Special Reports—SAS 62
- Reporting on OCBOA Financial Statements
- Desirability of cash or tax basis financial statements and attendant measurement, disclosure, and reporting requirements
- Reporting on special-purpose presentations
- Reporting on compliance with debt covenants

Chapter 3: Compliance Auditing—SAS 63
- When compliance auditing is applicable to audits of financial statements of nonprofit organizations or business enterprises
- Audit procedures appropriate for testing compliance with laws and regulations in accordance with GAAS
- Relationship of SAS 63 to SASs 53 and 54
- Requirements applicable to an audit in accordance with certain governmental publications

Chapter 4: Prospective Financial Information
- Partial presentations of prospective financial information
- Prospective statements for internal use only
- Questions concerning accountants' services on prospective financial information

Chapter 5: Other Current Developments in Auditing
- Bank confirmation procedures and forms
- Proposed revisions in guidance on using work and reports of internal auditors
• Proposed revisions of SAS 44 regarding controls at service organizations

Chapter 6: Accounting for Income Taxes—SFAS 96
• Explanation of SFAS 96 in conformity with steps in computing and reporting current and deferred income taxes
• Shortcutting the scheduling process
• Selected recommendations from A Guide to Implementation of Statement 96 on Accounting for Income Taxes
• Comprehensive applications on scheduling and computing deferred income taxes, accounting for NOLs, and computing the effects of a change in tax rules
• Expanded materials on AMT calculation

Chapter 7: Employers’ Accounting for Settlements and Curtailments—SFAS 88
Integrated explanation of SFAS 88 and the FASB special report on implementing the statement

Chapter 8: Accounting for Cash Flows—SFAS 95
• Demonstration of alternative statement presentations in conformity with the pronouncement
• Illustrations of preparation of the statement under the indirect and direct method of presentation.
• Survey of annual reports showing common adjustments in arriving at net cash flows from operating activities, typical financing and investing transactions, and noncash disclosures

Chapter 9: Real Estate Sale-Leasebacks—SFAS 98
Hierarchy of accounting methods available under alternative contractual terms and illustrations of application of SFAS 98 to particular sale-leaseback transactions

Chapter 10: FASB Exposure Drafts
• Employers’ accounting for postretirement benefits other than pensions
• Disclosure of information about financial instruments with off-balance-sheet risk and financial statements with concentration of credit risk
Chapter 11: The FASB Emerging Issues Task Force
Overview of EITF releases over the last two years that have general applicability to nonpublic and small public companies

Chapter 12: Overview of AICPA Technical Inquiries, Accounting Statements of Position, and Practice Bulletins
Reviews guidance of general applicability to nonpublic and small public companies contained in AICPA Technical Practice Aids, AcSec Statements of Position, and Practice Bulletins

Chapter 13: SEC Staff Accounting Bulletins
Reviews SABs issued during the last two years that have general applicability for nonpublic companies and form part of GAAP:
- Increasing rate preferred stock
- Nonrecourse debt collateralized by lease receivables and/or related lease assets
- Pushing down parent company debt in an acquisition
- Allocation of debt issue costs in an acquisition
- Transaction by a principal stockholder for a corporation’s benefit

Keeping up with developments in professional standards on a current basis is an almost impossible task for many busy professionals. This book is intended to ease the burden by summarizing those accounting and auditing pronouncements issued within the last two years.

We would like to express our gratitude to all those who helped in the preparation of the Accounting and Auditing Update Handbook. In particular we thank Kurt Pany, CPA, Arthur Andersen/Don Dupont Professor of Accounting, Arizona State University at Tempe and Steven Rubin, CPA, Director of Quality Control, Weissbarth, Altman & Michaelson, CPAs, Adjunct Assistant Professor of Accounting, Brooklyn College, City University of New York, who reviewed the text of this volume.

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CHAPTER 1
The Effects of SASs 53 Through 61 on the Audit Process

This chapter reviews the effects of the new Statements on Auditing Standards (SASs) on the audit process from the initial planning of the engagement through the final issuance of the audit report and other reports at the completion of the engagement. The chapter describes how the new SASs have affected the planning of an audit of financial statements and documentation of planning. It explains how the new SASs have affected the performance of audit procedures and evaluation of the results of those procedures. The chapter also identifies how the new SASs have affected communications between the auditor and users of audited financial statements, including the audit committee.

SASs 53 through 61 were issued by the AICPA’s Auditing Standards Board in April 1988 in response to criticisms expressed both within the accounting profession and by critics of the profession. Critical comment from outside the profession included the House Energy and Commerce Oversight and Investigations Subcommittee (the Dingell Committee) and the National Commission on Fraudulent Financial Reporting (the Treadway Commission).

The new SASs are as follows:

<table>
<thead>
<tr>
<th>SAS</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>53</td>
<td>The Auditor’s Responsibility to Detect and Report Errors and Irregularities</td>
</tr>
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<td>58</td>
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(continued)
The Effects of SASs 53 Through 61 on the Audit Process

59 The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern

60 Communication of Internal Control Structure Related Matters Noted in an Audit

61 Communication With Audit Committees

SAS 55 on internal control structure has a delayed effective date because of its complexity. It is effective for audits of financial statements for periods beginning on or after January 1, 1990. SAS 58, which establishes a new form of auditor’s standard report, is effective for reports dated on or after January 1, 1989, and is effective now. The other SASs are effective for audits of financial statements for periods beginning on or after January 1, 1989. Thus, they must be applied for audits of annual statements for periods ending December 31, 1989, or after.

This chapter is organized around the normal sequence of an audit. This organization is designed to better illustrate how the new SASs actually change the practice of auditing. The major steps in the audit that provide the organizational framework for this chapter are as follows:

— Audit Planning
  • General planning
  • Audit program planning

— Audit Performance
  • Completion of the audit
  • Evaluation of audit test results

— Audit Communications
  • Communications with management and the audit committee
  • Audit report on financial statements

The coverage in this chapter highlights the key requirements of the new SASs.

AUDIT PLANNING

General Planning

The major steps in general planning and the SASs that relate most directly to those steps are as follows:
• Obtain an understanding of the client’s business, its organization and its operations (SAS 22).
• Perform analytical procedures to improve the understanding of the client (SAS 56).
• Make a preliminary judgment about materiality levels to be used in audit planning (SAS 47).
• Assess the risk of material misstatements at the financial statements level (SASs 53 and 54).
• Obtain an understanding of the internal control structure (SAS 55).
• Develop an overall audit plan (SAS 22).

Analytical Procedures in Planning
SAS 56 requires that in all audits, the auditor should apply analytical procedures to assist in planning the nature, timing, and extent of other auditing procedures. In audit planning, analytical procedures have the following two broad uses: (1) enhancing the auditor’s understanding of the client’s business and the transactions and events that have occurred since the last audit date, and (2) identifying areas that may represent specific risks relevant to the audit.

SAS 56 supersedes SAS 23. There is a minor change in terminology. Whereas SAS 23 called the procedures analytical review procedures, SAS 56 has shortened the term to simply analytical procedures. However, the big change from SAS 23 is that analytical procedures are now required rather than procedures applied at the auditor’s option. Exhibit 1 summarizes the differences between the old and new standards.

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures range from simple comparisons to the use of complex models. Plausible relationships among data may reasonably be expected to exist and continue except as particular conditions cause change. Changes may be caused by specific unusual transactions or events, accounting changes, business changes, random fluctuations, misstatements (errors or irregularities).

Understanding financial relationships is essential to planning and evaluating the results of analytical procedures and generally
The Effects of SASs 53 Through 61 on the Audit Process

requires knowledge of the client and the industry in which it operates, understanding of the purposes of analytical procedures and the limitations of these procedures, and judgment by the auditor.

### Exhibit 1 Differences Between SASs 23 and 56

<table>
<thead>
<tr>
<th></th>
<th>Old</th>
<th>New</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement</td>
<td>SAS 23</td>
<td>SAS 56</td>
</tr>
<tr>
<td>Terminology</td>
<td>Analytical review pro-</td>
<td>Analytical procedures</td>
</tr>
<tr>
<td></td>
<td>cedures</td>
<td></td>
</tr>
<tr>
<td>Requirements</td>
<td>None required</td>
<td>Use of analytical procedures required in audit planning and in overall review phases</td>
</tr>
</tbody>
</table>

Analytical procedures involve comparisons of recorded amounts to expectations developed by the auditor from a variety of sources, including—

- Financial information for comparable prior period(s). This often requires adjustment of prior years’ data for known changes.
- Anticipated results, for example, budgets or forecasts, including extrapolations from interim or annual data.
- Relationships among elements of financial information within the period.
- Information regarding the industry in which the client operates.
- Relationships of financial information with relevant nonfinancial information.

Use of analytical procedures in the planning phase of the audit is required. However, SAS 56 does not mandate that particular ratios be calculated or that particular comparisons be made. The choice of which specific analytical tests are efficient and effective in the circumstances is a matter for the auditor’s professional judgment. What is mandated is that during audit planning the auditor should use analytical procedures to enhance understanding of the client and to identify specific risks of material misstatement.

SAS 56 does not draw a sharp distinction between analytical procedures used in general planning and analytical procedures used in audit program planning. However, making such a distinction can increase audit efficiency. In this chapter, analytical procedures used
in general planning are called preliminary analytical procedures, and these preliminary analytics are contrasted with detailed analytical procedures.

Preliminary analytical procedures usually are aimed at considering unusual or unexpected balances or relationships in data aggregated at a relatively high level such as financial statement line items. For example, the auditor might compare line items this period to the prior period and compute key ratios, such as accounts receivable and inventory turnover. A gross profit ratio might be compared to the prior annual gross profit ratio.

On the other hand, detailed analytical procedures used in program planning generally use more detailed financial or nonfinancial information. For example, the gross profit ratio by product and location on a monthly basis might be compared.

Preliminary analytical procedures may include—

• Account balance comparison. The auditor generally considers account balances in relation to a preliminary expectation based on previously reported amounts or budgets and forecasts, adjusted for known changes in the business, industry, or economy as a whole.

• Key ratios. In addition, the auditor might consider key financial or operating relationships, such as inventory turnover or gross margin percentages, in the search for unusual or unexpected balances or unexpected relationships.

• Nonfinancial to financial comparisons. Consideration of nonfinancial data often may be important in identifying matters that require further investigation (for example, available square footage related to revenue in a retail operation or labor hours related to labor costs).

No specific analytical procedures are expressly required by SAS 56. The sophistication, extent, and timing of the procedures may vary widely depending on the size and complexity of the client. In some cases, the procedures may consist of reviewing changes in account balance from the prior to the current year using the general ledger or the auditor’s preliminary or unadjusted working trial balance. In other cases, the procedures may involve an extensive analysis of quarterly financial statements. In both cases, the analytical procedures, combined with the auditor’s knowledge of the business, serve as a basis for additional inquiries and effective planning.
The Effects of SASs 53 Through 61 on the Audit Process

Preliminary analytical procedures are intended to improve the auditor’s understanding of the client and identify critical audit areas, that is, balances and transactions where the risk of misstatement may be high. In contrast, detailed procedures provide evidence about the risk of material misstatement of a particular balance or class of transactions, for example, comparison of salaries paid with number of personnel to assess the risk of unauthorized payroll expenditures. Exhibit 2 provides examples of analytical procedures related to specific audit objectives.

**Exhibit 2**  
Examples of Analytical Procedures Related to Specific Audit Objectives

<table>
<thead>
<tr>
<th>Objective</th>
<th>Analytical Procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uncollectible accounts are identified and provided for on a timely basis.</td>
<td>Average accounts receivable TO net sales</td>
</tr>
<tr>
<td></td>
<td>Average accounts receivable TO bad debt writeoffs</td>
</tr>
<tr>
<td></td>
<td>Percent of accounts receivable in each aging category</td>
</tr>
<tr>
<td>Obsolete, overstocked, and slow-moving inventory are identified and provided for on a timely basis.</td>
<td>Annual sales in units TO ending finished goods inventory quantities</td>
</tr>
<tr>
<td></td>
<td>Number of days of production in ending finished goods inventory</td>
</tr>
<tr>
<td>Commitments and contingencies are identified, monitored, and, if appropriate, recorded or disclosed.</td>
<td>Warranty expense TO cost of sales or units sold</td>
</tr>
<tr>
<td></td>
<td>Self-insurance reserve TO claims paid</td>
</tr>
</tbody>
</table>

**Errors, Irregularities, and Illegal Acts**

*Errors, irregularities, and illegal acts* are defined in the SASs as follows:

- *Errors*. The term refers to unintentional misstatements or omissions of amounts or disclosures in financial statements. Errors may involve mistakes in gathering or processing accounting data from which financial statements are prepared; incorrect accounting estimates arising from oversight or misinterpreta-
The Effects of SASs 53 Through 61 on the Audit Process

tion; or mistakes in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure.

- **Irregularities.** The term refers to intentional misstatements or omissions of amounts or disclosures in financial statements. Irregularities include fraudulent financial reporting undertaken to render misleading financial statements, sometimes called management fraud, and misappropriation of assets, sometimes called defalcation. Irregularities may involve such acts as (1) manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared; (2) misrepresentation or intentional omission of events, transactions, or other significant information; or (3) intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

- **Illegal Acts.** The term refers to violations of laws or government regulations. Illegal acts by clients are those attributable to the entity whose financial statements are being audited. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.

SAS 53 on fraud detection expands and clarifies the auditor's responsibility to detect material irregularities. SAS 54 on illegal acts essentially retains the present responsibility as described in SAS 17, but it also identifies a category of illegal acts for which the auditor has the same responsibility as irregularities. This increases the auditor's responsibility for detection and reporting.

The auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements. The auditor should exercise (1) due care in planning, performing, and evaluating the results of audit procedures; and (2) the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected. Since the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor is not an insurer and the audit report does not constitute a guarantee that no material errors and irregularities exist.

SAS 53 superseded SAS 16, which was issued in 1977. (See Exhibit 3.) SAS 16 required the auditor to plan the audit to search for material errors and irregularities. SAS 53, in contrast, requires the auditor to design the audit to provide reasonable assurance of detect-
ing errors and irregularities that are material to the financial statements.

Exhibit 3  

*Differences Between Old and New Standards on Errors and Irregularities*

<table>
<thead>
<tr>
<th>Statement</th>
<th>Old</th>
<th>New</th>
</tr>
</thead>
<tbody>
<tr>
<td>Responsibility for detecting errors and irregularities</td>
<td>SAS 16</td>
<td>SAS 53</td>
</tr>
<tr>
<td>Internal communication of irregularities</td>
<td>Plan audit to search for material errors and irregularities</td>
<td>Design audit to provide reasonable assurance that material misstatements will be detected</td>
</tr>
<tr>
<td>Acknowledgement of limits</td>
<td>Inherent limitations of the audit</td>
<td>Characteristics of irregularities may result in failure to detect</td>
</tr>
</tbody>
</table>

Is there a distinction between *plan to search* and *design to provide reasonable assurance of detection*? The difference in the words is subtle; however, the Auditing Standards Board had a message for auditors. That message is: Be more sensitive to the possibility of material irregularities in every audit! Carefully consider the risk in the client’s specific circumstances that the financial statements may be materially misstated because of intentional misconduct by senior management or employees.

The difference between SAS 16 and SAS 53 is exemplified by the attitude the auditor should have about the possibility of management dishonesty. Most auditors believed that SAS 16 entitled them to assume that management was honest. Unless information came to their attention that specifically contradicted that assumption, they believed they could continue to approach the audit with an attitude of assumed honesty of management. SAS 53 discards that idea. Auditors cannot assume that management is honest or dishonest. The auditor should take a hard, cold look at the possibility of management misrepresentation at the start of the audit and reexamine the likelihood of management misrepresentation as the audit progresses.

Another difference between SAS 53 and SAS 16 is that SAS 53 expresses the auditor’s responsibility in a much more affirmative and
positive fashion. SAS 16 stressed the inherent limitations of an audit that make it impossible for an auditor to provide absolute assurance of detecting even material frauds. SAS 53 continues to acknowledge that forgery or collusion may result in failure to detect a material irregularity. However, SAS 53 focuses more on what the auditor should do than on the things that preclude infallibility.

Closely related to the subject of responsibility to detect irregularities is the responsibility to detect illegal acts. SAS 54 explains the consideration the auditor should give to the possibility of illegal acts by the client in planning the audit. SAS 54 supersedes SAS 17, which was issued concurrently with SAS 16 in January 1977. (See Exhibit 4.)

The responsibility for detection of illegal acts differs depending on the type of illegal act. The auditor's responsibility to detect misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts (except disclosure of contingencies) is the same as that for errors and irregularities.

With respect to other illegal acts, the auditor should be aware of the possibility that such illegal acts may have occurred. If specific information comes to the auditor's attention that such acts may have occurred, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. However, an audit in accordance with generally accepted auditing standards (GAAS) provides no assurance that illegal acts will be detected or that any contingent liabilities that may result will be disclosed.

### Exhibit 4  Differences Between Old and New Standards on Illegal Acts

<table>
<thead>
<tr>
<th>Statement</th>
<th>Old</th>
<th>New</th>
</tr>
</thead>
<tbody>
<tr>
<td>Responsibility for detecting illegal acts</td>
<td>Not responsible for detecting any illegal acts</td>
<td>Responsible for detecting illegal acts with direct and material effect</td>
</tr>
<tr>
<td>Internal communication of illegal acts</td>
<td>To appropriate level of authority</td>
<td>To audit committee</td>
</tr>
</tbody>
</table>
Businesses in the United States are subject to a host of laws and regulations that can, if violated, have consequences very material to the financial statements. For example, laws related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment, price-fixing, or other antitrust violations can all have very material effects on financial statements. However, an auditor is not usually, by training or experience, equipped to spot violations of such laws and regulations. As a practical matter, an auditor would have little, if any, chance of detecting such matters unless he was informed by the client, or its attorney, or there was evidence of a governmental agency investigation or enforcement proceeding in the corporate minutes or correspondence made available to the auditor.

For these reasons, the auditor does not plan the audit to include audit procedures specifically designed to detect illegal acts. If procedures designed primarily for other purposes bring possible illegal acts to the auditor’s attention, then the auditor has some additional responsibilities that are discussed later in this chapter in relation to evaluation of audit test results. However, as a general matter, the possibility of illegal acts has no effect on audit planning.

There is, however, one very important exception to this generalization. As mentioned earlier, for illegal acts that have both a direct and a material effect on determination of financial statement line item amounts, the auditor has exactly the same responsibility as for material irregularities. In other words, the audit should be designed to provide reasonable assurance of detecting illegal acts that have a direct and a material effect on line item amounts in financial statements. For example, assume a client obtains a government contract that requires compliance with certain specified laws and regulations for revenue to be earned under the contract and the amount of the revenue recorded in the current period is material. The auditor would need to apply audit procedures to test compliance with the specified laws and regulations because compliance is necessary for the revenue to be earned and recorded.

In other words, compliance with the specific laws and regulations has a direct effect on the determination of recorded revenue. However, there are other laws and regulations that, if violated by the client, might cause the government to suspend the contract and no further revenue would be earned under that or similar contracts. For example, a contract may have a standard provision that the contractor is an equal opportunity employer. These laws and regulations
have an indirect effect on the financial statements. Their effect is a contingency that may need to be disclosed.

The auditor has no responsibility to design the audit to detect violations of laws and regulations that could have a material effect on the financial statements only through the need to disclose a contingency. In other words, laws and regulations that have an indirect effect on financial statements are normally outside the auditor's detection responsibility.

An assessment of the risk of material misstatement should be made during planning. The auditor's understanding of the internal control structure should either heighten or mitigate the auditor's concern about the risk of material misstatement. The factors that should be considered in assessing the risk of material misstatement include management characteristics, operating and industry characteristics, and engagement characteristics. Examples of these risk factors are presented in Exhibit 5. The auditor should assess the risk of management misrepresentation by reviewing information obtained about risk factors and the internal control structure.

<table>
<thead>
<tr>
<th>Exhibit 5</th>
<th>Risk Factors at Entity or Financial Statement Level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Management Characteristics</strong></td>
<td></td>
</tr>
<tr>
<td>Domination of operating or financing decisions by a single person.</td>
<td></td>
</tr>
<tr>
<td>Unduly aggressive attitude toward financial reporting.</td>
<td></td>
</tr>
<tr>
<td>High turnover (particularly of senior accounting personnel).</td>
<td></td>
</tr>
<tr>
<td>Undue emphasis on meeting earnings projections.</td>
<td></td>
</tr>
<tr>
<td>Poor reputation in the business community.</td>
<td></td>
</tr>
<tr>
<td><strong>Operating and Industry Characteristics</strong></td>
<td></td>
</tr>
<tr>
<td>Inadequate or inconsistent profitability relative to industry.</td>
<td></td>
</tr>
<tr>
<td>Operating results highly sensitive to economic factors—inflation, interest rates, etc.</td>
<td></td>
</tr>
<tr>
<td>Rapid rate of change in industry.</td>
<td></td>
</tr>
<tr>
<td>Decentralized organization with inadequate monitoring.</td>
<td></td>
</tr>
<tr>
<td>Indicators of substantial doubt about the entity's ability to continue as a going concern.</td>
<td></td>
</tr>
</tbody>
</table>

(continued)
Exhibit 5 (continued)

Engagement Characteristics

Many contentious or difficult accounting issues.
Frequent and significant difficult-to-audit transactions or balances.
Significant nature, cause, or amount of known and likely misstatements detected in prior audits.
New client with no prior audit history or insufficient information available from predecessor.

The auditor should specifically consider factors that influence audit risk at the entity or financial statement (overall) level and at the account balance or class of transactions level.

- The auditor makes an assessment of the risk of material misstatements during audit planning by considering the characteristics of management, the entity and industry, and the engagement. (See Exhibit 5.)
- The auditor considers whether the client’s internal control structure affects the assessment.
- The auditor specifically assesses the likelihood of management misrepresentation. (See Exhibit 6.)
- The auditor takes this assessment into consideration in making initial audit planning decisions concerning staffing, supervision, audit procedures in critical audit areas, and the degree of professional skepticism to be exercised.

In planning audit programs for particular account balances or transaction classes, the auditor should consider factors that influence the inherent risk and control risk for the balance or class.

Exhibit 6

Assessment of Likelihood of Management Misrepresentation

<table>
<thead>
<tr>
<th>Indications</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are there known circumstances that may indicate a predisposition to distort financial statements?</td>
<td>Frequent disputes about aggressive application of accounting principles.</td>
</tr>
<tr>
<td></td>
<td>Evasive responses to audit inquiries.</td>
</tr>
<tr>
<td></td>
<td>Excessive emphasis on meeting quantified targets.</td>
</tr>
</tbody>
</table>
### Exhibit 6 (continued)

<table>
<thead>
<tr>
<th>Indications</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are there indications that management has not established policies and procedures that provide reasonable assurance of reliable accounting estimates?</td>
<td>Personnel developing estimates appear to lack necessary knowledge and experience.</td>
</tr>
<tr>
<td></td>
<td>Supervisors of these personnel appear careless or are also inexperienced.</td>
</tr>
<tr>
<td></td>
<td>There is a history of unreliable or unreasonable estimates.</td>
</tr>
<tr>
<td>Are there conditions that indicate lack of control of activities?</td>
<td>Constant crisis conditions in operating or accounting areas.</td>
</tr>
<tr>
<td></td>
<td>Disorganized work areas.</td>
</tr>
<tr>
<td></td>
<td>Frequent or excessive backorders, shortages, or delays.</td>
</tr>
<tr>
<td>Are there indications of a lack of control over computer processing?</td>
<td>Lack of control over access to applications that initiate or control asset movement (e.g., a demand-deposit application in a bank).</td>
</tr>
<tr>
<td></td>
<td>High levels of processing errors.</td>
</tr>
<tr>
<td></td>
<td>Unusual delays in providing processing results.</td>
</tr>
<tr>
<td>Are there indications that management has not developed or communicated adequate policies and procedures for security of data or assets?</td>
<td>Employees in key positions not investigated before hiring or not bonded.</td>
</tr>
<tr>
<td></td>
<td>Unauthorized personnel having ready access to data or assets.</td>
</tr>
</tbody>
</table>

SAS 53 does not specifically require use of a generalized form to document the auditor’s assessment of the risk of material misstatement. However, SAS 53 does specifically require the auditor to make the assessment. Therefore it would be prudent to document the auditor’s consideration. Exhibit 7 presents an example general risk questionnaire.

The auditor’s response to the overall judgment about the level of risk in an engagement, according to SAS 53, paragraph 14, includes consideration of changes in engagement staffing and supervision,
The Effects of SASs 53 Through 61 on the Audit Process

Exhibit 7

GENERAL RISK QUESTIONNAIRE

Instructions
This form documents our consideration of the overall level of risk on the engagement. Assessing the engagement risk requires judgment. The particular matters to be considered and the significance of each should be determined based on the circumstances of the engagement. Not all the matters listed will be important in a particular engagement. If the conditions or circumstances in this engagement indicate higher or lower risk than normal, describe them in the column on the right. If other conditions or circumstances seem important, add them at the end. After all relevant factors are considered, the auditor should make an overall assessment of engagement risk and indicate its effect on the audit plan.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Indicator</th>
<th>Comment or description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management operating style</td>
<td>Lower</td>
<td>Higher</td>
</tr>
<tr>
<td>Management attitude on financial reporting</td>
<td>Effective oversight group</td>
<td>Domination of decisions by single person</td>
</tr>
<tr>
<td>Management turnover, including senior</td>
<td>Conservative</td>
<td>Aggressive</td>
</tr>
<tr>
<td>accounting personnel</td>
<td>Nominal</td>
<td>High</td>
</tr>
<tr>
<td>Emphasis on meeting earnings projections</td>
<td>Little</td>
<td>Very high</td>
</tr>
<tr>
<td>Reputation in business community</td>
<td>Honest</td>
<td>Credible allegation of improper conduct</td>
</tr>
<tr>
<td>Profitability relative to industry</td>
<td>Adequate and consistent</td>
<td>Inadequate or inconsistent</td>
</tr>
<tr>
<td>Sensitivity of operations to interest rate</td>
<td>Relatively insensitive</td>
<td>Very sensitive</td>
</tr>
<tr>
<td>changes or inflation</td>
<td>Stable</td>
<td>Rapid</td>
</tr>
<tr>
<td>Status of industry</td>
<td>Healthy</td>
<td>Distressed</td>
</tr>
<tr>
<td>Organization of operations</td>
<td>Centralized</td>
<td>Decentralized</td>
</tr>
<tr>
<td>Indicators of going-concern problems</td>
<td>No serious indications</td>
<td>Substantial doubt could exist</td>
</tr>
<tr>
<td>Contentious accounting issues</td>
<td>None</td>
<td>Many</td>
</tr>
<tr>
<td>Difficult-to-audit transactions or balances</td>
<td>Few</td>
<td>Many</td>
</tr>
<tr>
<td>Misstatements detected in prior audits</td>
<td>Few and immaterial</td>
<td>Greater than preliminary judgment about materiality</td>
</tr>
<tr>
<td>Relationship with client</td>
<td>Recurring engagement</td>
<td>New engagement</td>
</tr>
</tbody>
</table>

Consideration of the risk factors identified above has caused the following modifications of the audit plan in the following critical audit areas:

---

(Additional comments or modifications can be added here.)
revision of overall audit strategy, and increasing the degree of professional skepticism for higher risk circumstances. Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and the conduct of the engagement. Regarding audit strategy, higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of the audit date, or modify the nature of procedures to obtain more persuasive evidence. Also, higher risk ordinarily causes the auditor to exercise a heightened degree of professional skepticism in conducting the audit.

**Internal Control Structure and Planning**

SAS 55 replaces the concept of internal control in AU section 320 with a concept of internal control structure that consists of three subdivisions: the control environment, accounting system, and specific control procedures. The prior authoritative literature defined internal accounting control primarily in terms of control procedures. Thus, the internal control structure is now defined more broadly. Exhibit 8 summarizes the differences between the old and new standards.

The major new performance requirement imposed by SAS 55 is that the auditor must, in every audit, obtain an understanding of all three control structure elements—the control environment, accounting system, and control procedures—sufficient to plan the audit.

The understanding involves obtaining knowledge of the client’s policies, procedures, and records relevant to planning the audit. The understanding is used to do three things.

1. To identify the types of potential misstatements.
2. To consider the factors that may affect the risk of material misstatement.
3. To design effective substantive tests.

The auditor must document his or her understanding of the internal control structure. AU section 320 permitted the auditor to merely document the decision not to rely on internal control. Now the auditor must document the understanding of the design of the control environment, accounting system, and control procedures and whether they have been placed in operation.
The Effects of SASs 53 Through 61 on the Audit Process

Exhibit 8  Differences Between Old and New Standards

<table>
<thead>
<tr>
<th>Statement</th>
<th>Old</th>
<th>New</th>
</tr>
</thead>
<tbody>
<tr>
<td>Procedures</td>
<td>Study and evaluation</td>
<td>Obtaining an understanding</td>
</tr>
<tr>
<td>Auditor Decision</td>
<td>Determine whether or not to rely on internal control</td>
<td>Assess level of control risk for each assertion from maximum to minimum</td>
</tr>
<tr>
<td>Purpose</td>
<td>Restricting procedures</td>
<td>To plan the audit</td>
</tr>
<tr>
<td>Minimum Requirement</td>
<td>Understanding of control environment and flow of transactions</td>
<td>Understanding of control environment, accounting system, and control procedures</td>
</tr>
<tr>
<td>Procedure Terminology</td>
<td>Review of system</td>
<td>Tests of controls directed toward design</td>
</tr>
<tr>
<td></td>
<td>Compliance tests</td>
<td>Tests of controls directed toward operating effectiveness</td>
</tr>
</tbody>
</table>

The big change in practice arising from SAS 55 is the need to be concerned with control procedures in every audit. In many audits, there may be little, if any, change. SAS 55 acknowledges that "ordinarily, audit planning does not require an understanding of the control procedures related to each account balance, transaction class, and disclosure component of the financial statements or to every assertion relevant to these components." How to determine the exact extent of understanding of control procedures is considered later in relation to audit program planning.

In all audits, the auditor should obtain an understanding of each of the three elements of the entity's control structure sufficient to plan an audit of the entity's financial statements. The level of understanding of each element (control environment, accounting system, and control procedures) that the auditor should obtain varies according to the following factors:

- The complexity and sophistication of the entity's operations and systems
• The auditor’s experience with the entity in previous audits
• Assessment of inherent risk (that is, the susceptibility to material misstatement)
• Understanding of industry
• Judgment about materiality

The auditor should obtain an understanding of the control environment sufficient to assess management’s and the director’s attitude, awareness, and actions concerning the following factors:

• Management philosophy and operating style
• Organizational structure
• Functioning of the board of directors and its audit committee
• Management control methods (that is, use of budgets, internal audit function, and so on)
• Personnel policies and procedures
• External influences (for example, requirements of legislative and regulatory bodies)

The auditor’s understanding of the accounting system ordinarily should include the following:

• The major classes of transactions engaged in
• How those transactions are initiated
• The accounting records, supporting documents, and general ledger accounts involved in processing
• The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used in processing
• The financial reporting process used to prepare the financial statements, including estimates and disclosures

The understanding of control procedures necessary for audit planning depends on the auditor’s judgment about how extensive an understanding is necessary to do the following:

• Consider the types of potential material misstatements in the financial statements
• Design effective substantive tests
Ordinarily an understanding of all of an entity’s control procedures is not necessary for audit planning. The extent of understanding of control procedures that is necessary varies with the extent of knowledge obtained from other sources about potential causes of misstatements and the other considerations described above, such as the complexity and sophistication of the entity’s operations and systems.

The understanding should include knowledge about (1) the design of relevant policies, procedures, and records and (2) whether they have been placed in operation by the entity.

SAS 55 introduces a distinction between placed in operation and operating effectiveness. A policy or procedure is placed in operation when that policy or procedure actually exists and is in use. In other words, it is more than written in a manual or stated as a goal. It has been implemented. Operating effectiveness is concerned with whether a policy or procedure has been used over a period of time, the consistency with which it has been used, and who has applied it.

The auditor’s understanding of the control structure design ordinarily is obtained through a combination of the following:

- Previous experience with the entity
- Inquiries of appropriate management, supervisory, and staff personnel
- Inspection of entity documents and records
- Observation of entity activities and operations

The auditor’s understanding of whether policies, procedures, methods, and records have been placed in operation ordinarily is obtained by inspection of documents and reports related to the policy or procedure or direct observation of the application of the policy or procedure.

The first step in assessing control risk is identifying the control structure policies and procedures that pertain to a specific audit objective for a specific financial statement assertion (for example, existence, completeness, valuation, and so on). The second step is evaluating the effectiveness of those policies and procedures in achieving or contributing to the achievement of the audit objective.

The auditor is not required to evaluate the operating effectiveness of control structure policies and procedures in obtaining the understanding of the internal control structure necessary to plan
The Effects of SASs 53 Through 61 on the Audit Process

the audit. However, if the auditor wants to assess control risk at less than the maximum level, it is necessary to evaluate operating effectiveness.

The auditor makes an initial assessment of the level of control risk for financial statement assertions based on the procedures described previously. When the auditor extends the control risk assessment beyond the understanding of the control structure, he or she should obtain evidential matter sufficient to support the assessment that the control structure policies and procedures related to a particular assertion are—

- Suitably designed to prevent or detect material misstatements in that assertion.
- Operating in a manner consistent with the auditor’s assessment of the level of control risk.

The evidence may be obtained in one of two ways. First, the auditor may be able to assess control risk as less than 100 percent based on the minimum required understanding of the control structure, if that understanding provides evidence of the effective operation of a control structure element. For example, to determine that a computerized control has been placed in operation, the auditor may have examined several exception reports generated by the operation of the programmed control procedure. The auditor may conclude that inspection of these reports combined with the understanding obtained of related policies and procedures is sufficient to support a lower assessed level of control risk.

The second way to obtain the evidence is to apply additional procedures beyond those applied to obtain an understanding. This would be done when the auditor believes it would be efficient to seek a further reduction in the assessed level of control risk for some assertions. In this case, the auditor would apply additional tests of controls.

The Overall Audit Plan

The final product of general planning is an overall audit plan. The audit plan usually includes the following elements. (Those that have been affected by the new SASs have an asterisk.)

1. The significant economic, political, and legal factors affecting the client’s business
2. Recent significant changes in the client's business, operations, or organization, including accounting personnel, policies, or procedures
3. Assessment of the risk of material misstatement, including the assessment of control risk based on the understanding of the internal control structure
4. Preliminary judgment about materiality
5. Identification of critical audit areas, that is, those areas that are material and in which auditing, accounting, or financial reporting problems are anticipated
6. The tolerable misstatement and planned audit approach for each major audit area, for example, all substantive tests of details, use of analytical procedures as substantive tests alone or in combination with tests of details, tests of controls, and assessment of control risk at below the maximum
7. The timing of significant stages of the audit and preliminary deadlines for completion of those stages
8. Staffing requirements, overall time estimates, and the anticipated assistance from internal audit or other client personnel
9. The dates of planned meetings of the audit team alone, with client personnel, and, if applicable, with the audit committee as well as identification of the persons expected to attend those meetings

Audit Program Planning

The auditor should seek to restrict audit risk at the individual balance or class level in such a way that the auditor can express an opinion on the financial statements at an appropriately low level of audit risk. At the individual balance or class level, audit risk consists of (1) the risk that the balance or class contains misstatement that could be material to the financial statements when aggregated with misstatements in other balances or classes (that is, inherent risk and control risk) and (2) the risk that the auditor will not detect such misstatement (that is, detection risk). (See Exhibit 9.) SAS 55, Appendix B, defines these components of audit risk as follows:
- **Inherent risk.** The susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures.

- **Control risk.** The risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity’s internal control structure policies or procedures.

- **Detection risk.** The risk that the auditor will not detect a material misstatement that exists in an assertion.

### Exhibit 9  
*Audit Risk Consists of—*

<table>
<thead>
<tr>
<th>Risk That the Balance or Class</th>
<th>Risk That the Auditor Will</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Contains a Material Misstatement</em></td>
<td><em>Not Detect the Misstatement</em></td>
</tr>
<tr>
<td>Consisting of—</td>
<td>Consisting of—</td>
</tr>
</tbody>
</table>

**Inherent Risk**

The susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures. For example, cash is more susceptible to theft than an inventory of coal.

**Control Risk**

The risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity’s internal control structure policies or procedures.

Detection Risk

The risk that the auditor will not detect a material misstatement that exists in an assertion.

Inherent and control risks are not controlled by the auditor; they are characteristics of the client that are assessed by the auditor. The auditor assesses inherent risk and control risk to determine how effective audit procedures have to be to hold audit risk to an accept-
The Effects of SASs 53 Through 61 on the Audit Process

The more effective the audit procedures, the lower the detection risk. The auditor can reduce the assessed level of inherent and control risks below the maximum level by gathering evidence to support a lower assessed level, but the auditor cannot reduce the assessed level below the level that actually exists in the circumstances.

SAS 53, paragraph 15, enumerates the following factors that may influence the assessment of risk of material misstatement related to particular assertions at the balance or class level:

- Effect of risk factors identified at the financial statement or engagement level
- Complexity and contentiousness of accounting issues
- Frequency or significance of difficult-to-audit transactions
- Nature, cause, and amount of known and likely misstatements detected in prior audits
- Susceptibility of related assets to misappropriation
- Competence and experience of personnel assigned to processing data that affect the balance or class
- Extent of judgment involved in determining the total balance or class
- Size and volume of individual items constituting the balance or class
- Complexity of calculations affecting the balance or class
The Effects of SASs 53 Through 61 on the Audit Process

Exhibit 10

Components of Audit Risk

- Inherent Risk
- Control Risk
- Detection Risk
- Audit Risk
There are two ways that the assessment of control risk affects audit program planning. First, the understanding of the internal control structure provides the auditor with the knowledge of potential material misstatements and the risk of their occurrence. This knowledge is used to design substantive tests that should be effective in detecting material misstatements.

Second, after obtaining the understanding, the auditor assesses the control risk for the assertions for each of the material components of the financial statements. The auditor may assess control risk at the maximum level, or 100 percent, for some assertions because policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or evaluating their effectiveness would be an inefficient audit approach. Exhibit 11 illustrates the control risk assessment process for an assertion.

The assessed level of control risk is the level of control risk that the auditor uses in determining the detection risk to accept for a financial statement assertion. This level may vary along a range from maximum to minimum as long as the auditor has obtained evidential matter to support that assessed level. The acceptable detection risk is used by the auditor to determine the nature, timing, and extent of substantive tests. The lower the acceptable detection risk, the more effective substantive tests must be. The auditor must evaluate what contribution control structure policies and procedures make to achievement of the audit objectives.

After the auditor has identified the potential misstatements and assessed the levels of inherent and control risk associated with those misstatements, the auditor prepares written audit programs. SAS 22, paragraph 5, states the following:

In planning his audit, the auditor should consider the nature, extent, and timing of work to be performed and should prepare a written audit program (or set of written audit programs).

Among other purposes, an audit program aids in instructing assistants in the work to be done. An audit program should set forth in reasonable detail the audit procedures that the auditor believes are necessary to accomplish the objectives of the audit. However, the form of the audit program and the extent of detail will vary. As the audit progresses, changed conditions may make it necessary to modify planned audit procedures.
Exhibit 11  
Control Risk Assessment Process

<table>
<thead>
<tr>
<th>Concept</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assertion</td>
<td>Completeness of accounts receivable.</td>
</tr>
<tr>
<td>Audit Objective</td>
<td>Accounts receivable at the balance sheet date include all amounts owed by customers.</td>
</tr>
<tr>
<td>Control Objective</td>
<td>All goods shipped are billed.</td>
</tr>
<tr>
<td>Control Procedures</td>
<td>Prenumbered shipping documents; sequence accounted for; goods shipped reconciled with goods billed.</td>
</tr>
</tbody>
</table>

AUDIT PERFORMANCE

Completion of the Audit

SAS 56 requires the use of analytical procedures in the overall review stage of the audit. SAS 56, paragraph 22, states the following:

The objective of analytical procedures used in the overall review stage of the audit is to assist the auditor in assessing the conclusions reached and in the evaluation of the overall financial statement presentation.

The overall review generally includes reading the financial statements and notes. The auditor should consider the adequacy of evidence gathered in response to unusual or unexpected balances not previously identified.

SAS 59 supersedes SAS 34. The differences between the old and new standards are outlined in Exhibit 12. SAS 59 requires the auditor to evaluate whether the results of audit procedures indicate there is substantial doubt about the client’s ability to continue as a going concern for a reasonable period of time, for example, one year beyond the date of the financial statements being audited. SAS 59 enumerates the following as examples of auditing procedures that may provide evidence that indicates there could be substantial doubt:

- Applying analytical procedures
- Reviewing subsequent events
- Reviewing compliance with the terms of debt and loan agreements
- Reading the minutes of meetings of stockholders, board of
directors, and other important committees
- Inquiring of an entity’s legal counsel about litigation, claims,
and assessments
- Confirming with related and third parties details of arrange-
ments to provide or maintain financial support

**Exhibit 12**

<table>
<thead>
<tr>
<th>Differences Between SASs 34 and 59</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Old</strong></td>
</tr>
<tr>
<td>Statement</td>
</tr>
<tr>
<td>Auditor Responsibilities</td>
</tr>
<tr>
<td>Existence for Reasonable Period</td>
</tr>
<tr>
<td>Report</td>
</tr>
<tr>
<td>Report Modification Basis</td>
</tr>
</tbody>
</table>

If the auditor believes there is substantial doubt, the auditor should obtain information about management’s plans to mitigate the effect of conditions or events creating the doubt and assess the likelihood of those plans being implemented. (See Exhibit 13.) If, after evaluating management’s plans, the auditor concludes there is substantial doubt, the auditor should include an explanatory paragraph following the opinion paragraph that describes that conclusion and the auditor should consider the adequacy of disclosure about the client’s possible inability to continue. Exhibit 14 illustrates such a report.

When an auditor’s substantial doubt is eliminated, the auditor is not required to add an explanatory paragraph to the audit report.
However, the auditor should consider the adequacy of disclosure about conditions and events that initially caused substantial doubt about the client’s possible inability to continue and mitigating factors, including management’s plans.

**Exhibit 13 Consideration of Management’s Plans**

- **Plans to Dispose of Assets**
  - Restrictions on disposal of assets, such as covenants limiting such transactions in loans or similar agreements or encumbrances against assets.
  - Apparent marketability of assets that management plans to sell.
  - Possible direct or indirect effects of disposal of assets.

- **Plans to Borrow Money or Restructure Debt**
  - Availability of debt financing, including existing or committed credit arrangements, such as lines of credit, or arrangements for factoring receivables or sale-leaseback of assets.
  - Existing or committed arrangements to restructure or subordinate debt or to guarantee loans to the entity.
  - Possible effects on management’s borrowing plans of existing restrictions on additional borrowing or the sufficiency of available collateral.

- **Plans to Reduce or Delay Expenditures**
  - Apparent feasibility of plans to reduce overhead or administrative expenditures; to postpone maintenance or research and development projects; or to lease rather than purchase assets.
  - Possible direct or indirect effects of reduced or delayed expenditures.

- **Plans to Increase Ownership Equity**
  - Apparent feasibility of plans to increase ownership equity, including existing or committed arrangements to raise additional capital.
  - Existing or committed arrangements to reduce current dividend requirements or to accelerate cash distributions from affiliates or other investors.
Exhibit 14  

Example Report—Substantial Doubt Regarding Going Concern Status

Independent Auditor’s Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of (at) December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raises substantial doubt about its ability to continue as a going concern. Management’s plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[Signature]

[Date]
Evaluation of Audit Test Results

SAS 53 requires the auditor to consider the quantitative and qualitative aspects of audit differences and attempt to determine whether the differences are indicative of an error or irregularity. Irregularities are intentional and have implications beyond their direct monetary effect. The nature and extent of the auditor's responsibility depends on the potential materiality of the error or irregularity. Examples of adverse conditions or circumstances detected by audit procedures that may cause the auditor to reconsider the assessment of the risk of material misstatement made during audit planning and reconsider audit scope are presented in Exhibit 15.

SAS 54 requires that when the auditor becomes aware of specific information that provides evidence concerning a possible illegal act, the auditor should inquire of management at a level above those involved if possible. Examples of such specific information are provided in Exhibit 16. If management fails to provide satisfactory information, the auditor should consult with the client's legal counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements. The auditor should also apply additional procedures, if necessary, to obtain an understanding of the nature of the acts.

SAS 57 encourages the auditor to evaluate estimates with an attitude of professional skepticism and recognizes that an entity's internal control structure may reduce the likelihood of material misstatement of estimates. The Statement establishes that the auditor should determine that (1) all material accounting estimates have been developed, (2) the estimates are reasonable, and (3) the estimates conform with generally accepted accounting principles (GAAP). The Statement recognizes three ways to evaluate the reasonableness of estimates:

1. A future event (an event after the estimate is made but before the completion of audit fieldwork) provides evidence about actual amount with which to compare the estimate.
2. The auditor understands, evaluates, and reperforms management's process for making estimates.
3. The auditor independently develops an expectation based on knowledge of the facts and circumstances.
Exhibit 15  
*Adverse Conditions or Circumstances Detected by Audit Procedures*

- Analytical procedures disclose significant differences from expectations.
- Differences between reconciliations of a control account and subsidiary records or between an asset account (such as, securities in a safe deposit box) and a general ledger account are not appropriately investigated and corrected on a timely basis.
- Confirmation requests disclose significant differences or yield fewer responses than expected.
- Transactions selected for testing are not supported by proper documentation or appropriately authorized.
- Supporting records or files that should be readily available are not promptly produced when requested.
- Errors are detected in audit tests that apparently were known to client personnel but were not voluntarily disclosed to the auditor.

Exhibit 16  
*Specific Information Providing Evidence Concerning Possible Illegal Acts*

- Unauthorized transactions, improperly recorded transactions, or transactions not recorded in a complete or timely manner in order to maintain accountability for assets.
- Investigation by a government agency, an enforcement proceeding, or payment of fines or penalties.
- Violations of laws or regulations cited in reports of examinations by regulatory agencies that have been made available to the auditor.
- Large payments for unspecified services to consultants, affiliates, or employees.
- Sales commissions or agents’ fees that appear excessive in relation either to those normally paid by the client or to the services actually received.
- Unusually large payments in cash, purchases of bank cashiers’ checks in large amounts payable to bearer, transfers to numbered bank accounts, or similar transactions.
Exhibit 16 (continued)

- Unexplained payments made to government officials or employees.
- Failure to file tax returns or to pay government duties or similar fees that are common to the entity’s industry or the nature of its business.

AUDIT COMMUNICATIONS

Communications With Management and the Audit Committee

SASs 53 and 54

SASs 53 and 54 require that the auditor should communicate the following matters to the audit committee or those with equivalent authority and responsibility:

- Any irregularities or illegal acts involving senior management
- Any other irregularities or illegal acts unless those irregularities or illegal acts are clearly inconsequential

SAS 60

SAS 60 requires that if during an audit the auditor observes reportable conditions related to the internal control structure, the auditor should communicate the matter to the audit committee or other appropriate recipient. The communication would generally be to the audit committee or to individuals with a level of responsibility and authority equivalent to an audit committee in organizations that do not have one, such as the board of directors, the board of trustees, an owner in an owner-managed enterprise, or others who may have engaged the auditor. (See Exhibit 17.)

*Reportable conditions* are matters coming to the auditor’s attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control structure that could adversely affect the organization’s ability to record, process, summarize, and report financial data consistent with management’s assertions in the financial statements. (See Exhibit 18.)
The communication should preferably be written. Exhibit 19 illustrates such a report. If the communication is oral, it should be documented by appropriate memoranda or notations in the working papers.

The auditor may choose to communicate during the course of the audit rather than after the audit report date when the auditor believes timely communication is important.

**Exhibit 17** Differences Between SAS 60 and SASs 20 and 30

<table>
<thead>
<tr>
<th>Statement</th>
<th>Old</th>
<th>New</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement</td>
<td>SAS 20 and para. 47-53 of SAS 30</td>
<td>SAS 60</td>
</tr>
<tr>
<td>Matter to Be Reported</td>
<td>Material weakness</td>
<td>Reportable condition</td>
</tr>
<tr>
<td>Scope of Matter Reported</td>
<td>Matters related to accounting control</td>
<td>Matters related to the control environment, accounting system, and control procedures</td>
</tr>
<tr>
<td>Seriousness of Deficiency</td>
<td>Would permit material errors or irregularities to go undetected</td>
<td>Could adversely affect the organization's ability to record, process, etc.</td>
</tr>
<tr>
<td>Cautionary Language Re: Objectives of Control, Inherent Limitations, Projections to Future</td>
<td>Required</td>
<td>Inclusion is optional</td>
</tr>
<tr>
<td>Communication</td>
<td>To management and the board of directors</td>
<td>To the audit committee or its equivalent</td>
</tr>
</tbody>
</table>
Exhibit 18  
*Universe of Control Deficiencies*

Exhibit 19  
*Reportable Conditions Report*

In planning and performing our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization’s ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

[Include paragraphs to describe the reportable conditions noted.]

(continued)
Exhibit 19 (continued)

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (or specified regulatory agency or other specified third party).

SAS 61

SAS 61 establishes new communications requirements that apply in the following circumstances:

- All Securities and Exchange Commission (SEC) engagements (including 1933 and 1934 Act filings, filings by financial institutions with federal agencies, and certain companies associated with investment funds)
- Other entities that either have an audit committee or have formally designated oversight of financial reporting to a group equivalent to an audit committee (such as a finance or budget committee)

SAS 61 requires the following matters to be communicated, either orally or in writing, to the audit committee:

- Significant accounting policies
- Management judgments and accounting estimates
- Significant audit adjustments
- Responsibility for other information in documents containing audited financial statements
- Auditor's responsibility under GAAS
- Disagreements with management
- Consultation by management with other accountants
- Major issues discussed with management prior to retention
- Difficulties encountered in performing the audit

Exhibit 20 highlights the key features of the auditor's responsibility for communication with audit committees. Exhibit 21 lists SASs with requirements for communication with audit committees. Exhibit 22 presents considerations in determining the form of the communication.
Audit Report on Financial Statements

SAS 58 is intended to improve the flow and understandability of information that auditors provide to financial statement users. SAS 58 covers both the standard report and the form of report when conditions or circumstances dictate departures from the standard report.

Exhibit 20  
**Auditor Communications**

<table>
<thead>
<tr>
<th>To Whom:</th>
<th>To the audit committee or a similar, formally designated committee.</th>
</tr>
</thead>
<tbody>
<tr>
<td>What:</td>
<td>Information on the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process for which management is responsible.</td>
</tr>
<tr>
<td>How:</td>
<td>Oral or written communication. (If oral, document in working papers; if written, report should indicate that it is intended solely for the audit committee, the board of directors, and management.)</td>
</tr>
<tr>
<td>When:</td>
<td>After issuance of the audit report on financial statements, unless auditor believes earlier communication is necessary.</td>
</tr>
</tbody>
</table>

Exhibit 21  
**SASs With Requirements for Communication With Audit Committees**

- SAS 61, *Communication With Audit Committees*.
- SAS 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*.
- SAS 36, *Review of Interim Financial Information*.

Exhibit 22  
**Written vs. Oral Report Considerations**

Consider—

- To whom communicated.
- When communicated.
- Complexity of issues.
- Outside use.
- Other considerations.
The Effects of SASs 53 Through 61 on the Audit Process

The new SAS is a complete revision of AU section 509 and includes a revised auditor’s standard report. It also completely revises the guidance on reporting on comparative financial statements (AU section 505); guidance on reporting on accounting changes (AU section 546); and related guidance on reporting on loss contingencies, subsequent events, material uncertainties, and departures from GAAP (covered in auditing interpretations of AU sections 505 and 509). The key differences between the old and new standards are presented in Exhibit 23.

New Standard Report

The new standard report consists of three paragraphs:

- Identification of the financial statements audited in an opening (introductory) paragraph
- A statement describing the nature and objective of an audit in a scope paragraph
- An expression of the auditor’s opinion in a separate opinion paragraph

The basic elements of the new standard report are as follows:

1. A title that includes the word independent
2. A statement that the financial statements were audited
3. A statement that the financial statements are the responsibility of management and that the auditor’s responsibility is to express an opinion on them
4. A statement that the audit was made in accordance with GAAS
5. A statement that GAAS require the auditor to plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement
6. A statement that an audit includes examining evidence, on a test basis, supporting the amounts and disclosures in the financial statements, and descriptions of aspects of audit scope
7. A statement that the auditor believes the audit provides a reasonable basis for his opinion
8. An opinion as to whether the financial statements are fairly presented in all material respects, in conformity with GAAP
### Exhibit 23  
**Key Differences Between SAS 58 and AU Sections 505, 542, 545 and 546**

<table>
<thead>
<tr>
<th></th>
<th><strong>Old</strong></th>
<th><strong>New</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Statement</strong></td>
<td>AU sections 505, 542, 545, 546</td>
<td>SAS 58</td>
</tr>
<tr>
<td><strong>Terminology</strong></td>
<td>“Examined”</td>
<td>“Audited”</td>
</tr>
<tr>
<td><strong>Title</strong></td>
<td>None required</td>
<td>Title with word “independent” required</td>
</tr>
<tr>
<td><strong>Consistency/ Lack of consistency</strong></td>
<td>Consistency reference made/qualified opinion</td>
<td>No consistency reference/clean opinion with explanatory paragraph</td>
</tr>
<tr>
<td><strong>Management’s Responsibility</strong></td>
<td>No explicit statement</td>
<td>Statement added describing financial statements as management’s responsibility</td>
</tr>
<tr>
<td><strong>Description of Audit</strong></td>
<td>“Included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances”</td>
<td>Added: objective of detecting material misstatements, and a discussion of the factors involved in achieving reasonable assurance</td>
</tr>
<tr>
<td><strong>Materiality</strong></td>
<td>No explicit statement</td>
<td>“Present fairly in all material respects . . .”</td>
</tr>
</tbody>
</table>

Exhibit 24 presents the form of the standard report. Note in particular that a title, including the word independent, is required. (This requirement does not apply to an accountant’s report when the accountant is not independent.)

Also, note that the reference to consistency has been eliminated from the expression of opinion. The exposure draft of this SAS had proposed to do away entirely with reporting on the consistency of application of accounting principles. However, consistency reporting has been retained on an exception basis.

In many cases, modifications of the standard report are made in a manner essentially the same as modifications of the prior report. However, some modifications of the new report do differ significantly.
Exhibit 24  

*Standard Report—Comparative Statements*

**Independent Auditor’s Report**

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of (at) December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

**Consistency Modification**

When there is a material lack of comparability of the financial statements caused by a change in accounting principle, an explanatory paragraph follows the opinion paragraph, which remains unqualified. The explanatory paragraph simply discloses that there has been an accounting change and contains a cross-reference to the note to the financial statements that provides the disclosures concerning the change required by APB Opinion No. 20. Exhibit 25 illustrates this type of report.
This change in consistency reporting has resulted in a change in the second reporting standard of GAAS. The wording of the new standard is "The report should identify those circumstances in which such principles have not been observed in the current period in relation to the preceding period."

The same type of explanatory paragraph treatment used for lack of consistency will also apply to the existence of a material uncertainty, including substantial doubt about the entity’s ability to continue as a going concern.

**GAAP Departure Qualification**

An opinion qualified because of a departure from GAAP has the same first introductory paragraph and second paragraph describing the audit. It then has an additional explanatory paragraph describing the GAAP departure and the effect on the financial statements. The opinion is qualified, except for the effects of the GAAP departure. Exhibit 26 illustrates one type of report for departure from GAAP.

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**Exhibit 25**

* Lack of Consistency

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**Independent Auditor’s Report**

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

*(continued)*
In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of (at) December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, the Company changed its method of computing depreciation in 19X2.

[Signature]
[Date]

Exhibit 26  GAAP Departure Qualification

Independent Auditor’s Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by $____ and $_____, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 19X2 and 19X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.
Exhibit 26 (continued)

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

Scope Limitation Qualification

An opinion qualified because of a scope limitation has the same first introductory paragraph. The paragraph describing the audit is modified to state that except for as discussed in the following paragraph, the audit was performed in accordance with GAAS. An additional explanatory paragraph describing the scope limitations is presented next. The opinion is qualified, except for the effect of the adjustments, if any, that might have been determined to be necessary had scope not been limited as described above. Exhibit 27 illustrates this report.

Uncertainty Modification

SAS 58 (together with SAS 59 on going concern status) eliminates all "subject to" qualifications. Uncertainties that have a material effect on the financial statements should be disclosed in a required explanatory paragraph following the opinion paragraph. A report with an additional explanatory paragraph because of an uncertainty has the same first introductory paragraph, the same second paragraph describing the audit, and the same opinion paragraph. The last paragraph of the report is an explanatory paragraph with a description of the uncertainty indicating the ultimate outcome is unknown. The paragraph also includes a cross-reference to the financial statement note disclosing the uncertainty. Exhibit 28 is an example of a report with an uncertainty modification.
Exhibit 27

Scope Limitation Qualification

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $_______ and $_______ at December 31, 19X2 and 19X1, respectively, or its equity in earnings of that affiliate of $_______ and $_______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]
Exhibit 28  

Uncertainty  

Independent Auditor's Report  

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of (at) December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counteraction, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

[Signature]

[Date]

Adverse Opinion—GAAP Departure

An adverse opinion because of a GAAP departure has the same first introductory paragraph and the same second paragraph describing
The Effects of SASs 53 Through 61 on the Audit Process

the audit. The third paragraph is an additional explanatory paragraph describing the GAAP departure and the effect on the financial statements. The concluding paragraph states an opinion that the financial statements are not, in all material respects, fairly presented in conformity with GAAP. An example of an adverse opinion is presented in Exhibit 29.

Disclaimer of Opinion

A disclaimer of opinion because of a scope limitation begins the first introductory paragraph with the phrase "we were engaged to audit" rather than that the auditor actually audited the financial statements. The normal paragraph describing the audit is omitted entirely. The concluding paragraph states that the scope was not sufficient to express an opinion and no opinion is expressed. Exhibit 30 illustrates this kind of disclaimer of opinion.

Exhibit 29  Adverse Opinion

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Generally accepted accounting principles require that property,
Exhibit 29 (continued)

plant, and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from generally accepted accounting principles identified above, as of December 31, 19X2 and 19X1, inventories have been increased $_____ and $_____ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant, and equipment, less accumulated depreciation, is carried at $_____ and $_____ in excess of an amount based on the cost to the Company; and deferred income taxes of $_____ and $_____ have not been recorded; resulting in an increase of $_____ and $_____ in retained earnings and in appraisal surplus of $_____ and $_____ , respectively. For the years ended December 31, 19X2 and 19X1, cost of goods sold has been increased $_____ and $_____ , respectively, because of the effects of the depreciation accounting referred to above; and deferred income taxes of $_____ and $_____ have not been provided, resulting in an increase in net income of $_____ and $_____ , respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company as of December 31, 19X2 and 19X1, or the results of its operations or its cash flows for the years then ended.

[Signature]

[Date]

Exhibit 30 Disclaimer of Opinion—Scope Limitation

Independent Auditor’s Report

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management.

[Second paragraph of standard report should be omitted.]

The Company did not make a count of its physical inventory in 19X2 or 19X1, stated in the accompanying financial statements at $_____ as of December 31, 19X2, and at $_____ as of December 31, 19X1. Further, (continued)
Exhibit 30 (continued)

evidence supporting the cost of property and equipment acquired prior to December 31, 19X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[Signature]
[Date]

IMPLEMENTATION ISSUES

Errors, Irregularities, and Illegal Acts

Engagement Letters

The typical engagement letter has in the past contained a caveat that an audit is not specifically designed, and cannot be relied upon, to detect irregularities, although their discovery may result. However, SAS 53 clearly states that an audit should be designed to provide reasonable assurance of detecting material irregularities.

Does this mean that the wording of the typical engagement letter should be modified? Probably. The Auditing Standards Board did not take a position on this issue because an engagement letter is a business device for the auditor's protection and not a professional requirement. Engagement letters should be revised along the lines of the new description of an audit in the scope paragraph of the new standard report as presented in SAS 58, Reports on Audited Financial Statements.

Legal Representation Letter

Should the written representations ordinarily obtained from the client's lawyer be modified because of SAS 53 or 54? For example, should the attorney be asked to provide comfort on the absence of illegal acts? No. The lawyer doesn't conduct a legal audit and would not be able to provide such broad assurance on the legality of the client's conduct. The ordinary legal representation letter requires no modification.
In some cases, however, the client’s attorney may be asked to provide an opinion on the legality of a specific matter. Whether such documentation is needed is left to the auditor’s professional judgment. However, such documentation is usually a separate matter and not part of the ordinary legal representation letter.

**Materiality and Illegal Acts**

Does the concept of an illegal act with a direct and material effect on a financial statement line item mean that materiality is judged in relation to the individual amount? Definitely not! Materiality should be evaluated in relation to the financial statements taken as a whole as explained in SAS 47, *Audit Risk and Materiality in Conducting an Audit*. The Auditing Standards Board did not intend to change any of the guidance in SAS 47.

**Detection Responsibility Limitations**

Some auditors are concerned that the new SAS may mean that the auditor is responsible for detecting all types of irregularities, if material. This is not true. SAS 53 states that because of the characteristics of irregularities, such as forgery and collusion, a properly designed and executed audit may not detect a material irregularity.

**SASs 53 and 54 Working Papers**

SASs 53 and 54 do not have specific documentation requirements. SAS 41, *Working Papers*, requires auditors to document procedures performed and conclusions reached in audit engagements. Based on this responsibility, in conjunction with the responsibilities of SAS 53, auditors are well advised to include documentation of the risk factors and the assessment of risk of material misstatements. The form and content of such documentation is a matter of auditor judgment.

**Owner-Manager Fraud or Illegal Act**

When an irregularity or illegal act committed by the owner-manager is discovered, the auditor should discuss the matter with the owner-manager to be certain that the situation is fully understood. The perpetration of an irregularity or illegal act at such a high level in the organization usually has a pervasive effect on the audit and may cause the auditor to conclude that withdrawal from the engagement is appropriate.
SAS 53 (AU section 316.29) and SAS 54 (AU section 317.23) indicate that the disclosure of irregularities or illegal acts to parties outside the client is ordinarily outside the scope of the auditor’s responsibilities and may be precluded, unless the matter affects the audit opinion on the financial statements. State laws have differing requirements, ranging from laws requiring client confidentiality to laws making it a criminal offense to fail to report a felony. The auditor should consult with legal counsel before discussing the matter with others outside the client organization.

**Form of Communication of Errors and Irregularities**

How should auditors communicate irregularities to the audit committee or its equivalent? SAS 53 does not require the auditor to communicate the irregularity directly to the audit committee. The auditor must be assured that the audit committee is informed of the irregularities identified. If the auditor does communicate directly to the audit committee, that communication can be either oral or written. The auditor should document oral communications in the audit working papers.

**Audit Consideration of Laws and Regulations**

The auditor’s objective is not to assess the legality or illegality of an act. Instead, the auditor is required to assess whether the financial statements are free of material misstatement. For example, the client may not have filed tax returns or paid taxes, a violation of an act that directly affects the tax accrual on the financial statements. The omission may result in significant financial penalties that need to be reflected in the financial statements. The auditor is concerned with achieving audit objectives related to the existence, completeness, and valuation of the tax accrual and related items, and not directly with compliance with tax laws and regulations. However, determination of a proper accrual for the tax liability requires assessment of compliance because of the relation of compliance to achieving audit objectives.

**Effects of an Illegal Act on the Financial Statements**

The auditor should consider the effects of an illegal act on the amounts presented in the financial statements, including contingent monetary effects, such as fines, penalties, and damages. The auditor
should evaluate the adequacy of the financial statement disclosure of the potential effects on the entity's operations. If the auditor cannot assess the effects of the illegal act on the financial statements, he or she should consider the guidance regarding uncertainties provided in SAS 58, *Reports on Audited Financial Statements*.

**Internal Control Structure**

**Minimum Requirements for Internal Control Structure Consideration**

When the auditor does not intend to rely on internal control (for example, in small businesses), the auditor is still required to obtain an understanding of the internal control structure sufficient to plan the engagement. SAS 55 does not require auditors to evaluate effectiveness of the design or operation of policies and procedures when obtaining the understanding.

In audits of small owner-managed entities where there is a lack of segregation of duties, auditors may find it more efficient and effective to obtain sufficient evidential matter from substantive testing. The auditor assesses control risk at the maximum level for all assertions and performs no tests of controls to determine the effectiveness of design and operation of the internal control structure policies and procedures.

The auditor is required to document the understanding of the internal control structure obtained and also indicate in the audit workpapers that control risk has been assessed at the maximum level for the assertions.

**Minimum Level of Control Risk Assessment**

Can the auditor assess control risk low enough for all assertions to preclude the need for substantive testing? No. As discussed in paragraph 63 of SAS 55, the auditor should perform substantive tests for significant account balances and transaction classes, regardless of the assessed level of control risk.

**Requirement for Tests of Controls**

Can auditors assess control risk at less than maximum based on the understanding of the internal control structure without performing
The Effects of SASs 53 Through 61 on the Audit Process

tests of controls? SAS 55 indicates that assessing control risk below the maximum level involves, among other things, testing controls to evaluate the effectiveness of such policies and procedures, so tests of controls are needed.

However, the auditor may find that the procedures designed to obtain an understanding of the internal control structure also provide evidence about the effectiveness of the design and operation of the policies and procedures. In this case, separate (additional) tests of controls are not needed. The auditor’s procedures to obtain an understanding of the internal control structure also resulted in obtaining knowledge of the effectiveness of the policies and procedures relevant to specific assertions and are in fact tests of controls. For those assertions, the auditor may assess control risk at less than maximum.

**Accounting Controls and Administrative Controls**

Superseded AU section 320 included the definitions of “accounting controls” and “administrative controls,” but these terms are not in SAS 55. Are the terms now obsolete? Certainly not. They are useful concepts and are defined in the Single Audit Act of 1984 and other regulatory acts. SAS 55 does not supersede or nullify the requirements of such legislation or regulatory acts.

**Tests of the Control Environment**

The control environment comprises such factors as management’s philosophy and operating style and personnel policies and practices. What types of procedures would auditors perform to test the effectiveness of the control environment? Factors such as those in the control environment are conducive to testing by inquiry and observation. For example, auditors may inquire about policies and procedures related to the internal audit function, such as its authority and reporting relationships and the qualifications of the staff. Further testing may involve observation in support of the responses obtained from inquiry of management.

**Quantification of Level of Control Risk**

Control risk can be assessed in quantitative terms, such as percentages, or in nonquantitative terms that range from maximum to moderate to low. For example, if the auditor judges the risk as great that a material misstatement could occur in a financial statement assertion
without being prevented or detected on a timely basis by an entity's internal control structure, the auditor may indicate in quantitative terms the control risk is assessed at 100 percent or in nonquantitative terms as assessed at maximum.

**Inherent Risk**

SAS 55 does not require auditors to explicitly assess and document inherent risk as well as control risk for financial statement assertions. SAS 55 only requires auditors to assess control risk. SAS 47 requires the auditor to assess audit risk, which is composed of inherent risk, control risk, and detection risk. SASs 47 and 55 allow auditors to make a combined or separate assessment of inherent risk together with control risk.

**Multiple Policies and Procedures for an Assertion**

There may be many policies and procedures that contribute to the achievement of the control objectives related to an assertion for a particular account balance or transaction class. Depending on the circumstances, not all of them may need to be tested to support the control risk assessment. The evidential matter that is sufficient to support a specific assessed level of control risk is a matter of auditor judgment. However, the necessity of testing each policy and procedure depends on the relationship of the policies and procedures and their interdependence.

For example, assume five policies or procedures exist that pertain to the assertion, and the ability to reduce control risk is dependent on the effectiveness of all five policies or procedures. If any one policy is not effective, misstatements may occur. In this case, the auditor must perform tests of controls of all five policies or procedures to provide a basis for a reduction in the level of control risk.

On the other hand, if the ability to reduce control risk is dependent on the effectiveness of any one of the policies or procedures (that is, if one policy is not effective, any of the other four will prevent the misstatement), the auditor may perform tests of controls of only one of the policies or procedures.

**Improving Audit Effectiveness**

**Documentation of Going Concern Status**

SAS 59 does not have specific documentation requirements. SAS 41 requires auditors to document audit procedures performed and con-
conclusions reached in audit engagements. Based on this responsibility in conjunction with the responsibilities outlined in SAS 59, auditors should consider documenting the conclusions reached when substantial doubt is alleviated because of management plans and when the auditor concludes that there is substantial doubt.

Liquidation Plans

If a business (for example, a partnership) is to be liquidated at some future date (in the partnership agreement) is this a going concern problem? If the partnership agreement indicates a dissolution date that occurs within one year from the date of the financial statements under audit, the auditor would, most likely, have substantial doubt about the entity’s ability to continue as a going concern for the reasonable period of time defined in SAS 59. As such, in addition to management’s disclosure in the financial statements about the upcoming dissolution, the auditor should also include an explanatory paragraph, following the opinion paragraph, in the audit report that describes the auditor’s substantial doubt.

Going Concern and Development Stage Enterprises

A development stage enterprise may not generate substantial revenue, and significant losses may occur. Shareholder equity may even be negative. Once the auditor believes the conditions and events identified, when considered in the aggregate, indicate that substantial doubt exists, the auditor should then consider management’s plans for dealing with the conditions and events. In this case, the auditor would consider management’s plans for generating revenue and consider the likelihood that the adverse effect of the negative trends identified will be mitigated. If the auditor concludes that management’s plans do not relieve the auditor’s substantial doubt for one year from the date of the financial statements, an explanatory paragraph should be included in the audit report.

Considering whether the shareholder’s equity is positive or negative may assist the auditor in determining the aggregate effect of the conditions and events identified. However, once the auditor believes there is substantial doubt, ordinarily it is management’s plans that will heighten or mitigate the substantial doubt.
The Effects of SASs 53 Through 61 on the Audit Process

The Auditor’s Explanatory Paragraph vs. Financial Statement Disclosure
SAS 59 does not require the auditor to qualify the audit opinion when substantial doubt about the entity’s going concern status exists; only an explanatory paragraph is added. Accordingly, some practitioners have questioned, if management adequately discloses the substantial doubt in the notes to the financial statements, whether the explanatory paragraph could be excluded. SAS 59 requires the auditor to include the explanatory paragraph following the opinion paragraph when the auditor concludes there is substantial doubt about the entity’s ability to continue as a going concern. Management’s disclosure does not change this requirement.

Documentation of Analytical Procedures
SAS 56 does not contain specific documentation requirements. Procedures such as reading of the financial statements and considering whether the auditor has sufficient understanding have probably been performed in the overall review phase by most auditors in all their audits, before the issuance of SAS 56, but the procedures were probably not documented. Now that such analytical procedures are required by professional standards, the auditor should consider the requirements for the amount and type of audit documentation that are outlined in SAS 41, Working Papers.

Analytical Procedures for a New Entity
Even in the initial year of an entity’s operations, the use of analytical procedures during the planning phase of an audit can help the auditor gain an understanding of the entity’s business and assess the specific audit risks. SAS 56 requires the use of analytical procedures in all audits; however, the SAS does not require those procedures to be comparisons of current year data to prior year data. In the initial year of operations, the auditor can benefit from analytical procedures that involve comparisons of monthly or quarterly information and of relationships of financial data to nonfinancial data.

Extent of Reliance on Analytical Procedures
SAS 56 notes that the auditor’s reliance on substantive tests to achieve an audit objective related to a particular assertion may be
derived from tests of details, from analytical procedures, or a combination of both. For audit objectives of some assertions, analytical procedures alone may provide a sufficient level of assurance, and no other substantive procedures will need to be performed. In these cases, the analytical procedures must be precise enough so that the auditor’s risk that material misstatements will not be detected has been reduced to a sufficiently low level.

**Independence and Accounting Estimates**

The auditor often assists management in the development of accounting estimates. SAS 57 states that management is responsible for developing accounting estimates. Does the auditor’s assistance affect the auditor’s independence? No. Under Rule of Conduct 101 and Interpretation 101-3, management must accept responsibility for the financial statements. Often, those financial statements are prepared by the auditor. The same is true for accounting estimates. Management must accept responsibility for the development of accounting estimates. When the auditor assists management in the development of significant estimates, good audit practice would include determining that management understands the process used and agrees with significant assumptions used in the development of the estimate.

**Documentation of Understanding of Accounting Estimates**

SAS 57 does not contain documentation requirements. However, the auditor should consider the provisions of SAS 41, *Working Papers*. Management’s understanding and concurrence can, for example, be documented in a work paper or in the management representation letter. The auditor may also consider SAS 61, *Communication With Audit Committees*, which provides guidance on communicating information about management judgments and estimates.

**Auditor Communications**

**Emphasis of a Matter**

This use of an explanatory paragraph has been retained. SAS 58 (paragraph 37) discusses how an auditor may use an explanatory paragraph to emphasize a matter. It is silent regarding the recommended placement of an emphasis of a matter paragraph in the auditor’s standard report; however, footnote 8 of the SAS states that
“Unless otherwise required by the provisions of this Statement, an explanatory paragraph may precede or follow the opinion paragraph in the auditor’s report.” Therefore, the placement of this paragraph is a matter of auditor judgment.

**Explanatory Paragraph Placement (Inconsistency or Uncertainty)**

There is a prescribed order of presentation for explanatory paragraphs that describe a material change in accounting principle or a material uncertainty. Both of these explanatory paragraphs follow the opinion paragraph in the auditor’s standard report.

**Audit Report Address**

SAS 58 states that the auditor’s standard report should be addressed to the company whose financial statements are being audited or to its board of directors. The audit report of an unincorporated entity should be addressed as circumstances dictate.

**Explanatory Paragraphs and the SEC**

The SEC does not accept qualified opinions in registration statements. However, the SEC will accept an auditor’s report that includes an explanatory paragraph that describes a material uncertainty or change in accounting principles since the auditor’s opinion is unqualified.

**Disclosure of Uncertainties**

The addition of an explanatory paragraph to the audit report because of a material uncertainty does not change the auditor’s responsibility for evaluating the adequacy of note disclosures related to the uncertainty. The only change brought about by SAS 58 is in the way the auditor reports on material uncertainties.

**Reissued Reports**

When should the auditor apply the reporting provisions of SAS 58 to reword a previously issued audit report using the new form for the auditor’s standard report? If the auditor is not aware of any events or circumstances that would cause dual-dating or otherwise change the original report, there is no need to reissue the report following the
new standard report form. This applies even when the previously issued report is incorporated by reference, and the auditor includes consent (dated currently) for the use of the report.

However, if the auditor is aware of events or circumstances that occurred after the date of the original report that affect that report, the auditor should modify the report as appropriate and reissue the audit report with a new date using the language prescribed in SAS 58.

**Balance-Sheet-Only Reports**

SAS 58 discusses circumstances where the auditor is engaged to audit and report on the balance sheet only. (See Exhibit 31.) However, the SAS is silent about whether an accountant can accept an engagement to audit the balance sheet but compile or review the related statements of income and cash flows. This is permissible for nonpublic companies. Statement on Standards for Accounting and Review Services (SSARS) No. 1 states that when the accountant performs more than one service on financial statements, the accountant should issue the report that is appropriate for the highest level of service rendered. An example of a report an accountant might issue with an unqualified opinion on the balance sheet and a standard compilation report on the related statements of income and cash flows is presented in Exhibit 32.

**Communications With Audit Committees — Topics to Be Covered**

SAS 61 lists nine items to be addressed in communications with audit committees. However, an auditor need not address each of the nine items with the audit committee if some of the items are not applicable. For example, if the auditor has had no disagreements with management, there would be nothing to report.

**Management Letters and SAS 61**

Some auditors have questioned whether SAS 61 will preclude the need to prepare management letters to their clients. The answer is no. Auditors generally communicate reportable conditions in management letters. SAS 61 does not alter the communication requirements in other SASs; rather, it adds new ones. An auditor may, however, include some of the matters required to be communicated by SAS 61 in a management letter. For example, the auditor may
include a discussion of the level of responsibility the auditor assumes for the entity’s internal control structure in such a letter.

Exhibit 31  

Limited Reporting Engagements—
Balance Sheet Only

Independent Auditor’s Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX. This financial statement is the responsibility of the Company’s management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall balance sheet presentation. We believe that our audit of the balance sheet provides a reasonable basis for our opinion.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 19XX, in conformity with generally accepted accounting principles.

[Signature]

[Date]

Exhibit 32  

Mixed Report—Audit and Compilation

Independent Auditor’s Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX. This financial statement is the responsibility of the Company’s management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence (continued)
Exhibit 32 (continued)

supporting the amounts and disclosures in the balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall balance sheet presentation. We believe our audit of the balance sheet provides a reasonable basis for our opinion.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 19XX, in conformity with generally accepted accounting principles.

We have also compiled the accompanying statements of income and cash flows of X Company for the year ended December 31, 19XX, in accordance with standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. We have not audited or reviewed the accompanying statements of income or cash flows and, accordingly, do not express an opinion or any other form of assurance on them.

[Signature]

[Date]

Subsidiaries of SEC Registrants

If the auditor audits only a wholly-owned or majority-owned subsidiary of an SEC registrant (not the parent), SAS 61 would apply only if the subsidiary has an audit committee or has formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a budget or finance committee).

SAS 61 and Owner-Managed Businesses

Some of the other SASs (for example, SASs 53, 54, and 60) consider an owner-manager to be the equivalent of an audit committee. Why are small, owner-managed businesses made exempt from SAS 61’s requirements? Non-SEC entities without the equivalent of an audit committee were made exempt because the Auditing Standards Board believed it did not make sense to require that many of the matters be communicated to an owner-manager. Communications that would be pointless to make to an owner-manager include disagreements
with management, major issues discussed with management before
the auditor was hired, and serious difficulties encountered with man-
agement during the performance of the audit. However, an auditor is
not constrained by the applicability of this SAS and may discuss
these and other matters with individuals in an entity who might ben-
efit from these communications. In other words, the applicability of
SAS 61 frees the auditor from an obligation to communicate in cer-
tain circumstances, but does not prohibit communications.

SEC Company Without an Audit Committee

Some small SEC companies may not have an audit committee. How-
ever, the communication must be made. It should be made to the
board of directors unless the board has designated another commit-
tee, such as a budget or finance committee, to have responsibility for
oversight of the financial reporting process. Communication only
to senior management alone would not be appropriate unless the board
of directors has no members outside of senior management.

Material Weaknesses vs. Reportable Conditions

A reportable condition is defined by SAS 60 as a significant defi-
ciency in the design or operation of the internal control structure,
which could adversely affect the organization’s ability to record, pro-
cess, summarize, and report financial data consistent with the asser-
tions of management in the financial statements. A reportable condi-
tion may be of such magnitude as to be considered a material
weakness. SAS 60 defines a material weakness as a reportable condi-
tion in which the design or operation of the specific internal control
structure elements do not reduce to a relatively low level the risk that
errors or irregularities in amounts that would be material in relation
to the financial statements being audited may occur and not be
detected within a timely period by employees in the normal course of
performing their assigned functions.

In other words, a reportable condition is a deficiency that could
adversely affect the client’s ability to prepare proper financial state-
ments. A material weakness is a more significant reportable condi-
tion. It is a deficiency in the control structure that would permit
material errors or irregularities to go undetected.

The concept of reportable conditions does not replace the con-
cept of material weaknesses. It is applicable only when reporting on
internal control structure is made as part of a financial statement
The Effects of SASs 53 Through 61 on the Audit Process

audit. Engagements to report on an entity’s internal control structure not in connection with a financial statement audit are not affected by SAS 60. Accordingly, SAS 60 only supersedes SAS 20, Required Communication of Material Weaknesses in Internal Accounting Control, and paragraphs 47 through 53 of SAS 30, Reporting on Internal Accounting Control.

Responsibility for Identification of Reportable Conditions

SAS 60 does not require the auditor to search for reportable conditions. Instead, the auditor is only required to communicate those reportable conditions noted. The auditor’s objective in an audit in accordance with GAAS is to form an opinion on the entity’s financial statements taken as a whole. In fulfilling this objective, the auditor may become aware of possible reportable conditions in the course of applying normal audit procedures.

Form of Communication of Reportable Conditions

SAS 60 states that reportable conditions should preferably be communicated in writing. However, the Statement permits such conditions to be reported orally. If the information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the work papers.

Reportable Conditions—Reporting Requirements

A written report about reportable conditions should include the following:

- An indication that the purpose of the audit was to report on the financial statements and not to provide assurance on the internal control structure
- The definition of reportable conditions
- A restriction on distribution for the sole use of the audit committee, management, or others within the organization

Outside Distribution of Reportable Conditions Report

Is the auditor allowed to provide a written report about reportable conditions to individuals outside the entity? Generally, no. However, in certain circumstances, it would be permissible. SAS 60 states that the report on reportable conditions is intended solely for limited dis-
The Effects of SASs 53 Through 61 on the Audit Process

distribution within the organization (see above). However, the auditor may issue a report about reportable conditions to regulatory agencies, but only when there are requirements established by governmental authorities to furnish reports about reportable conditions.

"No Material Weakness" Report

While SAS 60 precludes the auditor from issuing a written "no reportable conditions" report, the auditor is not prohibited from issuing a written "no material weaknesses" report. The auditor's awareness of reportable conditions varies with each audit and is influenced by numerous factors, such as the entity's size, its complexity, and the nature and diversity of its business activities. Because of the potential for misinterpretation of the limited degree of assurance that a written report representing "no reportable conditions" would provide, the Auditing Standards Board determined that the auditor should not issue such a report. The board believed that a "no reportable conditions" report might confuse users by implying a greater level of assurance about the lack of any significant deficiencies than the auditor could really provide. In contrast, because material weaknesses are identified based on the risk that the condition would result in a material misstatement in the financial statements, material weaknesses have a more direct effect on the auditor's opinion. Thus, there is less potential for misinterpretation from the auditor issuing a written report representing that "no material weaknesses" were noted during the audit. Also, many governmental regulatory agencies require the auditor to issue reports about material weaknesses in internal control structure.

Less Significant Deficiencies

SAS 60 does not preclude the auditor from reporting matters viewed to be of value to management even when those items are not of significance to be classified as reportable conditions.

Completeness of Reporting Reportable Conditions

In some circumstances, the auditor may not be required to report all reportable conditions identified. The existence of a reportable condition may already be known and, in fact, may represent a conscious decision by management—a decision of which the audit committee is aware—to accept that degree of risk because of cost or other considerations. Management is responsible for making that cost/benefit
decision. If the audit committee has acknowledged its understanding and consideration of such deficiencies and the associated risks, the auditor may decide the matter does not need to be reported. However, the auditor should periodically consider whether, because of changes in management or the audit committee or simply because of the passage of time, it is appropriate and timely to report such matters.

**SUMMARY**

SAS 53 requires the auditor to assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement and to design the audit to provide reasonable assurance of detecting (1) errors and irregularities that are material to the financial statements and (2) illegal acts that have a direct and material effect on financial statement amounts.

SAS 54 advises the auditor to maintain an awareness of the possibility that illegal acts by clients having an indirect effect on the financial statements may have occurred and may be material to the financial statements. If such possible acts are noted, the auditor must apply additional procedures.

SAS 55 requires that the auditor obtain in all audits an understanding of the internal control structure sufficient to plan the audit.

SAS 56 requires the use of analytical procedures in the planning and in the overall review stages of all audits.

SAS 57 provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates.

SAS 58 establishes a new three paragraph auditor’s standard report that must have a title that includes the word *independent*.

SAS 59 requires the auditor to evaluate whether the results of audit procedures have identified conditions or events that when considered in the aggregate indicate there could be substantial doubt about the client’s ability to continue as a going concern.

SAS 60 requires the auditor to communicate reportable conditions related to the internal control structure to the audit committee or equivalent body.

SAS 61 requires the auditor, in certain audits, 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.
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Special Reports — SAS 62

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CHAPTER 2
Special Reports — SAS 62

This chapter reviews the new guidance on special reports. Statement on Auditing Standards (SAS) No. 62 on special reports replaces SAS 14 and is effective for reports dated on or after July 1, 1989. SAS 62 makes changes to existing guidance to make the format of a special report conform to the new style auditor's standard report required by SAS 58, Reports on Audited Financial Statements. For example, each report must have a title that includes the word independent, such as “Independent Auditor’s Report.” SAS 62 also makes some changes to the prior guidance that clarify prior requirements or that provide new client service opportunities. This chapter explains the conforming changes as well as the new requirements. Changes to SAS 14 and existing practice are given special emphasis.

This chapter discusses how to —

- Identify whether a particular financial presentation qualifies as an “other comprehensive basis of accounting” (OCBOA) financial statement.
- Evaluate whether it would be desirable to put a client’s financial statements on the cash or tax basis.
- Understand the measurement, disclosure, and reporting requirements that apply to cash and tax basis financial statements.
- Determine whether a financial presentation prepared in accordance with an agreement or with regulations qualifies for special-report treatment.
- Explain the factors that should be considered in auditing specified elements, accounts, or items and prepare a report that expresses an opinion on such a presentation.
- Describe the considerations applicable to reporting on compliance with debt covenants or similar requirements.
- Decide the appropriate response to a request to complete a pre-printed form that contains assertions that are not justifiable.
This chapter also covers many practice issues that may arise in implementing SAS 62 and focuses on those matters to enable the CPA to provide each client with the types of services and reports that are best suited to the client’s needs and circumstances.

**SPECIAL REPORTS STANDARDS**

SAS 62 is the new Statement on Auditing Standards on special reports. SAS 62 is effective for reports issued on or after July 1, 1989. SAS 14 is superseded by SAS 62. There are two primary changes. First, the format of a special report was revised to conform to the new audit report as required by SAS 58. Second, the standards were revised to clarify prior requirements or to provide new client service opportunities.

SAS 62 addresses only audits of OCBOA financial statements. This chapter also illustrates reports for compilation or review of OCBOA financial statements.

**“Special Reports” Categories of Service**

“Special Reports” are those that are covered by SAS 62. Other specialized reporting situations exist that are not covered by SAS 62, for example, comfort letters to underwriters or reports on computer software. The following five broad categories of service are described in SAS 62:

1. An audit of financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles (GAAP)

2. An audit of specified elements, accounts, or items of a financial statement

3. Reporting on compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements

4. Reporting on financial information presented in prescribed forms or schedules that require a prescribed form of auditor’s report
5. Reporting on financial presentations that comply with contractual agreements or regulatory provisions (This is a new category of service, not covered in SAS 14, that was added by SAS 62.)

OCBOA FINANCIAL STATEMENTS — AN OVERVIEW

Several requirements must be met for an engagement to qualify for issuance of an SAS 62 report. One requirement is that financial statements can be prepared for the entity. (See “Definition of Financial Statements” below.) The second requirement is that the financial statements are prepared in accordance with a basis of accounting that qualifies as an OCBOA. (See “Categories of OCBOA Statements” below.)

If the auditor can issue an SAS 62 report on a presentation that qualifies as an OCBOA, the auditor need not express a qualified or adverse opinion for departure from GAAP. Further, disclosure of the monetary effect of GAAP departures is not required.

Categories of OCBOA Statements

To be recognized as an OCBOA and be suitable for the form of special report prescribed by SAS 62 for such presentations, the presentation must be one of the following:

1. Regulatory basis — A basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject. A restrictive paragraph in the report, limiting distribution to the entity and to the regulatory agency, is considered appropriate, even when by law or regulation, the auditor’s report is made a matter of public record. However, if an AICPA accounting and audit guide or an auditing interpretation issued for the particular regulated industry states that additional distribution of the report is appropriate, no restrictive paragraph is required.

2. Tax basis — A basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.
3. *Cash basis or modified cash basis* — The cash receipts and disbursements basis of accounting, and modifications of the cash basis having substantial support, such as recording depreciation on fixed assets or accruing income taxes.

4. *Definite set of criteria having substantial support* — The basis is applied to all material items appearing in the financial statements. An example of this basis is general price-level adjusted financial statements. If the set of criteria does not have substantial support (for example, current value basis), the attestation standards apply rather than SAS 62.

These four categories are not changed from SAS 14.

**Definition of Financial Statements**

A financial statement is a presentation of financial data including accompanying notes, derived from accounting records, and intended to communicate an entity’s economic resources or obligations at a point in time, or the changes therein, for a period of time in conformity with a comprehensive basis of accounting.

The auditor should consider each of the following types of financial presentations to be financial statements for reporting purposes:

- Balance sheet
- Statement of income or statement of operations
- Statement of retained earnings
- Statement of cash flows
- Statement of changes in owners’ equity
- Statement of assets and liabilities that does not include owners’ equity accounts
- Statement of revenues and expenses
- Summary of operations
- Statement of operations by product line
- Statement of cash receipts and disbursements
Entities for which financial statements may be prepared include a corporation, a consolidated group of corporations, a combined group of affiliated companies, a not-for-profit organization, a governmental unit, an estate or trust, a partnership, a proprietorship, a segment of any of the foregoing entities, and an individual.

Form of Audit Report on OCBOA Presentations

The four-paragraph unqualified auditor’s report on an OCBOA presentation should include the components discussed below.

The report should have a title that includes the word independent. The title does not have to describe the nature of the report or identify the basis of accounting used.

The first paragraph, essentially the same as the first paragraph of the auditor’s standard report prescribed by SAS 58, should state that the financial statements identified in the report were audited. It should further state that the financial statements are the responsibility of the company’s management and that the auditor is expressing an opinion on the financial statements based on the audit.

The second paragraph, essentially the same as the second paragraph of the auditor’s standard report prescribed by SAS 58, should state that the audit was conducted in accordance with generally accepted auditing standards (GAAS). It should also state that GAAS require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The paragraph includes a statement that an audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The paragraph concludes by stating that the auditor believes that his or her audit provides a reasonable basis for the opinion.

The third paragraph is an explanatory paragraph unique to a special report that states the basis of presentation and refers to the note to the financial statements that describes the basis. The note should explain how the basis of accounting qualitatively differs from GAAP, but there is no requirement to quantify the effects of the differences between GAAP and the basis of accounting used in the
financial statements. This note is usually the first note, labelled "Significant Accounting Policies."

The third paragraph also states that the basis of presentation is a comprehensive basis of accounting other than GAAP. No additional negative references about what the statements do not present are required.

The next paragraph, following the general format of the standard SAS 58 audit report, expresses the auditor’s opinion (or disclaims an opinion) on whether the financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described. If the auditor concludes that the financial statements are not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, he or she should disclose all the substantive reasons for that conclusion in one or more explanatory paragraphs (preceding the opinion paragraph) of the report and should include in the opinion paragraph the appropriate modifying language and a reference to such explanatory paragraphs.

This opinion paragraph is consistent with the SAS 58 audit report. Note the reference to materiality and the lack of reference to consistency unless there has been a change in accounting principles.

If the financial statements are prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency, a fifth paragraph is required that restricts the distribution of the report solely to those within the entity and for filing with the regulatory agency.

Many of the changes in the form of the report from the old report in SAS 14 parallel the new standard audit report prescribed by SAS 58.

In addition, the OCBOA is described simply as a comprehensive basis of accounting other than GAAP; the reference required by SAS 14 that the financial statements are not intended to present financial position and operating results in conformity with GAAP is eliminated. This way of describing the basis of presentation is intended to be less negative.

SAS 62 also clarifies that the description of the differences between GAAP and the basis of accounting used can be entirely in a note to the financial statements. The description need not be included in the audit report. SAS 14 did not explicitly require the description in the audit report, but the illustrative report is presented on cash basis financial statements included in the description in the audit report.
Exhibit 1 illustrates an audit report on an OCBOA presentation.

Exhibit 1

Audit Report — Financial Statements
Prepared on a Basis Prescribed by a Regulatory Agency
Solely for Filing With That Agency

Independent Auditor's Report

We have audited the accompanying statements of admitted assets, liabilities, and surplus-statutory basis of XYZ Insurance Company as of December 31, 19X2 and 19X1, and the related statements of income and cash flows-statutory basis and changes in surplus-statutory basis for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared in conformity with the accounting practices prescribed or permitted by the Insurance Department of [State], which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of (at) December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Insurance Company and for filing with the [name of regulatory agency] and should not be used for any other purpose.

[Signature]

[Date]
OCBOA Financial Statement Presentation and Disclosure

Financial statement titles that are generally understood to be applicable to GAAP basis presentations, such as, balance sheet, income statement, and the like, should not be used for OCBOA presentations. Examples of titles that might be appropriate for various OCBOA presentations are “statement of assets and liabilities arising from cash transactions,” “statement of revenue collected and expenses paid,” or “statement of income — statutory basis.”

A title that includes the basis of accounting with the normal title is also appropriate, for example, “balance sheet — tax basis” or “statement of income — tax basis.”

OCBOA financial statements should include in the body of the statements or in the notes disclosure of matters that would affect their use, understanding, and interpretation.

A summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from GAAP should be included. The effects of the differences need not be quantified. (This is not a change from SAS 14 but is intended to clarify the point.)

When the financial statements contain items that are the same as, or similar to, those in GAAP basis statements, then similar informative disclosures are appropriate; for example, if the statements include depreciation, the informative disclosures required by GAAP related to depreciation should be included.

There should also be disclosure of matters that may not be specifically identified on the face of the financial statements, such as related party transactions, restrictions on assets or owners’ equity, subsequent events, and uncertainties.

The 1989 AICPA Financial Statement Preparation Manual provides guidance on other comprehensive bases of accounting in its sections 11,100 through 11,700. The same information is available in a booklet in the AICPA’s series, Technical Information for Practitioners. The booklet is titled, Other Comprehensive Bases of Accounting.
**Modifications of the Four Paragraph Special Report on OCBOA Statements**

Circumstances requiring the addition of explanatory language to a special report on OCBOA statements that do not change the auditor’s opinion are identified in SAS 62 as follows:

1. *Changes in accounting principles or in the method of their application.* If there is a material inconsistency, the auditor should add an explanatory paragraph to the report (following the opinion paragraph) that describes the change and refers to the note to the financial statements that discusses the change and its effect.

2. *Uncertainties.* The auditor generally should add an explanatory paragraph after the opinion paragraph to describe an uncertainty when the OCBOA financial statements are affected by uncertainties concerning future events, the outcome of which is not susceptible of reasonable estimation at the date of the auditor’s report.

3. *Going-concern uncertainties.* If the auditor has substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the financial statements, the auditor should add an explanatory paragraph after the opinion paragraph of the report, but only if the auditor’s substantial doubt is relevant to the presentation.

4. *Using the work and reports of other independent auditors.* When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, the auditor should disclose that fact in the introductory paragraph of the report and should refer to the report of the other auditors in expressing his or her opinion.

5. *Changes in a prior opinion when reporting on comparative financial statements.* If the auditor expresses an opinion on prior-period financial statements that is different from the opinion he or she previously expressed on that same information, the auditor should disclose all of the substantive reasons for the different opinion in a separate explanatory paragraph preceding the opinion paragraph of the report.

The circumstances are generally similar to those requiring additional explanatory language for audit reports for GAAP statements,
identified in SAS 58. However, special considerations may arise when applying the guidance in SAS 58 for these circumstances to a special report engagement. For material uncertainties, the explanatory paragraph should be added even if the OCBOA financial statements would not be adjusted when the uncertainty is resolved. For example, settlement of a lawsuit in a future period would not cause adjustment of cash basis financial statements, but explanatory language about a significant lawsuit should be included in the auditor’s report because it is relevant to the use and understanding of the financial statements.

A lack of consistency in OCBOA financial statements caused by a change in accounting principle or in the method of applying a principle that causes a material lack of comparability in OCBOA financial statements results in application of the same consistency standard to OCBOA statements as the standard for GAAP basis financial statements.

A change in the basis of accounting is not a change in accounting principle. No additional explanatory paragraph is required. The auditor may wish to add an explanatory paragraph to highlight the difference in the basis from that used in prior years, but such a paragraph is not required. When the company issues financial statements on different bases (for example, issuing GAAP statements to a bank and OCBOA tax basis statements to partners), the auditor may wish to add an optional explanatory paragraph.

Reports on Compilation or Review of OCBOA Financial Statements

SAS 62 does not apply to compilation or review of OCBOA financial statements. Statements on Standards for Accounting and Review Services (SSARS) do not provide for a special report on OCBOA financial statements. SSARS 1 (AR section 100.04) footnote 3 states, “reference to generally accepted accounting principles in this statement includes, where applicable, another comprehensive basis of accounting.”

An interpretation of SSARS 1, codified at AR section 9100.44, explains that for OCBOA financial statements, the notes to the financial statements ordinarily would state the basis of presentation and describe how that basis differs from GAAP. If such disclosures are made appropriately, the standard form of compilation report or
review report included in SSARS 1 should be used. The accountant’s report should be modified from the SSARS 1 report appropriately to identify the accompanying financial statements. No separate explanatory paragraph about the basis is required. The compilation and review reports substitute a reference to an OCBOA for the reference to GAAP. The report contains no reference to GAAP.

A second interpretation of SSARS 1, codified as AR section 9100.44, provides examples of the language for compilation reports and review reports on OCBOA financial statements.

CASH BASIS FINANCIAL STATEMENTS

This section addresses three technical aspects of cash basis financial statements and certain considerations related to client service. Technical aspects addressed are cash basis measurement, disclosure, and reporting. The primary client service consideration is how to determine when a client would benefit from being on the cash basis.

Measurement

Cash basis financial statements include only those assets, liabilities, revenues, and expenses arising from cash transactions. All recorded transactions involve cash receipts or cash disbursements.

Modified cash basis financial statements may contain "modifications having substantial support." Determining whether a modification has substantial support requires professional judgment. There is no authoritative accounting literature on cash basis accounting. Support usually derives from common usage and practice.

Section 11,100.04 of the AICPA’s Financial Statement Preparation Manual states two criteria for determining whether a modification to the cash basis has substantial support, both of which must be met.

1. The method is equivalent to the accrual basis of accounting for the particular item. Examples are depreciating fixed assets and accruing income taxes.

2. The modification is not illogical. An example of an illogical modification is to record revenue on the accrual basis while recording purchases and other product costs on the cash basis.
Modification should generally be limited to a few significant items. If the modifications are so extensive that the financial statements are virtually the equivalent of accrual basis statements, then the accrual basis should be used. If the modified cash basis financial statements differ from accrual basis statements in only one or a few material respects, they are "virtually the equivalent of accrual basis statements." An example of statements that are virtually the equivalent of accrual basis statements is a set of financial statements that are the same as accrual basis except that material leases are not capitalized and the related obligations are not recorded. In this situation, the auditor should report on the conformity of the financial statements with GAAP and express a qualified or adverse opinion because of the departure related to material leases.

Disclosure

There should be prominent disclosure that the financial statements are prepared on the cash basis of accounting. The titles of the financial statements should be appropriate for the cash basis, for example "assets and liabilities arising from cash transactions," or "revenues collected and expenses paid."

One method of highlighting the basis of presentation is to have each page of the financial statements refer to the notes. An example of such wording is "the accompanying notes are an integral part of the financial statements."

The notes to the financial statements should contain a summary of significant accounting policies. This note should explain the cash basis and explain any modifications made to the cash basis. The accounting policies note should preferably be the first note.

Assets and Liabilities

The statement of assets and liabilities arising from cash transactions should include information on the significant assets and liabilities. Any restricted cash should be disclosed. Cash available for current operations should be presented separately. For marketable securities, the aggregate quoted market price should be disclosed. Accounts or notes receivable from officers, employees, or affiliates
should be presented separately, and the effective interest rate on notes should be disclosed.

If depreciation is recorded on fixed assets, the following should be disclosed:

- Major classes of depreciable property and equipment
- Depreciation expense for the period
- The depreciation method
- Aggregate accumulated depreciation

Leasing arrangements should be described, and future lease payments for the next five years should be disclosed. For notes payable and other debt, the interest rates, maturities, collateral, and a five-year schedule of maturity should be disclosed. Material commitments and contingencies should be disclosed, including the existence and nature of a pension plan, if any exists.

**Equity**

The needed disclosures related to the equity section of a statement of assets and liabilities arising from cash transactions depend on the nature of the entity.

For a corporation, more disclosures are required than for other entities. The disclosures for stockholder’s equity are essentially the same as those required for GAAP basis statements and include the following:

- Number of shares authorized, issued, and outstanding for each class of stock
- Par or stated value
- Rights and privileges of each outstanding class
- Existence of stock option and stock purchase plans
- Restrictions on the payment of dividends
- Changes in the components of stockholders’ equity

For a sole proprietorship or partnership, the owners’ equity section may present equity as a single line item without additional disclosures. However, more detail on partner capital is often provided.
Revenues and Expenses
The statement of revenues collected and expenses paid should address several matters. For corporations, the disclosures are primarily income tax related matters including an explanation of an unusual ratio of income tax to income before taxes, the amount of tax credits, the amounts and expiration dates of unused net operating loss, and tax credit carryovers.

For all entities, including sole proprietorships, partnerships, and other entities, as well as corporations, material events or transactions that are unusual in nature or infrequent in occurrence should be disclosed. The disclosures needed related to such events or transactions include the nature of such event or transaction and the financial effects thereof.

Other Disclosures
Additional disclosures concern matters that do not appear in the body of the financial statements. There should be disclosure of such matters as commitments and contingencies, subsequent events, related-party transactions, accounting changes, and business combinations. These types of disclosures are essentially the same as they would be for GAAP basis financial statements.

Reporting
Audit Report on Cash Basis Financial Statements
The special report expressing an opinion on cash basis financial statements should include—

1. A title that includes the word independent.

2. A first (introductory) paragraph that states that the financial statements identified in the report were audited. The auditor should use the exact titles used in the financial statements and should consider whether the titles are suitable for cash basis statements. The report should also identify the dates of the financial statements. The first paragraph also states that the
financial statements are the responsibility of the company’s management and that the auditor is expressing an opinion on the financial statements based on the audit.

3. A second (scope) paragraph that states that the audit was conducted in accordance with GAAS and that states that GAAS require the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. It also states that an audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. The second paragraph includes a statement that the auditor believes that his or her audit provides a reasonable basis for the opinion.

4. A third (special report explanatory) paragraph that states that the financial statements were prepared on the basis of cash receipts and disbursements and refers to the note to the financial statements that describes the cash basis. The paragraph further states that the basis of presentation is a comprehensive basis of accounting other than GAAP.

5. A paragraph that expresses the auditor’s opinion (or disclaims an opinion) on whether the financial statements are presented fairly, in all material respects, in conformity with the cash basis or modified cash basis of accounting as described in the notes. If the auditor concludes that the financial statements are not presented fairly on the cash basis of accounting described or if there has been a limitation on the scope of the audit, he or she should disclose all the substantive reasons for that conclusion in one or more explanatory paragraphs (preceding the opinion paragraph) of the report and should include in the opinion paragraph the appropriate modifying language and a reference to such explanatory paragraphs.

6. The manual or printed signature of the auditor’s firm.

7. Date.
Exhibit 2 presents an illustrative audit report for cash basis statements.

Compilation Reports and Review Reports on Cash Basis Financial Statements

The standard form of compilation report or review report included in SSARS 1 should be used. The accountant's report should be modified from the SSARS 1 report appropriately to identify the accompanying cash basis financial statements. No separate explanatory paragraph about the basis is required. The compilation and review reports substitute the reference to GAAP with a reference to an OCBOA, in this case, the basis of cash receipts and disbursements. The report contains no reference to GAAP.

Exhibit 3 illustrates a review report on cash basis statements. Exhibit 4 illustrates a compilation report on cash basis statements with full disclosure. Exhibit 5 illustrates a compilation report on cash basis statements with omission of substantially all disclosures.

Exhibit 2

<table>
<thead>
<tr>
<th>Audit Report — Cash Basis Statements</th>
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<tr>
<td>Independent Auditor’s Report</td>
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We have audited the accompanying statements of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of revenue collected and expenses paid for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than generally accepted accounting principles.
Exhibit 2 (continued)

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19X2 and 19X1, and its revenue collected and expenses paid during the years then ended, on the basis of accounting described in Note X.

[Signature]
[Date]

Exhibit 3  
Review Report — Cash Basis Statements

I (we) have reviewed the accompanying statement of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19XX, and the related statement of revenue collected and expenses paid for the year then ended, in accordance with standards established by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the cash basis of accounting, as described in Note X.

[Signature]
[Date]

When financial statements are prepared in accordance with a comprehensive basis of accounting other than GAAP, the notes ordinarily would state the basis of presentation and describe how that basis differs from GAAP.
Exhibit 4  
*Compilation Report — Cash Basis Statements*  
(*Full Disclosure*)

I (we) have compiled the accompanying statement of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19XX, and the related statement of revenue collected and expenses paid for the year then ended, in accordance with standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

[Signature]

[Date]

When financial statements are prepared in accordance with a comprehensive basis of accounting other than GAAP, the notes ordinarily would state the basis of presentation and describe how that basis differs from GAAP.

Exhibit 5  
*Compilation Report — Cash Basis Statements*  
(*Omission of Substantially All Disclosures*)

I (we) have compiled the accompanying statement of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19XX, and the related statement of revenue collected and expenses paid for the year then ended, in accordance with standards established by the American Institute of Certified Public Accountants. The financial statements have been prepared on the cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

A compilation is limited to presenting information in the form of financial statements that is the representation of management (owners). I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

Management has elected to omit substantially all of the informative disclosures ordinarily included in financial statements. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Company's assets, liabilities, revenue, and expenses.
Exhibit 5 (continued)

Accordingly, these financial statements are not designed for those who are not informed about such matters.

[Signature]

[Date]

Client Service Considerations

Suitability

In considering whether to recommend cash basis statements to a client, the accountant may wish to consider the factors discussed below.

Users of the Financial Statements. The cash basis is generally considered useful for small nonpublic companies for which the cost of GAAP financial statements is not beneficial in relation to the needs of likely users. For example, some lenders may expect to receive GAAP basis financial statements, and cash basis statements would not be appropriate. Many owners or managers, on the other hand, may be satisfied with cash basis statements.

Nature of the Client's Operations. This consideration influences both the choice of basis and the modifications of the cash basis that may be appropriate for the client. The number of modifications to the cash basis generally determines whether cash basis statements are appropriate. There should be relatively few significant modifications. Capital intensive entities often find it useful to capitalize the cost of fixed assets and depreciate them over their economic life. Entities that pay taxes often find it useful to accrue income taxes.

Nature of the Entity. Cash basis accounting is generally useful for estates, trusts, civic centers, student activity funds of school districts, certain professional service organizations, and individuals, such as CPAs, physicians, and attorneys.

Cash Basis vs. Tax Basis

The selection of cash basis statements over tax basis statements is influenced by the nature of the entity and the interests of the owners.
C corporations are taxable entities for which tax basis financial statements are often more suitable than cash basis statements. GAAP basis financial statements tend to be more costly to prepare. A C corporation must file federal, state, or local income tax returns in any case. A C corporation can avoid duplicate costs by using the same basis to prepare financial statements as that used to prepare the tax returns.

S corporations and partnerships may find either cash basis or tax basis statements to be useful. If tax aspects of the entity’s operations are important, tax basis financial statements may best suit the needs of the owners. For example, tax-shelter investment limited partnerships often require through the partnership agreement that the tax basis accounting be used.

**TAX BASIS FINANCIAL STATEMENTS**

The income tax basis of accounting is based on the rules and regulations for accounting for transactions under the Internal Revenue Code. This section addresses the suitability of tax basis statements for the client entity, including consideration of alternative minimum tax implications for corporate clients, as well as several tax basis related implementation issues: (1) dual role of a CPA as tax return preparer and independent auditor, reviewer, or compiler of financial statements; (2) subsequent IRS examinations and adjustments; and (3) treatment of nontaxable revenues and nondeductible expenses in tax basis financial statements. The section also addresses materiality in tax basis financial statements, disclosure issues, and reporting.

**Suitability of Tax Basis for the Client Entity**

Tax basis financial statements are suitable when statement users are primarily interested in the tax aspects of their relationship with the entity (for example, tax-shelter limited partnerships), but want more information and detail than would be provided by receipt of a copy of the entity’s tax return.

Generally, profit-oriented entities are required to maintain records of the tax basis of their assets and liabilities. Therefore, using the tax basis instead of GAAP in preparing financial statements can usually reduce overall financial reporting costs.
One factor that makes tax basis financial statements attractive to CPAs of small businesses is the increasing complexity of GAAP. This is sometimes referred to as the “standards overload.” The number and complexity of accounting standards are burdensome to many small businesses. A second factor is the increasing complexity of Internal Revenue Service regulations. The IRS continues to issue many complex regulations needed to implement the new provisions of the Tax Reform Act of 1986 (TRA '86). The time and cost of training for the CPA can be considerable. Being able to use the same basic knowledge base to prepare tax returns and financial statements is useful.

For corporate clients, the alternative minimum tax (AMT) for corporate clients may be a factor. In considering whether tax basis financial statements are appropriate for a corporate client, the CPA may wish to consider the effect of the basis used in preparing financial statements on the client’s tax liability. As discussed below, use of the tax basis in preparing financial statements may, in some cases, reduce the tax liability.

**Alternative Minimum Tax**

The basis of accounting used in preparing financial statements can have an effect on the client’s tax liabilities. The AMT provisions of TRA '86 were adopted to help ensure that a corporation earning significant economic income would not escape paying income taxes by use of various exclusions, deductions, and credits. For tax years beginning on or after January 1, 1987, corporations have had to compute tax liabilities under both the AMT system and the regular tax system and pay the larger of the two amounts.

One of the adjustments to determine alternative minimum taxable income (AMTI) for a corporation is an adjustment related to the difference between the income reported in its financial statements and its taxable income. Before 1990, a corporation will need to add a book income adjustment to regular taxable income to determine AMTI. The book income adjustment is calculated as 50 percent of the amount by which adjusted book income exceeds prebook AMTI. Book income is the net income or loss shown on an entity’s financial statements that include a balance sheet. TRA '86 assigned priorities to corporate financial statements and required use of the highest ranked statements to compute the adjustment. The priorities include four ranks.
1. **Financial statements filed with the Securities and Exchange Commission (SEC).** Generally, the SEC requires statements in conformity with GAAP, and corporations that must file with the SEC cannot achieve any economies by using tax basis financial statements.

2. **Audited financial statements used for credit purposes, reports to shareholders, or for any substantial nontax purpose.** If the corporation has audited tax basis financial statements that are used by lenders or other significant users, savings may be achieved from both lower financial reporting costs and from lower taxes.

3. **Financial statements that must be filed with federal, state, or local governments or agencies.** For this purpose, it makes no difference whether the financial statements are audited, reviewed, or compiled. If the governmental unit does not specify that GAAP basis (or another required basis of accounting) financial statements are required, tax basis financial statements may be used, and the savings may be achieved.

4. **Any financial statements prepared for a substantial nontax purpose.** If the corporation prepares financial statements in this fourth category, the corporation can elect to use earnings and profits with deductions for distributions and federal income tax as the basis for deriving book income.

In summary, unless the corporation must file with the SEC, or an important lender or other user requires GAAP basis financial statements, the corporation may be able to use tax basis financial statements to determine book income and thereby minimize the book income adjustment and reduce the likelihood of paying additional taxes and reduce financial reporting costs.

After 1990, the AMT's book income adjustment is replaced by the Adjusted Current Earnings (ACE) adjustment. The ACE adjustment is 75 percent of the difference between ACE and prebook AMTI. There are several adjustments to prebook AMTI for computation of ACE. Income items are added that are included in computing earnings and profits but that are not included in computing regular taxable income or prebook AMTI. For example, tax-exempt interest would be added. Expense items are deducted that are included in computing earnings and profits but not included in computing.
regular taxable income or prebook AMTI. For example, fines and penalties and expenses allocable to tax-exempt income would be deducted. There are also adjustments related to depreciation on fixed assets and inventories.

The foregoing enumeration of adjustments is intended to suggest the nature of the computation rather than provide definitive guidance. The Treasury has not issued final regulations, and Congress may reconsider ACE before it is scheduled to become effective.

Two parallel tax systems exist: an AMT system and a regular tax system. The tax basis of accounting is defined by SAS 62 as "a basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements." Does this mean that the client should prepare financial statements on the regular tax system basis when no additional taxes are payable due to the AMT and use the AMT system in years when such taxes are payable?

There is no authoritative literature for tax basis accounting; the decision involves interpretation and judgment. The usefulness of tax basis financial statements would probably be improved by consistently using the regular tax system to prepare financial statements. In years when additional taxes are payable because of the AMT provisions, that information and the amount of the tax expense and liability attributable to AMT should be disclosed.

A situation may arise in which no additional taxes due to AMT provisions would be payable except for the book income or ACE adjustment. In that case, tax savings would result from using the AMT system to prepare the financial statements. However, if that were done, no additional taxes would be due, and the tax liability would be computed under the regular tax system. Since there are other AMT adjustments, the book income or ACE adjustment will not necessarily be the deciding factor in determining whether additional taxes are owed.

It is likely that in enacting the book income and ACE provisions, Congress was not aware of the fact that OCBOA rather than GAAP financial statements might be the primary financial statements for a nonpublic company. This is likely to be an area of controversy between the IRS and taxpayers. The CPA may wish to consult with the client regarding the possibility of IRS challenge and determine how aggressive a position the client wishes to take.
Implementation Issues

Dual Role of CPA as Tax Return Preparer and Independent Auditor, Reviewer, or Compiler of Financial Statements

When a CPA reports on tax basis financial statements without modifying the report, the CPA believes that the tax accounting in the financial statements represents acceptable tax practice. The tax laws and regulations constitute the criteria against which the CPA is reporting when issuing a special report on tax basis financial statements.

Generally, accountants believe that the standard for judging acceptable tax practice should not change simply because tax accounting is also the basis used to prepare financial statements. Many accountants use the following rule of thumb: A CPA may conclude that financial statements reflect acceptable tax practice if a tax return preparer, with knowledge of all information brought to light during an audit, review, or compilation, would be willing to sign the tax return as preparer.

Subsequent IRS Examination and Adjustment

An IRS examination may occur at a future time, and an adjustment of taxable income and the tax liability may result. The treatment of an adjustment resulting from an IRS examination is different when the financial statements are on the tax basis than it is when the statements conform with GAAP. If the IRS disallows amounts charged to expense in prior years or requires recognition of previously unrecognized revenue, these tax adjustments should be treated as prior-period adjustments in tax basis financial statements. If the years in question are presented, they should be restated. If the years in question are prior to the earliest period presented, the effect on the earliest period should be recognized by adjusting the assets or liabilities affected and beginning owners’ equity.

Because of the potential adjustment that could result from an IRS examination, a note disclosure such as the following is usually advisable.

The corporation prepares its financial statements in conformity with methods of accounting it considers appropriate for federal income tax reporting. As with all tax presentations, these tax accounting methods are subject to review and possible adjustment by the Internal Revenue Service.
This disclosure can be incorporated in the note on significant accounting policies that describes the basis of accounting used to prepare the financial statements.

When an IRS examination is actually in progress or is expected, additional disclosure may be appropriate.

**Treatment of Nontaxable Revenues and Nondeductible Expenses**

Certain revenues, such as interest on state or local government bonds, are not taxable, and certain expenses, such as premiums on company officers' life insurance policies, are not deductible. Common practice is to include these items in tax basis financial statements even though they do not enter into the determination of taxable income. Generally, all significant sources of revenue and expense should be included in the tax basis income statement.

**Materiality in Tax Basis Financial Statements**

Generally, it is well-accepted that the measure of significance, or materiality, is lower for tax purposes than it is for GAAP basis financial statements. The Internal Revenue Code and regulations do not explicitly recognize the concept of materiality, and tax return preparation, as a result, has usually involved more exacting measurements than those considered necessary for preparing financial statements. However, materiality is used for both accounting and auditing purposes, that is —

- Materiality is used in evaluating financial statement presentation and disclosure.
- Materiality is used in making decisions about the necessary scope of auditing procedures to detect a material misstatement.

In evaluating financial statement presentation and disclosure for tax basis financial statements, it is probably appropriate to use the same threshold of materiality that would be used for tax return preparation. Generally, this would mean that amounts considered material to tax basis financial statements would be lower (more exacting) than for comparable GAAP basis financial statements. This does not mean that an audit of tax basis financial statements must be more extensive than an audit of GAAP basis financial statements.
In making decisions about the necessary scope of auditing procedures, the amount considered material when planning the audit of tax basis financial statements is likely to be very similar to the amount considered material to GAAP basis financial statements. SAS 47, Audit Risk and Materiality in Conducting an Audit, recognizes that the auditor may decide to insist on an audit adjustment or a disclosure even though the scope of the audit was not planned to detect misstatements of that size. That is, the amount used as the preliminary judgment about materiality in planning the audit may be different than the amount considered material when evaluating the financial statements. Planning materiality for a tax basis financial statement audit may be similar to that for planning an audit of GAAP basis statements, while the materiality amount used in evaluating tax basis financial statement presentation and disclosure can be a lower amount (that is consistent with tax preparation decision making).

**Disclosure for Tax Basis Financial Statements**

**Basis and Significant Accounting Policies**

There should be prominent disclosure that the financial statements are prepared on the income tax basis of accounting. This can be accomplished by using the term *tax basis* in the titles of the financial statements (such as "balance sheet — tax basis"). Also, a legend could be included that refers to the notes to the financial statements on each page of the financial statements, such as "the accompanying notes are an integral part of the financial statements."

The notes to the financial statements should preferably begin with a summary of significant accounting policies. This note should include an explanation that the financial statements are prepared on the basis of accounting that the company expects to use to file its income tax return for the period, and it should indicate whether the basic method of accounting is cash or accrual. If the entity is other than a normal taxable corporation, the tax filing status should be disclosed. The note should explain that the tax basis means that revenues and related expenses are recognized when they are reported or deducted for federal income tax purposes. Any nontaxable income or nondeductible expenses that are included in the determination of income should be disclosed. If any optional tax methods of accounting are used, their nature should be disclosed. The nature of any important judgments or policies necessary for an understanding of
the methods of recognizing revenue or allocating costs to current and future periods should be disclosed. The nature of the differences between the income tax basis and GAAP should be disclosed, but there is no need to quantify those differences. As mentioned earlier, it is advisable to disclose that the tax accounting methods used are subject to review and possible adjustment by the IRS.

Accounting Changes

Any accounting changes made for the period should be identified, and the nature and effect on income should be disclosed. Under the tax basis, accounting changes can be treated differently than under GAAP. The effect of an accounting change, for tax purposes, may be recognized prospectively over a ten-year period.

In the year of the change, the total effect should be recorded in the tax basis balance sheet, and the amount should be amortized over the ten-year period.

Other Disclosures

When they could affect the use and understanding of the tax basis financial statements, there should be disclosure of such matters as contingencies, uncertainties, subsequent events, and related-party transactions.

These types of disclosures may be influenced by the nature of the income tax basis of accounting. For example, when an IRS examination is in process or is expected and it is reasonably possible that adjustments material to the financial statements could be required, that uncertainty should be disclosed. Also, the auditor should consider whether it is necessary to add an explanatory paragraph to the audit report to highlight the uncertainty. In this case, the paragraph highlighting the uncertainty would be the final paragraph of the special report.

Assets and Liabilities

There should be informative disclosure about the assets and liabilities in the tax basis financial statements. Restricted cash should be segregated from cash available for current operations, and the nature of the restriction should be described. The aggregate quoted market price of investments in marketable securities should be disclosed. Any accounts or notes receivable from officers, employees, or
affiliates should be presented separately, and the terms, including the effective interest rate of notes receivable, should be disclosed. The inventory method should be described. The major classes of depreciable fixed assets should be identified, and for each class there should be disclosure of the methods used for computing depreciation, depreciation expense, and the aggregate accumulated depreciation.

The existence and nature of a pension plan and related commitments should be disclosed. A lessee should disclose the general terms of the leasing arrangement and the future lease payments for five years. For notes payable and other debt, there should be disclosure of interest rates, maturities, collateral, and a five-year schedule of maturity.

Owners’ Equity
The information disclosed about owners’ equity depends on the nature of the entity. For a corporation, there should be disclosure of the number of shares authorized, issued, and outstanding, the par or stated value, the pertinent rights and privileges for each class of stock, any restrictions on payments of dividends, and changes in separate components of stockholders’ equity during the period.

For S corporations, there are additional disclosure considerations for the stockholders’ equity section of the financial statements. Because the income of an S corporation is taxable to its stockholders, an S corporation may be required to maintain information on distinct classes of retained earnings. In tax basis financial statements, however, S corporations may report retained earnings as a single amount. Distributions to stockholders should be recorded as dividends.

Income and Expense
There should be informative disclosure about the income and expense in the tax basis income statement. The nature and financial effects of material events or transactions that are unusual in nature or of infrequent occurrence should be disclosed. Tax related matters that should be disclosed include the amount and expiration dates of unused net operating loss and tax credit carryovers; the amount of tax credits; and, if applicable, an explanation if income tax is not provided or if there is an unusual relationship between income before taxes and income taxes.

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Statements

Under GAAP, when a balance sheet and income statement are presented, a statement of cash flows is also required. However, for tax basis financial statements, a statement of cash flows is not required. If a CPA believes that such a statement would provide useful information to users, a statement of cash flows may be presented.

Reporting

Audit Report on Tax Basis Financial Statements

The special report expressing an opinion on tax basis financial statements should include—

1. A title that includes the word independent.

2. A first (introductory) paragraph that states that the financial statements identified in the report were audited. The auditor should use the exact titles used in the financial statements and should consider whether the titles are suitable for tax basis statements. The report should also identify the dates of the financial statements. The first paragraph should also contain a statement that the financial statements are the responsibility of the company's management and that the auditor is expressing an opinion on the financial statements based on the audit.

3. A second (scope) paragraph that states that the audit was conducted in accordance with GAAS and that GAAS require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The paragraph should indicate that an audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The paragraph should also state that the auditor believes that his or her audit provides a reasonable basis for the opinion.

4. A third (special report explanatory) paragraph that states that the financial statements were prepared on the basis of accounting that the entity uses for income tax purposes and refers to the
note to the financial statements that describes the income tax basis. The paragraph should explain that the basis of presentation is a comprehensive basis of accounting other than GAAP.

5. A paragraph that expresses the auditor’s opinion (or disclaims an opinion) on whether the financial statements are presented fairly, in all material respects, in conformity with the basis of accounting as described in the notes. If the auditor concludes that the financial statements are not presented fairly on the tax basis of accounting described or if there has been a limitation on the scope of the audit, he or she should disclose all the substantive reasons for that conclusion in one or more explanatory paragraphs (preceding the opinion paragraph) of the report and include in the opinion paragraph the appropriate modifying language and a reference to such explanatory paragraphs.

6. The manual or printed signature of the auditor’s firm.

7. Date.

Exhibit 6 presents an illustrative audit report for tax basis statements.

Exhibit 6  
Audit Report — Income Tax Basis Statements

Independent Auditor’s Reports
We have audited the accompanying statements of assets, liabilities, and capital—income tax basis of ABC Partnership as of December 31, 19X2 and 19X1, and the related statements of revenue and expenses—income tax basis and of changes in partners’ capital accounts—income tax basis for the years then ended. These financial statements are the responsibility of the Partnership’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
Exhibit 6 (continued)

As described in Note X, these financial statements were prepared on the basis of accounting the Partnership uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and capital of ABC Partnership as of (at) December 31, 19X2 and 19X1, and its revenue and expenses and changes in partners’ capital accounts for the years then ended, on the basis of accounting described in Note X.

[Signature]

[Date]

Going-Concern and Tax Basis Statements

Before the issuance of SAS 59, some accountants believed that doubt about a company’s status as a going concern indicated uncertainty about whether the going-concern basis or the liquidation basis was appropriate for preparing financial statements. These accountants maintained that since tax laws and regulations did not permit a choice between the going-concern and liquidation basis, there was no conceptual support for a going-concern report modification on tax basis financial statements.

This issue was addressed by SAS 59 on consideration of going-concern status in an audit. SAS 59 indicated that the going-concern concept applies to both GAAP basis and OCBOA financial statements. Accordingly, the auditor should evaluate whether there is substantial doubt about the company’s ability to continue as a going concern. If there is substantial doubt, the auditor should add an additional paragraph to the report when reporting on an audit of tax basis financial statements.

Changes in Tax Laws and Reporting on Tax Basis Statements

Another reporting issue is whether a change in the tax law constitutes a change in accounting principle that under the consistency standard requires the addition of an explanatory paragraph that refers to the change.
The tax basis of accounting is based on the rules and regulations for accounting for transactions under the Internal Revenue Code. Thus, some accountants have argued that a change in the tax law is the equivalent of a change in accounting principle under GAAP.

SAS 62 addresses this issue explicitly. A footnote explains that “a change in the tax law is not considered a change in accounting principle for which the auditor would need to add an explanatory paragraph, although disclosure may be necessary.”

Compilation Reports and Review Reports on Tax Basis Statements

The standard form of compilation report or review report included in SSARS 1 should be used. The accountant’s report should be modified from the SSARS 1 report appropriately to identify the accompanying tax basis financial statements.

No separate explanatory paragraph about the basis is required. The compilation and review reports substitute the reference to GAAP with a reference to an OCBOA, in this case, the basis of accounting that the entity uses for income tax purposes. The report contains no reference to GAAP.

Exhibit 7 illustrates a review report on tax basis financial statements. Exhibit 8 illustrates a compilation report on tax basis financial statements with full disclosure. Exhibit 9 illustrates a compilation report on tax basis financial statements with omission of substantially all disclosures.

Exhibit 7 Review Report — Income Tax Basis Statements

I (we) have reviewed the accompanying statements of assets and liabilities — income tax basis of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of revenue and expenses — income tax basis and retained earnings — income tax basis for the years then ended, in accordance with standards established by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the
Exhibit 7 (continued)

objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the income tax basis, as described in Note X.

[Signature]

[Date]

Exhibit 8 Compilation Report — Income Tax Basis Statements
(Full Disclosure)

I (we) have compiled the accompanying statements of assets and liabilities—income tax basis of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of revenue and expenses—income tax basis for the years then ended, in accordance with standards established by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

[Signature]

[Date]

Exhibit 9  Compilation Report — Income Tax Basis Statements
(Omission of Substantially All Disclosures, With No Reference to Basis)

I (we) have compiled the accompanying statements of assets and liabilities—income tax basis of XYZ Company as of December 31, 19X2 and 19X1, and the related statements of revenues and expenses—income (continued)
Exhibit 9 (continued)

tax basis for the years then ended, in accordance with standards established by the American Institute of Certified Public Accountants. The financial statements have been prepared on the accounting basis used by the Company for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying financial statements, and accordingly, do not express an opinion or any form of assurance on them.

Management has elected to omit substantially all of the disclosures ordinarily included in financial statements prepared on the income tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the Company’s assets, liabilities, revenue, and expenses. Accordingly, these financial statements are not designed for those who are not informed about such matters.

[Signature]

[Date]

SPECIAL AND INCOMPLETE PRESENTATIONS

Reports on special-purpose presentations were not dealt with explicitly in SAS 14. However, after SAS 14 was issued, a variety of implementation problems arose in practice related to special or incomplete presentations and these matters were explained in auditing interpretations of SAS 14. This topic is now addressed explicitly in SAS 62, and the form of report is less negative and the reporting guidance is more tailored to the nature of these special-purpose engagements.

This section addresses the following areas related to special-purpose presentations:

• Applicability — Which engagements involve special-purpose presentations?
• Materiality
Applicability

This section applies to engagements involving special-purpose financial presentations prepared to comply with contractual agreements or regulatory provisions. SAS 62 divides these engagements into two broad categories: incomplete presentations and special-purpose complete presentations.

1. Special-purpose incomplete presentations — a financial presentation that is based on measurement of assets, liabilities, revenues, and expenses in conformity with GAAP or an OCBOA, but the presentation does not constitute a complete set of financial statements or a complete individual financial statement. One example of this category of presentation is an agreement on the sale of a business may require that assets and liabilities be presented in conformity with GAAP but that the presentation include only those assets and liabilities being sold and transferred. The presentation is incomplete, but the assets and liabilities presented are measured properly in conformity with GAAP. A second example of this category of presentation is a common type of presentation for rental real estate operations. The schedule presents the excess of gross income over defined expenses in which expenses are defined to exclude certain items such as interest, depreciation, and income taxes.

2. Special-purpose complete presentations — a complete presentation of financial statements or a complete individual financial statement prepared on a basis of accounting prescribed in an agreement that is neither in conformity with GAAP nor an OCBOA. An example is an agreement on the sale of a business that requires the financial statements of the seller to be prepared in conformity with GAAP except for certain assets, such as receivables or as inventories, for which valuation basis is specified in the agreement.

The types of engagements covered in other sections of this chapter sound similar and can be confusing. An “incomplete presentation” does not include presentations of specified elements, accounts, or items. These are covered in the next section.
The section "Compliance With Agreements or Regulations," later in this chapter, addresses reporting in connection with an audit of financial statements. Such reports do not involve separate presentations. This section covers reporting on special and incomplete presentations in connection with agreements or regulations.

Materiality

Special-Purpose Incomplete Presentations

What materiality base is appropriate for an incomplete presentation?

The CPA is reporting on the overall presentation, but that presentation is neither a financial statement nor a specified element, account, or item of a financial statement. If the auditor had to audit and express an opinion on each amount in the presentation, the scope of work would have to be extensive. SAS 62 resolves this issue by treating this type of presentation as equivalent to a financial statement.

Both materiality for establishing audit scope and materiality for evaluating the measurement and disclosure of the presentation should be established in relation to the presentation taken as a whole, not in relation to its individual components. For example, if the auditor is engaged to audit and report on a schedule of assets and liabilities sold or transferred in a business acquisition, the preliminary judgment about materiality used in planning the audit might be based on the total of the assets included in the schedule.

Special-Purpose Complete Presentations

As with other complete presentations, materiality should be established in relation to the presentation taken as a whole.

Presentation and Disclosure

SAS 62 indicates that the presentation should differ from complete financial statements only to the extent necessary to meet the special purpose for which it was prepared. In other respects, the presentation should be in conformity with the GAAP or OCBOA applicable to the presentation.

For those items in the presentation that are the same as, or similar to, those contained in complete financial statements prepared in
conformity with GAAP, informative disclosures similar to those required by GAAP should be made.

The presentation should be suitably titled to avoid any implication that it is intended to present financial position, results of operations, or cash flows.

**Reporting**

**Audit Report on an Incomplete Presentation**

The special report expressing an opinion on an incomplete presentation is normally five paragraphs and should include —

1. A title that includes the word *independent*.

2. A first (introductory) paragraph that states that the presentation identified in the report was audited. The auditor should use the exact title used in the presentation and should consider whether the title is suitable for the presentation. The report should also identify the date of the presentation. The paragraph should also state that the presentation is the responsibility of the company's management and that the auditor is expressing an opinion on the presentation based on the audit.

3. A second (scope) paragraph that states that the audit was conducted in accordance with GAAS and indicates that GAAS require that the auditor plan and perform the audit to obtain reasonable assurance about whether the presentation is free of material misstatement. The paragraph further states that an audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the presentation; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The paragraph further states that the auditor believes that his or her audit provides a reasonable basis for the opinion.

4. A third (explanatory) paragraph that explains what the presentation is intended to present. If the incomplete presentation is in conformity with GAAP, the paragraph states that the presentation is not intended to be a complete presentation of the entity's assets, liabilities, revenues, and expenses. If the incom-
plete presentation was prepared in conformity with an OCBOA, the paragraph states that the presentation is a comprehensive basis of accounting other than GAAP and that it is not intended to be a complete presentation of the entity’s assets, liabilities, revenues, and expenses. The third paragraph also refers to the note to the presentation that describes the basis of the presentation. Whether the presentation is presented in accordance with GAAP or an OCBOA, the third paragraph should both describe what the special-purpose presentation is intended to present, as well as state that it is not intended to be a complete presentation of assets, liabilities, revenues, and expenses.

5. A paragraph that expresses the auditor’s opinion (or disclaims an opinion) on whether the presentation is presented fairly, in all material respects, in conformity with GAAP or the OCBOA as described in the notes. If the auditor concludes that the presentation is not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, he or she should disclose all the substantive reasons for that conclusion in one or more explanatory paragraphs (preceding the opinion paragraph) and should include appropriate modifying language and a reference to the explanatory paragraph in the opinion paragraph.

6. The fifth and final paragraph in a special report with an unqualified opinion on an incomplete presentation is a restrictive paragraph. It should restrict distribution of the report to those within the entity and to the parties to the contract or agreement or to those with whom the entity is directly negotiating a contract or agreement. In some cases, the report may be intended for filing with a regulatory agency and the paragraph should restrict use of the report to that purpose.

SAS 62 provides one major exception to the normal requirement for a restrictive paragraph for this type of presentation. A restrictive paragraph is not appropriate when the report and related financial presentation are to be filed with a regulatory agency (for example, the SEC), and are to be included in a document, such as a prospectus that is distributed to the general public. This exception relates to real estate operations. This exception appears to be a practical recognition that an SEC filing is a public document; the SEC has deemed the
incomplete presentation to be appropriate in the circumstances, and a restrictive paragraph would not be meaningful.

7. The manual or printed signature of the auditor’s firm.

8. Date.

Exhibits of illustrative audit reports for incomplete presentations are presented in this chapter: Exhibit 10 illustrates a report on a schedule of gross income and certain expenses to meet a regulatory requirement and to be included in a document distributed to the general public. Exhibit 11 illustrates a report on a statement of assets sold and liabilities transferred to comply with a contractual agreement.

**Exhibit 10**  
**Audit Report on an Incomplete Presentation**  
**Report on a Schedule of Gross Income and Certain Expenses to Meet a Regulatory Requirement and to Be Included in a Document Distributed to the General Public**

*Independent Auditor's Report*

We have audited the accompanying Historical Summaries of Gross Income and Direct Operating Expenses of ABC Apartments, City, State (Historical Summaries), for each of the three years in the period ended December 31, 19XX. These Historical Summaries are the responsibility of the Apartments’ management. Our responsibility is to express an opinion on the Historical Summaries based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Historical Summaries are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Historical Summaries. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Historical Summaries. We believe that our audits provide a reasonable basis for our opinion.

The accompanying Historical Summaries were prepared for the purpose of complying with the rules and regulations of the Securities and Exchange Commission (for inclusion in the registration statement on Form S-11 of DEF Corporation) as described in Note X and are not intended to be a complete presentation of the Apartments’ revenues and expenses.

*(continued)*
Exhibit 10 (continued)

In our opinion, the Historical Summaries referred to above present fairly, in all material respects, the gross income and direct operating expenses described in Note X of ABC Apartments for each of the three years in the period ended December 31, 19XX, in conformity with generally accepted accounting principles.

[Signature]

[Date]

Exhibit 11  Audit Report on an Incomplete Presentation —
Report on a Statement of Assets Sold and Liabilities Transferred
to Comply With a Contractual Agreement

Independent Auditor’s Report

We have audited the accompanying statement of net assets sold of ABC Company as of June 8, 19XX. This statement of net assets sold is the responsibility of ABC Company’s management. Our responsibility is to express an opinion on the statement of net assets sold based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statement of net assets sold is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statement of net assets sold. We believe that our audit provides a reasonable basis for our opinion.

The accompanying statement was prepared to present the net assets of ABC Company sold to XYZ Corporation pursuant to the purchase agreement described in Note X, and is not intended to be a complete presentation of ABC Company’s assets and liabilities.

In our opinion, the accompanying statement of net assets sold presents fairly, in all material respects, the net assets of ABC Company as of June 8, 19XX sold pursuant to the purchase agreement referred to in Note X, in conformity with generally accepted accounting principles.
Exhibit 11 (continued)

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and XYZ Corporation and should not be used for any other purpose.

[Signature]

[Date]

Audit Report on a Special-Purpose Complete Presentation

The special report expressing an opinion on a complete presentation, prepared in accordance with an agreement rather than GAAP or an OCBOA, is normally five or six paragraphs and should include—

1. The title, first (introductory) paragraph, and second (scope) paragraph that are the same as those for the report on incomplete presentations described above.

2. The third (explanatory) paragraph that explains what the presentation is intended to present. It should refer to the note to the special-purpose presentation that describes the basis of the presentation and states that the special-purpose presentation is not intended to be a presentation in conformity with GAAP.

3. After the explanatory paragraph on the nature of the presentation, an additional paragraph may be necessary. This paragraph should describe the source of significant interpretations made by management relating to the provisions of the agreement. For example, certain provisions of the agreement may seem ambiguous when management attempts to prepare the special-purpose financial statements, and management may need to interpret these provisions in order to be able to prepare the statements.

4. The next paragraph expresses the auditor’s opinion (or disclaims an opinion) on whether the presentation presents fairly, in all material respects, the information the presentation is intended to present on the basis of accounting specified.

5. In some cases, an unqualified opinion may not be possible. The auditor may conclude that the information is not presented
fairly on the basis of accounting described or there may have been a limitation on the scope of the audit. In these circumstances, the auditor should disclose all substantive reasons for the conclusion in one or more explanatory paragraphs (preceding the opinion paragraph) and include in the opinion paragraph appropriate modifying language and a reference to the explanatory paragraph.

6. The final paragraph for a report on this type of special-purpose presentation is always a restrictive paragraph. It should restrict distribution of the report to those within the entity, to the parties to the contract or agreement, for filing with a regulatory agency, or to those with whom the entity is directly negotiating a contract or agreement.

Exhibit 12 presents illustrative wording for an audit report for a special-purpose complete presentation.

**Exhibit 12  Report on a Special-Purpose Complete Presentation**

*Not in Conformity With GAAP or OCBOA — Report on Financial Statements Prepared Pursuant to a Loan Agreement That Results in a Presentation Not in Conformity With GAAP or an OCBOA*

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**Independent Auditor’s Report**

We have audited the special-purpose statement of assets and liabilities of ABC Company as of December 31, 19X2 and 19X1, and the related special-purpose statements of revenues and expenses and of cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying special-purpose financial statements were prepared for the purpose of complying with Section 4 of a loan agreement between DEF
Exhibit 12 (continued)

Bank and the Company as discussed in Note X, and are not intended to be a presentation in conformity with generally accepted accounting principles.

In our opinion, the special-purpose financial statements referred to above present fairly, in all material respects, the assets and liabilities of ABC Company as of December 31, 19X2 and 19X1, and the revenues, expenses and cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and DEF Bank and should not be used for any other purpose.

[Signature]
[Date]

Changes From SAS 14 and Its Interpretations

Even though the agreement does not qualify as an OCBOA, the auditor is not required to express a qualified or adverse opinion on the presentation because of the GAAP departures.

There is no requirement to quantify the effect of the differences between the presentation in accordance with an agreement and GAAP.

The changes increase the opportunity to serve clients. One rationale for having SAS 62 permit this new service is that the only parties who are likely to be interested in the conformity of a presentation with an agreement are those with some interest in and knowledge of the agreement. The restrictive paragraph limits distribution to these parties.

Compilation and Review of Special-Purpose Incomplete and Complete Presentations

The accountant’s involvement with incomplete and special-purpose presentations is a new type of service, and questions concerning similar engagements involving a scope of work less extensive than an audit have not arisen, but they can certainly be expected. The guidance in SAS 62 on the presentation and disclosure of the information
would seem to be equally applicable to a compilation or review engagement.

Previously, a report on an incomplete presentation or a complete presentation prepared in conformity with an agreement rather than GAAP or an OCBOA could be furnished only if an audit of the information was performed. Now differences between an agreement and GAAP do not have to be quantified, and the CPA does not have to express a qualified or adverse opinion on the information. Why couldn’t an accountant compile or review such a presentation? At this point there is no authoritative guidance that indicates that a compilation or review engagement is permissible.

An accountant undertaking a compilation or review engagement for a special or incomplete presentation would be well-advised to consider carefully the application of the guidance in SAS 62 to the circumstances of the engagement.

SPECIFIED ELEMENTS, ACCOUNTS, OR ITEMS

The authoritative guidance regarding this category of service was carried forward from SAS 14 to SAS 62 with a few changes.

“Specified elements, accounts, or items” are components, segments, or parts of a financial statement. The term element as used in this category of service is not defined as the term element used in the Financial Accounting Standards Board’s Statements of Concepts. A specified element, account, or item may be a single line item from financial statements or include several related items. Examples of specified elements, accounts, or items include rentals, royalties, profit participations, provision for income taxes, stockholders’ equity, accounts receivable, and current liabilities. These are only examples and do not constitute an enumeration of all possible specified elements, accounts, or items.

Types of Services for Reporting on Specified Elements, Accounts, or Items

- Expression of an opinion based on an audit in accordance with GAAS. This is the service addressed by SAS 62.
• *Report based on applying agreed-upon procedures*. SAS 35 (AU section 622) applies to this type of engagement, and the guidance is not modified by SAS 62.

• *Report based on a review*. Statements on Standards for Attestation Engagements (AU section 2010) applies to this type of engagement.

**Guidance on the Scope of the Audit for Expressing an Opinion**

**General Guidance**

SAS 62 states “When expressing an opinion on one or more specified elements, accounts, or items of a financial statement, the auditor should plan and perform the audit and prepare his or her report with a view to the purpose of the engagement.” All GAAS, except the first standard of reporting, apply.

Generally, SASs are written in the context of audits of complete financial statements. To interpret the meaning and significance of all of these pronouncements in an audit of a specified element, account, or item, it is necessary to keep in mind the purpose of the engagement. For example, there is an AU section on related-party transactions that suggests audit procedures that should be applied to identify related parties. Not all of these procedures would be applicable in the audit of specified elements, accounts, or items. However, if the auditor has been engaged to audit and express an opinion on accounts receivable, the auditor would want to identify for separate disclosure any receivables from officers, employees, or affiliates.

The first standard of reporting is the one auditing standard that does not necessarily apply to audits of specified elements, accounts, or items. This standard requires the auditor to state in his or her report whether the financial statements are presented in conformity with GAAP. However, when the specified element, account, or item is intended to be in conformity with GAAP then the first standard of reporting does apply.

The consistency standard is applicable to a report on a specified element, account, or item whether the basis of accounting is GAAP or an OCBOA. This is a change from SAS 14. Now when there is a
material change in accounting principle or method of application, a special-purpose report on a specified element, account, or item will need to include an additional paragraph after the opinion paragraph that describes the change.

**Materiality**

Materiality should be related to each individual element, account, or item reported on rather than to the aggregate thereof or to the financial statements taken as a whole. The auditor is expressing an individual opinion on each of the specified elements, accounts, or items identified in the report. Therefore, an audit of a specified element, account, or item is usually more extensive than if the same information were being considered in conjunction with an audit of the financial statements taken as a whole.

**Interrelationships Among Items**

The interrelationships among financial statement items should be considered by the auditor. For example, auditors generally recognize that relationships will exist among sales and receivables, inventories and payables, and fixed assets and depreciation.

The auditor should be satisfied that elements, accounts, or items that are interrelated with those on which he or she has been engaged to express an opinion have been considered. For example, an auditor engaged to audit a schedule of accounts receivable may decide that it is necessary to apply procedures to revenue, even though the auditor is not reporting on revenue.

**Limitations on Use of Report Form**

**Report Equivalent to Piecemeal Opinion**

The auditor should not express an opinion on specified elements, accounts, or items included in financial statements on which he or she has expressed an adverse opinion or disclaimed an opinion if the report would be tantamount to expression of a piecemeal opinion on the financial statements.

A piecemeal opinion is a prohibited form of reporting. Before it was banned in 1972, the piecemeal reporting approach was often used when the auditor expressed an adverse opinion or disclaimed an opinion. The piecemeal opinion enumerated and expressed positive
assurance on all those items in the financial statements that were not affected by the cause of the adverse opinion or disclaimer.

This does not mean that the auditor is prohibited from expressing an opinion on one or more specified elements, accounts, or items when he or she has expressed an adverse opinion or disclaimed an opinion. The auditor needs to consider the extensiveness of the elements, accounts, or items so as to determine whether they encompass a major portion of the financial statements. For example, it may be appropriate for an auditor to express an opinion on a schedule of accounts receivable even though the auditor has disclaimed an opinion on financial statements that contain that accounts receivable balance. However, the cause of the disclaimer should not be a scope limitation related to accounts receivable. Also, the report on the specified element, account, or item should be presented separately from the report on the financial statements of the entity.

**Circumstances Requiring an Audit of the Complete Financial Statements**

SAS 62 states that if a specified element, account, or item is, or is based on, an entity’s net income or stockholder’s equity or the equivalent thereof, the auditor should have audited the complete financial statements to express an opinion on a specified element, account, or item.

For other engagements, SAS 62 continues the notion that an engagement to express an opinion on a specified element, account, or item may be undertaken as a special engagement or in conjunction with an audit of financial statements. However, for net income, stockholders’ equity, or the equivalent, the engagement may be undertaken only in conjunction with an audit of the complete financial statements.

SAS 14 indicated that expression of an opinion on a profit participation or on the provision for income taxes should be undertaken only in conjunction with an audit of the financial statements containing those items. SAS 62 extends this restriction to many other types of specified elements, accounts, or items.

**Reporting**

The special report expressing an opinion on one or more specified elements, accounts, or items should include —
1. A title that includes the word *independent*.

2. A first (introductory) paragraph that states the specified elements, accounts, or items identified in the report were audited. If the audit was made in conjunction with an audit of the company’s financial statements, the paragraph should so state and indicate the date of the auditor’s report on those financial statements. Furthermore, any departure from the standard report on those statements should also be disclosed if considered relevant to the presentation of the specified element, account, or item.

   The auditor should consider the effect of any departure on the ability to report on the specified element, account, or item. For example, a failure to observe a physical inventory that resulted in a disclaimer on the financial statements would affect a report on inventories, cost of sales, and net income.

   The first paragraph should also state that specified elements, accounts, or items are the responsibility of the company’s management and that the auditor is expressing an opinion on the financial statements based on the audit.

3. A second (scope) paragraph that states that the audit was conducted in accordance with GAAS and that GAAS require that the auditor plan and perform the audit to obtain reasonable assurance about whether the specified elements, accounts, or items are free of material misstatement. The second paragraph further states that an audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the presentation of the specified elements, accounts, or items; assessing the accounting principles used and significant estimates made by management; and evaluating the overall presentation of the specified elements, accounts, or items. Also, the paragraph contains a statement that the auditor believes that his or her audit provides a reasonable basis for the opinion.

4. SAS 62 acknowledges that in this type of report the auditor may wish to provide more information about the scope of the audit than is provided by the standard paragraph. However, the standard paragraph should not be modified. If additional detail on the scope of the audit is to be provided, that should be accomplished by adding a separate paragraph that describes the other auditing procedures applied.
5. An explanatory paragraph that describes the basis on which the specified elements, accounts, or items are presented, and when applicable, any agreements specifying such basis, if the presentation is not prepared in conformity with GAAP. SAS 62 permits this information concerning the basis of accounting to be included in the introductory paragraph if the auditor wishes. However, as a practical matter, a separate paragraph would be advisable unless the basis of accounting is GAAP. The reference to GAAP is short and straightforward. Information on another basis of accounting would overburden the introductory paragraph.

The explanatory paragraph contains a reference to the note to the financial statements that describes the basis. If considered necessary, the report paragraph includes a description and source of significant interpretations, if any, made by the company’s management relating to the provisions of a relevant agreement.

6. A paragraph that expresses the auditor’s opinion (or disclaims an opinion) on whether the specified elements, accounts, or items are presented fairly, in all material respects, in conformity with the basis of accounting as described in the notes. If the auditor concludes that the specified elements, accounts, or items are not presented fairly on the basis of accounting described or if there has been a limitation on the scope of the audit, he or she should disclose all the substantive reasons for that conclusion in one or more explanatory paragraphs (preceding the opinion paragraph) of the report and include in the opinion paragraph the appropriate modifying language and a reference to such explanatory paragraphs.

7. If the specified element, account, or item is prepared to comply with the requirements or financial reporting provisions of a contract or agreement that results in a presentation that is not in conformity with GAAP or an OCBOA (other than one prescribed by a governmental regulatory agency), a paragraph that restricts the distribution of the report to those within the entity and the parties to the contract or agreement should be included. Such a restriction is necessary because the basis of presentation is determined by reference to a document that would not generally be available to other third parties.
8. The manual or printed signature of the auditor’s firm.

9. Date

The following exhibits present an illustrative audit report for specified elements, accounts, or items:

- **Exhibit 13** is an illustrative audit report relating to accounts receivable based on an audit in accordance with GAAS. Note that because the presentation is in conformity with GAAP, the report need not be restricted.

- **Exhibit 14** is an illustrative audit report relating to the amount of sales for the purpose of computing rental. Note that this report does need to be restricted, and the appropriate paragraph is added.

- **Exhibit 15** is an illustrative audit report relating to royalties. It includes an example of an explanatory paragraph containing management’s interpretations of the agreement on which the royalty calculations are based.

- **Exhibit 16** is an illustrative audit report relating to profit participation. Note that since net income ("Profit participation") is involved, the auditor must have audited the complete financial statements.

- **Exhibit 17** is an illustrative audit report relating to federal and state income taxes included in financial statements. Note that since federal and state income taxes are involved, and since these taxes depend upon net income, the auditor must have audited the complete financial statements.

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**Exhibit 13**

*Report Relating to Accounts Receivable*

*Independent Auditor’s Report*

We have audited the accompanying schedule of accounts receivable of ABC Company as of December 31, 19X2. This schedule is the responsibility of the Company’s management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of accounts receivable is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of...
Exhibit 13 (continued)

accounts receivable. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of accounts receivable referred to above presents fairly, in all material respects, the accounts receivable of ABC Company as of December 31, 19X2, in conformity with generally accepted accounting principles.¹

[Signature]
[Date]

¹Since this presentation was prepared in conformity with generally accepted accounting principles, the report need not be restricted.

Exhibit 14 Report Relating to Amount of Sales for the Purpose of Computing Rental

Independent Auditor’s Report

We have audited the accompanying schedule of gross sales (as defined in the lease agreement dated March 4, 19XX, between ABC Company, as lessor, and XYZ Stores Corporation, as lessee) of XYZ Stores Corporation at its Main Street store, [City], [State], for the year ended December 31, 19X2. This schedule is the responsibility of XYZ Stores Corporation’s management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of gross sales is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of gross sales. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

(continued)
Exhibit 14 (continued)

In our opinion, the schedule of gross sales referred to above presents fairly, in all material respects, the gross sales of XYZ Stores Corporation at its Main Street store, [City], [State], for the year ended December 31, 19X2, as defined in the lease agreement referred to in the first paragraph.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Stores Corporation and ABC Company and should not be used for any other purpose.

[Signature]
[Date]

Exhibit 15  Report Relating to Royalties

Independent Auditor’s Report

We have audited the accompanying schedule of royalties applicable to engine production of the Q Division of XYZ Corporation for the year ended December 31, 19X2, under the terms of a license agreement dated May 14, 19XX, between ABC Company and XYZ Corporation. This schedule is the responsibility of XYZ Corporation’s management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of royalties is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that, under XYZ Corporation’s interpretation of the agreement referred to in the first paragraph, royalties were based on the number of engines produced after giving effect to a reduction for production retirements that were scrapped, but without a reduction for field returns that were scrapped, even though the field returns were replaced with new engines without charge to customers.

In our opinion, the schedule of royalties referred to above presents fairly, in all material respects, the number of engines produced by the Q Division of
Exhibit 15 (continued)

XYZ Corporation during the year ended December 31, 19X2, and the amount of royalties applicable thereto, under the license agreement referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Corporation and ABC Company and should not be used for any other purpose.

[Signature]
[Date]

Exhibit 16  
Report on a Profit Participation  

Independent Auditor’s Report

We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company for the year ended December 31, 19X1, and have issued our report thereon dated March 10, 19X2. We have also audited XYZ Company’s schedule of John Smith’s profit participation for the year ended December 31, 19X1. This schedule is the responsibility of the Company’s management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit of the schedule in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of profit participation is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that the documents that govern the determination of John Smith’s profit participation are (a) the employment agreement between John Smith and XYZ Company dated February 1, 19X0, (b) the production and distribution agreement between XYZ Company and Television Network Incorporated dated March 1, 19X0, and (c) the studio facilities agreement between XYZ Company and QRX Studios dated April 1, 19X0, as amended November 1, 19X0.

(continued)
Exhibit 16 (continued)

In our opinion, the schedule of profit participation referred to above presents fairly, in all material respects, John Smith’s participation in the profits of XYZ Company for the year ended December 31, 19X1, in accordance with the provisions of the agreements referred to above.

This report is intended solely for the information and use of the board of directors and management of XYZ Company and John Smith and should not be used for any other purpose.

[Signature]
[Date]

Exhibit 17  Report on Federal and State Income Taxes Included in Financial Statements

Independent Auditor’s Report

We have audited, in accordance with generally accepted auditing standards, the financial statements of XYZ Company, Inc., for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX. We have also audited the current and deferred provision for the Company’s federal and state income taxes for the year ended June 30, 19XX, included in those financial statements, and the related asset and liability tax accounts as of June 30, 19XX. This income tax information is the responsibility of the Company’s management. Our responsibility is to express an opinion on it based on our audit.

We conducted our audit of the income tax information in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the federal and state income tax accounts are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures related to the federal and state income tax accounts. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the federal and state income tax accounts. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Company has paid or, in all material respects, made adequate provision in the financial statements referred to above for the payment of all federal and state income taxes and for related deferred income
Exhibit 17 (continued)

taxes that could be reasonably estimated at the time of our audit of the financial statements of XYZ Company, Inc., for the year ended June 30, 19XX.

[Signature]

[Date]

Alternative Services in Relation to Specified Elements, Accounts, or Items

Are there less costly alternatives to the approach of making an audit of each specified element, account, or item?

SSARS 1 Review

An interpretation of the compilation and review standards deals explicitly with the applicability of a SSARS 1 review to engagements involving specified elements, accounts, or items. It takes the position that a SSARS 1 review is not appropriate for such engagements. The interpretation is codified at AR section 9100.27.

SSARS 1 provides guidance concerning the standards and procedures applicable to compilations and reviews of financial statements. Presentations of specified elements, accounts, or items of a financial statement are not financial statements. The interpretation also states that there are SASs that deal explicitly with expression of an audit opinion and providing limited assurance on specified elements, accounts, or items. SAS 62 covers the audit opinion. SAS 35, codified at AU section 622, covers applying agreed-upon procedures to specified elements, accounts, or items.

The interpretation is presented in its entirety in Exhibit 18.

Exhibit 18  Interpretation of Compilation and Review Standards

8. Reports on Specified Elements, Accounts, or Items of a Financial Statement

.27 Question—Paragraph 43 of SSARS 1 [section 100.43] provides guidance when the basic financial statements are accompanied by informa-

(continued)
Exhibit 18 (continued)

ition presented for supplementary analysis purposes. However, a nonpublic entity may wish to engage an accountant to issue a review report on a separate presentation of specified elements, accounts, or items of a financial statement or to report the results of applying agreed-upon procedures to specified elements, accounts, or items of a financial statement. Do SSARS 1 [section 100] reporting requirements for a review apply in such circumstances?

.28 Interpretation— No. SSARS 1 [section 100], Compilation and Review of Financial Statements, provides guidance concerning the standards and procedures applicable to compilations and reviews of financial statements. Presentations of specified elements, accounts, or items of a financial statement are not financial statements. Statements on Auditing Standards Nos. 14 [AU section 621] and 35 [AU section 622] and Interpretations thereof provide guidance with respect to reporting on such presentations when the engagement is intended to result in the expression of an audit opinion (a report on specified elements, accounts, or items of a financial statement) or limited assurance (a report on the results of applying agreed-upon procedures to specified elements, accounts, or items of a financial statement).

[Issue Date: November, 1981.]

SAS 35 Agreed-Upon Procedures

SAS 35 permits an accountant to describe the procedures applied to the specified elements, accounts, or items and state that nothing came to his or her attention as a result of applying the procedures that would cause any adjustments to the information other than those disclosed in the report.

The primary condition for accepting this type of engagement is that the recipients of the report will have agreed to the procedures to be applied. This type of engagement was originally covered by SAS 14. SAS 35 amended SAS 14 to indicate that there were several practical means to reach an agreement with report recipients and that the auditor did not have to meet personally with all potential report recipients. One example is that agreement might be reached with a representative of recipients such as a lawyer representing a creditor’s
committee. A second example of how to accomplish an agreement might be by means of an engagement letter acknowledged by the recipients.

Exhibit 19 illustrates a report in connection with a proposed acquisition. Exhibit 20 illustrates a report in connection with claims of creditors.

Exhibit 19  Report in Connection With a Proposed Acquisition

Board of Directors
X Company

We have applied certain agreed-upon procedures, as discussed below, to accounting records of Y Company, Inc., as of December 31, 19XX, solely to assist you in connection with the proposed acquisition of Y Company, Inc. It is understood that this report is solely for your information and is not to be referred to or distributed for any purpose to anyone who is not a member of management of X Company. Our procedures and findings are as follows:

1. We reconciled cash on deposit with the following banks to the balances in the respective general ledger accounts and obtained confirmation of the related balances from the banks.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Balance Per General Ledger</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC National Bank</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>DEF State Bank</td>
<td>13,776</td>
</tr>
<tr>
<td>XYZ Trust Company—regular account</td>
<td>86,912</td>
</tr>
<tr>
<td>XYZ Trust Company—payroll account</td>
<td>5,000</td>
</tr>
</tbody>
</table>

2. We obtained an aged trial balance of the accounts receivable subsidiary records, traced the age and amounts of approximately 10 percent of the accounts to the accounts receivable ledger, and added the trial balance and compared the total with the balance in the general ledger control account. We mailed requests for positive confirmation of balances to 150 customers. The differences disclosed in confirmation replies were minor in amount and nature, and we reconciled them to our satisfaction. The results are summarized as follows:

   (continued)
Exhibit 19 (continued)

<table>
<thead>
<tr>
<th>Accounts Receivable Aging and Confirmation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Account Balance</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Current</td>
</tr>
<tr>
<td>Past due:</td>
</tr>
<tr>
<td>Less than one month</td>
</tr>
<tr>
<td>One to three months</td>
</tr>
<tr>
<td>Over three months</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

Because the above procedures do not constitute an examination made in accordance with generally accepted auditing standards, we do not express an opinion on any of the accounts or items referred to above. In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the specified accounts or items should be adjusted. Had we performed additional procedures or had we made an examination of the financial statements in accordance with generally accepted auditing standards, matters might have come to our attention that would have been reported to you. This report relates only to the accounts and items specified above and does not extend to any financial statements of Y Company, Inc., taken as a whole.

[Signature]

[Date]

Exhibit 20 Report in Connection With Claims of Creditors

Trustee

XYZ Company

At your request, we have performed the procedures enumerated below with respect to the claims of creditors of XYZ Company as of May 31, 19XX, set forth in the accompanying schedules. Our review was made solely to assist you in evaluating the reasonableness of those claims, and our report is not to be used for any other purpose. The procedures we performed are summarized as follows:
Exhibit 20 (continued)

1. We compared the total of the trial balance of accounts payable at May 31, 19XX, prepared by the company, to the balance in the company’s related general ledger account.

2. We compared the claims received from creditors to the trial balance of accounts payable.

3. We examined documentation submitted by the creditors in support of their claims and compared it to documentation in the company’s files, including invoices, receiving records, and other evidence of receipt of goods or services.

Our findings are presented in the accompanying schedules. Schedule A lists claims that are in agreement with the company’s records. Schedule B lists claims that are not in agreement with the company’s records and sets forth the differences in amounts.

Because the above procedures do not constitute an examination made in accordance with generally accepted auditing standards, we do not express an opinion on the accounts payable balance as of May 31, 19XX. In connection with the procedures referred to above, except as set forth in Schedule B, no matters came to our attention that caused us to believe that the accounts payable balance might require adjustment. Had we performed additional procedures or had we made an examination of the financial statements in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you. This report relates only to the accounts and items specified above and does not extend to any financial statements of XYZ Company, taken as a whole.

[Signature]

[Date]

Compilations

The interpretation logic that SSARS 1 applies to compilations and reviews of financial statements would seem to apply equally to reviews and compilations. However, the interpretation does not explicitly state that a compilation engagement is inappropriate. Some accountants have taken this to mean that an engagement to compile specified elements, accounts, or items is permitted by authoritative standards. The general understanding is that these engagements can be accepted, but there is no authoritative guidance on the matter.
SAS 29—Specified Elements, Accounts, and Items as Accompanying Information

Another alternative to the audit and expression of an opinion on specified elements, accounts, or items is to treat the information as accompanying and report on it in accordance with SAS 29, *Reporting on Information Accompanying the Basic Financial Statements*. The form of expression of opinion is codified at AU section 551 and states that the information is fairly stated in relation to the financial statements taken as a whole.

The requirements to permit use of this approach are that the specified elements, accounts, or items would have to accompany the basic financial statements, and the auditor reporting on the specified elements, accounts, or items would have to have audited those financial statements.

The advantage of this approach is that the scope of work could be determined based on the amount considered material to the financial statements taken as a whole rather than to each individual specified element, account, or item. This should mean a less stringent materiality amount and less audit work.

COMPLIANCE WITH AGREEMENTS OR REGULATIONS

SAS 62 does not provide broad guidance on reporting on compliance with agreements or regulatory requirements. There is a separate SAS (SAS 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*) that applies when the auditor is engaged to test compliance with laws and regulations in accordance with the Government Auditing Standards.

Nature of Engagement

The type of engagement to which the guidance in SAS 62 applies usually involves a bond indenture or loan agreement that imposes obligations on the company related to matters such as payments into sinking funds, payments of interest, maintenance of a specified current ratio, and adherence to restrictions on payment of dividends.
Lenders or trustees request assurance (normally negative assurance) from the auditor that the borrower has complied with certain covenants of the agreement related to accounting matters.

SAS 62 carries forward this category of service without substantial change from SAS 14. However, SAS 62 makes explicit certain matters that were traditionally assumed to exist concerning this type of engagement. SAS 62 codifies these traditional practices.

**Conditions for Engagement Acceptance**

The conditions to be met for the accountant to accept the engagement are as follows:

1. The auditor has audited the financial statements to which the contractual agreements or regulatory requirements relate.
2. The assurance requested does not extend to covenants that relate to matters that have not been subjected to audit procedures applied in the audit of financial statements.
3. The auditor’s report on the audited financial statements to which the covenants relate is not an adverse opinion or disclaimer of opinion.

If regulatory requirements are involved, the requirements must be something other than those to which SAS 63 on compliance auditing would apply.

**Form of Report**

The assurance may be given either in a separate report or in one or more paragraphs of the audit report accompanying the financial statements. A separate report should include—

1. A title that includes the word *independent*.
2. A paragraph that states that the financial statements were audited in accordance with GAAS and includes the date of that auditor’s report on those financial statements. If the auditor’s report on the financial statements was other than a standard report, the auditor should describe the report modification and the reasons that caused it.
3. A paragraph that includes a reference to the specific covenants or paragraphs of the agreement, provides negative assurance relative to compliance with the applicable covenants of the agreement in so far as they relate to accounting matters, and specifies that it is being given in connection with an audit of financial statements. The auditor should ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance.

4. A paragraph that includes a description and the source of significant interpretations, if any, made by the company’s management in the course of the engagement relating to the provisions of a relevant agreement.

5. A paragraph that restricts the distribution to those within the entity and the parties to the contract or regulatory agency, since the matters on which the auditor is reporting are set forth in a document that is generally not available to other third parties.

6. The manual or printed signature of the auditor’s firm.

7. Date.

Exhibit 21 illustrates a separate report on compliance with contractual provisions. Exhibit 22 illustrates a separate report on compliance with regulatory requirements. Note that in this illustration, the auditor’s report on the financial statements was modified. It included an explanatory paragraph because of an uncertainty.

When the report on compliance with contractual agreements or regulatory provisions is included in the audit report on financial statements, the last two paragraphs in Exhibit 21 are simply added to the standard three paragraph report on the financial statements.

Although SAS 62 is not explicit on this point, the general understanding is that if assurance is provided based only on those audit procedures performed in connection with the audit of the financial statements, the assurance should be limited to negative assurance. SAS 62 does not prohibit providing more than negative assurance, but it does not provide guidance on that category of service. If a client requests an auditor to provide more than negative assurance, the auditor should look to Statements on Standards for Attestation Engagements to decide whether the engagement can be accepted and
to determine the scope of work and form of report that would be appropriate.

**Reviews and Assurance on Compliance**

Can an accountant who has reviewed financial statements in accordance with SSARS 1 provide limited assurance on compliance with contractual agreements or regulatory requirements related to those reviewed financial statements?

This service would not seem to be appropriate because SAS 62 states that the conditions for giving negative assurance on compliance include an audit of the financial statements. A review of financial statements is more limited in scope than an audit and would not provide sufficient basis for even limited assurance on compliance. An interpretation of the compilation and review standards which takes this position is being prepared by the AICPA staff. A draft of the interpretation is presented as Exhibit 23.

**Exhibit 21  Report on Compliance With Contractual Provisions Given in a Separate Report**

*Independent Auditor’s Report*

We have audited, in accordance with generally accepted auditing standards, the balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated February 16, 19X3.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to XX, inclusive, of the Indenture dated July 21, 19X0, with ABC Bank insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Company and ABC Bank and should not be used for any other purpose.

[Signature]

[Date]
Exhibit 22


Independent Auditor's Report

We have audited, in accordance with generally accepted auditing standards, the balance sheet of XYZ Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated March 5, 19X3, which included an explanatory paragraph that described the litigation discussed in Note X of those statements.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the accounting provisions in sections (1), (2), and (3) of the [name of state regulatory agency]. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the board of directors and management of XYZ Company and the [name of state regulatory agency] and should not be used for any other purpose.

[Signature]

[Date]

Exhibit 23

Draft Interpretation

Compliance with Aspects of Contractual Agreements or Regulatory Requirements

Question—A nonpublic entity may wish to engage an accountant to issue a report on compliance with an agreement such as bond indentures or certain types of loan agreements in conjunction with a review engagement. May an accountant provide limited assurance on the entity's compliance with such agreements in connection with a review engagement?

Interpretation—No. SSARS 1, Compilation and Review of Financial Statements, provides guidance concerning compilations and reviews of financial statements; it does not apply to guidance on reporting on compliance with agreements. SAS 62, Special Reports, states that an auditor can only provide negative assurance on compliance with covenants that relate to matters that have been subjected to the audit procedures applied in an audit. SAS 35, Special Reports—Applying Agreed-Upon Procedures to Speci-
fied Elements, Accounts, or Items of a Financial Statement [AU section 622], provides guidance with respect to reporting on the results of applying agreed-upon procedures to specified elements, accounts, or items of a financial statement. Statements on Standards for Attestation Engagements, Attestation Standards, provides guidance with respect to reporting on such presentations when the accountant is engaged to express moderate assurance in a review report.

PREScribed FORMs OR SCHEDULES

In some cases, printed forms or schedules designed or adopted by the bodies with which they are to be filed prescribe the wording of an auditor’s report. These forms or schedules may be prepared, among other bodies, by lenders, industry trade associations, credit agencies, franchisors, or governmental and regulatory bodies other than those concerned with the sale or trading of securities.

Often these forms are not acceptable to the independent auditor because the prescribed report does not conform to applicable professional reporting standards. The prescribed language of the report may call for representations by the auditor that are not consistent with the auditor’s function or responsibility. For example, the report may state that the information is true and correct. This kind of representation is inappropriate because it does not recognize the need for a definite set of criteria to report against nor the concept of materiality.

Reporting

When a printed report form calls for the auditor to make a statement that the auditor is not justified in making, the auditor may be able to make the report form acceptable by either inserting additional wording or by completely revising the form or attaching a separate report.

GAAP Departures

A prescribed form may call for a departure from GAAP by either specifying a measurement principle not in conformity with GAAP or
by failing to request disclosures required by GAAP. In these circum-
stances, if the CPA has been engaged to audit or review the financial
information in the prescribed form, the CPA should consider
whether the prescribed accounting qualifies as an OCBOA. If the
departure qualifies as an OCBOA, it may be possible to issue a special
report suitable for OCBOA financial statements. If the accounting
basis called for by the prescribed form does not qualify as an
OCBOA, an audit report or review report would need to be modified
appropriately because of the departure from GAAP.

The audit report would be a qualified or adverse opinion. The review report would contain a modification of the standard report and would have a separate paragraph disclosing the departure. The CPA should consider whether a compilation report would be accept-
able. SSARS 5, which is codified as AR section 300, provides guid-
ance on compilation reports for financial statements included in a
prescribed form.

Compilation of Financial Statements Included in a
Prescribed Form

Definition
A prescribed form is defined as any standard preprinted form
designed or adopted by the body to which it is to be submitted. It is
very important to recognize that a form designed or adopted by the
entity whose financial statements are to be compiled is not consid-
ered to be a prescribed form.

According to SSARS 5, there is a presumption that the informa-
tion required by a prescribed form is sufficient to meet the needs of
the body that designed or adopted the form. There is no need for that
body to be advised of departures from GAAP required by the pre-
scribed form or related instructions.

Form of Compilation Report
The standard form of compilation report with an additional para-
graph added concerning the prescribed form may be issued on the
unaudited financial statements of a nonpublic company. The addi-
tional paragraph should state the basis of the presentation, including
which organization established the requirements; indicate that the
basis differs from GAAP; and state that the financial statements are not designed for those who are not informed about the requirements that served as the basis.

The following is example wording of the additional paragraph.

These financial statements are presented in accordance with the requirements of the XYZ trade association which differ from generally accepted accounting principles. Accordingly, these financial statements are not designed for those who are not informed about such matters.

A complete report is illustrated in SSARS 5, AR section 300, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms*.

If the prescribed form includes a preprinted report that does not conform with the standard compilation report with an additional paragraph concerning the prescribed form, the accountant should append the appropriate form of report.

**SUMMARY**

A special report on financial statements presented in accordance with an OCBOA should include a paragraph that—

1. States the basis of presentation.
2. Refers to a note that describes the basis.
3. States that the basis of presentation is a comprehensive basis other than GAAP.

A special report on a specified element, account, or item of a financial statement that expresses an opinion should be based on an audit of the element, account, or item in accordance with GAAS and may state whether the presentation is fairly presented in all material respects in accordance with GAAP or an OCBOA.

A report that provides assurance on compliance with contractual agreements or regulatory requirements may be presented as a separate special report or as part of the standard audit report on financial statements; the matters covered should be only those that were subjected to auditing procedures applied in the audit of the financial statements.
A special report on a presentation that is incomplete (less than a full set of financial statements or less than an individual financial statement) but that is otherwise in conformity with GAAP or an OCBOA should—

1. Explain what the presentation is intended to present.
2. Refer to a note that describes the basis of presentation.
3. If GAAP, state either that the presentation is not intended to be a complete presentation of assets, liabilities, revenue, and expenses or if an OCBOA, state that the presentation is in conformity with a comprehensive basis other than GAAP and that the presentation is not intended to be a complete presentation of assets, liabilities, revenues, and expenses.
4. Express an opinion on conformity with either GAAP or an OCBOA, as appropriate.

A special report on financial statements that are prepared in conformity with an agreement that are not in conformity with GAAP or an OCBOA should—

1. Explain what the presentation is intended to present.
2. Refer to a note that describes the basis of presentation.
3. State that the presentation is not intended to be in conformity with GAAP.
4. Express an opinion on the conformity of the presentation with the basis of accounting specified.

An additional explanatory paragraph may have to be added to a special report for—

1. Lack of consistency in accounting principles.
2. Uncertainties.
3. Going-concern uncertainties.
4. Other auditors.
5. Comparative presentations.

A special report should include a final paragraph that restricts distribution of the report in the following circumstances:

1. The financial statements are prepared in accordance with a regulatory basis OCBOA.
2. A specified element, account, or item is prepared to comply with the requirements or financial reporting provision of a contract or agreement that results in a presentation that is not in conformity with GAAP or an OCBOA.

3. A special report provides assurance on compliance with contractual agreements or regulatory provisions related to financial statements.

4. An incomplete presentation is intended for the use of parties negotiating directly with each other rather than for filing with a regulatory agency.

5. The financial statements are prepared in conformity with an agreement that results in a presentation not in conformity with GAAP or an OCBOA.

When a printed form would require an auditor to make an assertion the auditor does not believe is justified, the auditor should reword the form or attach a separate report.
CHAPTER 3
Compliance Auditing

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SUMMARY ................................................................. 168
This chapter reviews the basic requirements of Statement on Auditing Standards (SAS) No. 63, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance. An audit of an entity’s compliance with laws and regulations is not a new development, but this is the first SAS devoted to the topic.

There is a tendency to associate compliance auditing with audits of governmental units, and, indeed, a large part of SAS 63 is devoted to such audits. However, tests of compliance with applicable laws and regulations may also be a significant factor in the audit of non-profit organizations and certain business enterprises.

This chapter explains when the new statement on compliance auditing is applicable to the audit of the financial statements of a non-profit organization or a business enterprise. It describes the audit procedures that are usually appropriate for testing compliance with laws and regulations in an audit in accordance with generally accepted auditing standards (GAAS).

In addition to reviewing the basic requirements of SAS 63, this chapter explains its relationship to SAS 53 and to SAS 54, provides some guidance on how SAS 63 may affect practice, and briefly reviews the additional requirements applicable to an audit in accordance with certain federal government publications.

The chapter is organized as follows:

- Background and applicability of the SAS
- Relations to SASs 53 and 54
- Test of compliance defined
- Types of audits that may require tests of compliance with laws and regulations
- Requirements applicable to all audits of all governmental units
• Requirements applicable to all audits of entities that receive financial assistance from governments

• Additional requirements applicable to an audit in accordance with generally accepted governmental auditing standards (GAGAS)

• Additional requirements applicable to a Single Audit

• Implementation issues

• Summary

BACKGROUND AND APPLICABILITY OF SAS 63

In the last few years a great deal of attention has been focused on the performance by independent CPAs in audits of entities that receive financial assistance under government funded programs. Congressional committees were particularly dissatisfied with audit quality failures related to federal funding. In 1986, two reports were issued that expressed dissatisfaction with the quality of such audits. The titles alone are a serious indictment of auditor performance.


These reports added impetus to the calls for increased regulation of the public accounting profession. The AICPA appointed a task force to study ways to improve auditor performance in this area. One of the recommendations of that task force was an SAS on compliance auditing.

The intent of the SAS is to make auditors more sensitive to government audit requirements, and to make government requirements enforceable under the AICPA Code of Professional Conduct.

In early 1988, the Auditing Standards Board issued an exposure draft on compliance auditing, The Auditor’s Responsibility for Testing
Compliance Auditing

Compliance With Laws, Regulations, and Contractual Terms Governing Financial Assistance Certain Entities Receive From Government. The exposure draft focused on testing compliance with laws, regulations, and contractual requirements related to financial assistance from governments. SAS 63 is broader and deals with all aspects of compliance auditing for governmental units. However, for audits of non-profit organizations and business enterprises, the focus is still on the requirements that apply when an entity receives financial assistance from federal, state, or local levels of government.

Governmental Units

SAS 63 is applicable to audits of the financial statements of all governmental units, for example, states, counties, townships, cities, towns, other municipalities, school districts, authorities, and the like. The Governmental Accounting Standards Board’s Codification of Governmental Accounting and Financial Reporting Standards (GASB Codification) section 1200.103, explains that governmental units generally are subject to a variety of laws and regulations that have a direct effect on their financial statements.

An important aspect of GAAP as applied to governments is the recognition of the variety of legal and contractual considerations typical of the government environment. These considerations underlie and are reflected in the fund structure, bases of accounting, and other principles and methods set forth here, and are a major factor distinguishing governmental accounting from commercial accounting.

Examples of violations of laws and regulations that may be material to the financial statements of governmental units include failure to establish funds required by law, expenditures in excess of a legally appropriated budget, expenditure of the proceeds of a grant without satisfying matching requirements, expenditure of the proceeds of a tax in violation of legal restrictions on use of those proceeds, or issuance of debt in excess of ceiling limitations imposed by law.

Nonprofit Organizations and Business Enterprises

SAS 63 is also applicable to audits of the financial statements of non-profit organizations and business enterprises that receive financial
assistance from some level of government. Federal, state, and local governmental units provide financial assistance to nongovernmental units in the form of grants of cash and other assets, loans, loan guarantees, interest rate subsidies, and the like. Examples of governmental agencies that provide such assistance include the Department of Education, National Endowment for the Arts, Department of Health and Human Services, and the Department of Housing and Urban Development. By accepting such assistance, both governmental and nongovernmental entities may be subject to laws and regulations that may have a direct and material effect on the determination of amounts in their financial statements.

Examples of nonprofit organizations that often receive governmental financial assistance include the following:

- Community-based action agencies, such as crisis intervention centers and shelters for the homeless
- Day care centers
- Libraries
- Museums and other cultural centers
- Colleges and universities
- Hospitals and other health care providers

Examples of business enterprises that receive governmental assistance include some for-profit organizations that provide services similar to nonprofit organizations and such organizations as private vocational schools and housing projects and programs.

The SAS also applies when the auditor is engaged specifically to test and report on compliance with laws and regulations, whether or not in connection with an audit.

RELATION TO SASs 53 AND 54

In an audit performed in accordance with GAAS, the auditor’s responsibility for consideration of laws and regulations and how they affect the audit is described in SASs 53 and 54. SAS 54, Illegal Acts by Clients, states that illegal acts with a direct and material effect on the financial statements are to be considered irregularities and that the auditor (following the guidance in SAS 53, The Auditor’s Responsibil-
Compliance Auditing

*ity to Detect and Report Errors and Irregularities*) is responsible for applying audit procedures to provide reasonable assurance of detecting material errors and irregularities. The SAS on compliance auditing explains these responsibilities in greater detail for audits of governmental entities and of nongovernmental entities that receive financial assistance from a governmental agency.

SAS 54 equates the auditor’s responsibility for misstatements caused by certain illegal acts with the responsibility for other errors and irregularities.

The auditor considers law and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. . . . However, the auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality per se. The auditor’s responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors and irregularities as described in SAS 53, *The Auditor’s Responsibility to Detect and Report Errors and Irregularities*.

SAS 53 describes the auditor’s responsibility for errors and irregularities as follows:

The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.

The auditor should design the audit to provide reasonable assurance of detecting material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. Thus, the auditor should obtain an understanding of the possible effects on an entity’s financial statements of laws and regulations that have a direct and material effect on the determination of financial statement amounts and assess audit risk associated with possible violations of such laws and regulations.
TESTS OF COMPLIANCE DEFINED

The AICPA audit guide, *Audits of State and Local Governmental Units*, Section 4.1, defines tests of compliance with laws and regulations as follows:

The objectives of tests of compliance with laws and regulations are to determine whether there have been events of noncompliance that may have a material effect on the financial statements or to provide a basis of reporting on the government’s compliance with such laws and regulations. Accordingly, *tests of compliance with laws and regulations are substantive tests* usually accomplished by examining supporting documentation (emphasis added).

Thus, tests of compliance with laws and regulations should be distinguished from tests of compliance with internal accounting control. Since SAS 55 on internal control structure eliminates the term *compliance test* of controls from the literature, the potential confusion should be reduced.

TYPES OF AUDITS THAT MAY REQUIRE TESTS OF COMPLIANCE WITH LAWS AND REGULATIONS

The nature and extent of the auditor’s responsibility for testing compliance with laws and regulations differs depending on the type of audit. There are the following three types:

1. *Financial Audit.* An audit of financial statements conducted in accordance with GAAS.

2. *Audit Under Governmental Auditing Standards.* A GAAS audit plus additional requirements of the U.S. General Accounting Office’s *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions* (1988). This type of audit is also called an audit in accordance with GAGAS.


As mentioned earlier, the SAS applies when a state or local governmental unit or a nongovernmental entity such as a nonprofit orga-
Organization receives financial assistance from any level of government (federal, state, or local). If the financial assistance is received from a federal agency (either directly or passed through another level of government), the auditor may need to consult the following publications in addition to OMB Circular A-128 to identify the requirements applicable to the assistance:

- *The Compliance Supplement for Single Audits of State and Local Governments (Revised April 1985)*, published by the OMB as a supplement to OMB A-128
- OMB A-87, *Cost Principles for State and Local Governments*
- OMB A-122, *Cost Principles for Nonprofit Organizations*

The nature and content of each publication are discussed below.

**Compliance Supplement**

The *Compliance Supplement* specifies (1) general requirements and (2) specific program compliance requirements and suggested audit procedures for 62 federal financial assistance programs.

The “general requirements” are those specified in the *Compliance Supplement* as “requirements that involve significant national policy and of which failure to comply could have a material impact on an organization’s financial statements.” Accordingly, tests for compliance with those requirements “should be included as a part of every audit of state, local, and Tribal governments that involve Federal financial assistance.” Those requirements pertain to the following matters:

- *Political activity*. Prohibits the use of federal funds for partisan political activity.
- *Davis-Bacon Act*. Requires that laborers working on federally financed construction contracts be paid a wage not less than that established by the Secretary of Labor.
- *Civil rights*. Prohibits violation of anyone’s civil rights in a program funded by the federal government.
- *Cash management*. Requires recipients of federal assistance to minimize the time lapsed between receipt and disbursement of that assistance.
Compliance Auditing

- **Relocation assistance and real property acquisition.** Prescribes how real property should be acquired with federal financial assistance and how recipients must help relocate people displaced when that property is acquired.

- **Federal financial reports.** Prescribes federal financial reports that must be filed.

  The "specific requirements" are defined in the *Compliance Supplement* as those requirements that are specific to 62 federal programs that provide approximately 90 percent of the federal aid to state and local governments. Those requirements generally pertain to the following categories:

  - Types of services allowed or unallowed
  - Eligibility
  - Matching, level of effort, or earmarking
  - Reporting
  - Special tests and provisions

**OMB A-87**

This circular requires that federal assistance programs provided to state and local governments and Indian Tribal governments bear their fair share of costs by defining costs that are allowable and unallowable for that assistance.

**OMB A-122**

This circular requires that federal assistance programs provided to nonprofit organizations bear their fair share of costs by defining costs that are allowable and unallowable for that assistance.

**REQUIREMENTS APPLICABLE TO AUDITS OF ALL GOVERNMENTAL UNITS**

The auditor’s responsibility related to misstatements resulting from illegal acts having a direct and material effect on the determination of
financial statement amounts is (1) to assess the risk of such misstatements; and (2) based on the assessment, design the audit to provide reasonable assurance that such misstatements are detected. The SAS discusses the characteristics of direct effect laws and regulations, and lists the GASB’s illustrations of types of laws and regulations that have a direct and material effect on the determination of financial statement amounts. These include consideration of—

- Reporting entity. Section 2100 of the GASB Codification provides the criteria for determining the organizations, functions, and activities of government that should be included in the financial statements of the governmental unit. Examples of the criteria include scope of public services, accountability for fiscal matters, and special financing relationships.

- Establishment of funds. Section 1300 of the GASB Codification establishes the principles of fund accounting. For example, a state constitution may require that proceeds of a state gasoline tax be accounted for in a special revenue fund.

- Budgetary reporting. Section 2400 of the GASB Codification requires that the general purpose financial statements present an aggregation of the appropriated budgets, as amended, compared to actual results of operations.

- Grant revenue recognition. A grant is a contribution of cash or other assets to be used for a specified purpose. Matching requirements may exist. If so, revenue recognition depends on compliance with the requirements.

- Restrictions on expenditures. Proceeds of certain governmental revenues are restricted by law regarding the purposes for which they may be spent. For example, a housing program may require distribution of the proceeds only to families meeting eligibility requirements.

The GASB Codification further requires disclosure of violations of certain laws and regulations, such as failure to establish funds, or expenditures in excess of appropriated budget. Also, the GASB Codification requires disclosures regarding the types of investments the governmental units are legally authorized to make and any violations of provisions for deposits and investments. The auditor should evaluate the adequacy of such disclosures.
REQUIREMENTS APPLICABLE TO ALL AUDITS OF ENTITIES THAT RECEIVE FINANCIAL ASSISTANCE FROM GOVERNMENTS

In planning and conducting the audit, the auditor should obtain an understanding of the effects of laws and regulations on the financial statements, assess the risk of material misstatements caused by non-compliance, and perform audit procedures in consideration of that risk.

The auditor is responsible for testing compliance with laws and regulations that have a direct and material effect on the financial statements (except disclosure of contingencies). For example, as GASB Codification section G60.109 states in its discussion of recognizing revenues from grants, entitlements, and shared revenues, "if cost sharing or matching requirements exist, revenue recognition depends on compliance with these requirements." The auditor should design audit procedures to provide reasonable assurance of detecting noncompliance with such laws and regulations.

Procedures to Obtain an Understanding and Assess Audit Risk

In obtaining an understanding of the effects of laws and regulations on the financial statements, the auditor should consider the characteristics of the laws and regulations in general, as well as specific laws and regulations applicable to the entity whose financial statements are being audited.

One approach to obtaining an understanding of specific laws and regulations includes the following steps.

First, the auditor should request management to identify the amount of financial assistance received, the government source of that assistance, and the requirements that govern that financial assistance that, if not complied with, could have a material effect on the financial statements.

Second, the auditor should assess the materiality of the financial assistance in relation to the financial statements taken as a whole, and
assess the risk that noncompliance with requirements governing financial assistance could occur and have a material effect on the financial statements. One factor in the risk assessment is the auditor’s understanding of the internal control structure.

Third, the auditor should corroborate management’s identification of requirements and obtain an understanding of those requirements. If applicable, the auditor should refer to the Compliance Supplement. However, some federal and all state and local programs are not covered by the Compliance Supplement. In this case, the auditor should obtain an understanding of the requirements by discussing the compliance requirements with the entity’s chief financial official and legal counsel, and review any directly related agreements, such as grant or loan documents. For federal programs, the auditor should inquire of the inspector general of the federal agency providing assistance. For state and local programs, the auditor should inquire of the audit function of the agency that provided assistance, or inquire of the state auditor or other state audit oversight organization, or review information about compliance requirements made available by state societies of CPAs.

Fourth, the auditor should design the audit to provide reasonable assurance of detecting material misstatements resulting from violations of the requirements determined above to have a direct and material effect. The auditor should consider whether evidence obtained from procedures performed in evaluating the completeness and classification of revenues (for example, sampling from all cash receipts to test recording accuracy) indicates possible inadequacies in the identification of sources and amounts of financial assistance. If assistance from various levels of government may have been commingled, the auditor should consider reviewing contracts or other documentation of assistance or inquire of the funding source identified by management about whether the assistance it provided included assistance from another source. The auditor should consider any applicable specific requirements related to receipt of assistance, for example, contract terms governing advances and draws.

Fifth, the auditor should request management to make written representations on their responsibility for compliance governing the assistance received, their disclosure to the auditor of the sources and amounts of assistance, and the adequacy of identification of requirements governing assistance.
The auditor’s assessment of control risk for assertions affected by compliance with laws and regulations identified by the above procedures may be influenced by policies and procedures in all three elements of the internal control structure (control environment, accounting system, and control procedures). For example, the following control environment factors may influence the auditor’s assessment of control risk:

- Management’s awareness or lack of awareness of applicable laws and regulations
- Entity policy regarding such matters as acceptable operating practices and codes of conduct
- Assignment of responsibility and delegation of authority to deal with such matters as organizational goal and objectives, operating functions, and regulatory requirements

**Procedures to Test Compliance With Laws and Regulations**

The types of laws and regulations that may need to be tested for compliance in the audit of a governmental unit or of a nonprofit organization or a business enterprise that receives governmental financial assistance include laws that specify the types of goods or services allowed or not allowed, that is, the types that the entity may purchase with the financial assistance. Other laws may specify eligibility requirements: the characteristics of individuals or groups to whom entities may give financial assistance. A third type of laws or regulations specifies matching level of effort or earmarking. These laws establish requirements for amounts that the entity should contribute from its own resources towards projects paid for with financial assistance.

Allowability and eligibility are often tested as part of testing transactions, for example, the auditor selects a sample of cash disbursements charged to governmental assisted programs and considers the allowability of costs charged, or the auditor selects a sample from recipient records and tests for eligibility. Allowability of costs may include specific requirements of the program or more general requirements for federal programs specified in circulars issued by the OMB.

In addition to tests of the eligibility of individual recipients of service, for example, legal aid, health care, student loans, and the
like, the auditor may need to test whether the entity is an eligible provider of the service.

**ADDITIONAL REQUIREMENTS APPLICABLE TO AN AUDIT IN ACCORDANCE WITH GAGAS**

A governmental unit, nonprofit organization, or business enterprise may engage an auditor to audit its financial statements in accordance with government auditing standards. GAGAS are also called the GAO Standards, or more commonly, the “Yellow Book.” The Yellow Book was revised in mid-1988. When performing an audit in accordance with GAGAS, the scope is the same as in an audit in accordance with GAAS. However, certain additional requirements apply. The auditor should issue the two reports in addition to an opinion on the financial statements.

The first is a report on internal control structure based solely on the understanding and control risk assessment made as part of the audit of financial statements. However, there are several differences in the requirements under SAS 63 and the requirements under SAS 60 that pertain to the form and content of the report. For audits in accordance with GAGAS, a *written* report is required in all audits. Identification of reportable conditions that are material weaknesses is required, as well as coverage of some additional matters (on identifying controls and the scope of work). See Exhibit 1, which illustrates such a report.

**Exhibit 1**

*Example Report on the Internal Control Structure—GAGAS Audit*

We have audited the financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
Exhibit 1 (continued)

In planning and performing our audit of the financial statements of [name of entity] for the year ended June 30, 19X1, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of [name of entity] is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management’s authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories [identify internal control structure categories].

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity’s ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

[Include paragraphs to describe the reportable conditions noted.]
Exhibit 1 (continued)

A material weakness is a reportable condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of [name of entity] in a separate letter dated August 15, 19X1.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

The second required additional report is a report on compliance with laws and regulations. The report should disclose all material instances of noncompliance, and all indications of illegal acts that could result in criminal prosecution. The SAS defines material noncompliance as, “failures to follow requirements, violations of prohibitions, contained in statutes, regulations, contracts, or grants that cause the auditor to conclude that the aggregation of the misstatements (that is, the auditor's best estimate of the total misstatement) [not just known misstatements] resulting from those failures or violations is material to the financial statements.” The report should provide positive assurance on the transactions tested and negative assurance (nothing came to the auditor’s attention) on the untested transactions. Exhibit 2 is an example of a report on compliance when the auditor’s procedures disclosed no material violations.

The auditor, based on the assessment of audit risk and materiality, may conclude that it was not necessary to perform tests of compliance with laws and regulations. (For example, the relevant trans-
actions and balances were not material to the financial statements taken as a whole.) Accordingly, the auditor does not provide positive assurance in the report. Exhibit 3 is an example of a report in such circumstances.

When material noncompliance is identified, neither positive nor negative assurance is included in the report. The auditor reports material instances of noncompliance even if the misstatements have been corrected, and the financial statements are not misstated. Exhibit 4 illustrates a report when the auditor identifies material instances of noncompliance.

Exhibit 2  
Example Report on Compliance—No Material Violations Identified

We have audited the financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [name of entity] is the responsibility of [name of entity]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [name of entity]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, our objective was not to provide an opinion on overall compliance with such provisions.

The results of our tests indicate that, with respect to the items tested, [name of entity] complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with those provisions.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. This restriction is not intended to limit the distribution of this report, which is a matter of public record.
Compliance Auditing

Exhibit 3

Example Report on Compliance—Tests of Compliance Unnecessary

We have audited the financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [name of entity] is the responsibility of [name of entity]'s management. As part of our audit, we assessed the risk that noncompliance with certain provisions of laws, regulations, contracts, and grants could cause the financial statements to be materially misstated. We concluded that the risk of such material misstatement was sufficiently low that it was not necessary to perform tests of [name of entity]'s compliance with such provisions of laws, regulations, contracts, and grants.

However, in connection with our audit, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with the laws, regulations, contracts, and grants referred to in the preceding paragraph.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Exhibit 4

Example Report on Compliance—Material Noncompliance Identified

We have audited the financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
Exhibit 4 (continued)

Compliance with laws, regulations, contracts, and grants applicable to [name of entity] is the responsibility of [name of entity]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [name of entity]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, our objective was not to provide an opinion on overall compliance with such provisions.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in statutes, regulations, contracts, or grants that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following material instances of noncompliance, the effects of which have been corrected in [name of entity]'s 19X1 financial statements.

[Include paragraphs describing the material instances of noncompliance noted.]

We considered these material instances of noncompliance in forming our opinion on whether [name of entity]'s 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated [date of report] on those financial statements.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, [name of entity] complied, in all material respects, with the provisions referred to in the third paragraph of this report, and with respect to items not tested, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with those provisions.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

**ADDITIONAL REQUIREMENTS APPLICABLE TO A SINGLE AUDIT**

The Single Audit Act of 1984 and OMB A-128, *Audits of State and Local Governments* (issued to prescribe policies, procedures, and
guidelines to implement the act), require certain state and local governments to have a so-called Single Audit. Governments receiving over $100,000 of federal financial assistance must have an audit in accordance with the Single Audit Act of 1984. Many of the requirements of the audit relate to major federal assistance programs as defined by the act and by OMB A-128. A major program is the larger of $300,000 or 3 percent of grant-funded expenditures for governments with up to $100 million of such expenditures. For governments with over $100 million of expenditures, OMB A-128 contains a sliding scale for determining major programs.

The Single Audit Act and OMB A-128 require the auditor to report on various matters pertaining to compliance with laws and regulations. They also require the auditor to issue reports on a supplementary schedule of federal financial assistance and on internal control structure policies and procedures relevant to federal financial assistance programs. The scope of the audit procedures has to be expanded appropriately to provide a basis for the reports described above.

State and local governments that are primary recipients of federal financial assistance may require nonprofit organizations that are subrecipients to have audits performed in accordance with the Single Audit Act. Also, on November 10, 1988, the OMB proposed Circular A-133, Audits of Institutions of Higher Education and Other Nonprofit Organizations, which is patterned after Circular A-128. When OMB A-133 becomes effective, nonprofit recipients of specified amounts of federal financial assistance will be required to have an audit that is for all practical purposes the same as an audit in accordance with OMB A-128. Until OMB A-133 becomes effective, nonprofit recipients of federal financial assistance are required to have an audit in accordance with OMB A-110, which is generally interpreted to mean the same thing as an audit in accordance with GAO Government Auditing Standards. Business enterprises are not subject to either OMB A-128 or OMB A-133 unless they agree contractually to have such an audit as part of obtaining a government contract.

Audit Procedures for a Single Audit

The auditor should plan and perform audit procedures to test compliance with the general requirements of the Compliance Supplement for major federal assistance programs and the specific requirements of those programs. The auditor should also test compliance with the
requirements relating to federal financial reports and claims for advances and reimbursements; that is, test whether such reports contain information that is supported by the books and records from which the basic financial statements were prepared.

Matching requirements, levels of effort, and earmarking (that is, whether such limitations were met and amounts used for matching were determined in accordance with OMB A-87 or A-122) should also be subjected to audit procedures.

As part of testing expenditures, the auditor should consider whether evidence obtained from the audit procedures performed in evaluating the validity, completeness, or valuation of expenditures charged to governmental assistance programs selected for financial audit purposes indicates noncompliance with applicable specific requirements related to—

- **Allowability** of the cost as set forth in OMB A-87 cost principles (or, if applicable, state or local equivalent requirements) or OMB A-122.
- **Eligibility** of the recipient of the expenditure to receive aid under the program. (This would apply only to social welfare programs.)

In addition, the auditor should select and test a representative number of expenditures charged to each major program.

A single audit also requires the issuance of several reports in addition to those for an audit in accordance with GAGAS.

The first is an opinion on compliance with the laws and regulations that may have a material effect on each major program and a schedule of findings and questioned costs. Exhibit 5 is an example of an unqualified opinion report. The second is a report on compliance with the general requirements applicable to the major programs as reported on in the first report (Exhibit 5). A report on compliance with general requirements is illustrated in Exhibit 6.

The third is a report on compliance with certain laws and regulations and a schedule of findings and questioned costs for transactions charged to nonmajor programs tested as part of the audit of the financial statements. An example report is presented in Exhibit 7.

**Exhibit 5**

*Example Report on Compliance with Requirements for Major Programs—Single Audit*

We have audited the City of Example, Any State's compliance with the requirements governing types of services allowed or unallowed; eligibility;
Exhibit 5 (continued)

matching, level of effort, or earmarking; reporting; [describe any special tests and provisions]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1. The management of the City of Example is responsible for the City's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards, Government Auditing Standards, issued by the Comptroller General of the United States, and OMB Circular A-128, Audits of State and Local Governments. Those standards and OMB A-128 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about the City's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying schedule of findings and questioned costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, the City of Example, Any State, complied, in all material respects, with the requirements governing types of services allowed or unallowed; eligibility; matching, level of effort, or earmarking; reporting; [describe any special tests and provisions]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

Exhibit 6 Example Report—Compliance With General Requirements for Major Programs

We have applied procedures to test [name of entity]'s compliance with the following requirements applicable to each of its major federal financial assistance programs, which are identified in the schedule of federal financial assistance, for the year ended June 30, 19X1: [List the general requirements applicable to the entity's major federal financial assistance programs (such as
Exhibit 6 (continued)

political activity, Davis-Bacon Act, civil rights, cash management, relocation assistance and real property management, or federal financial reports).

Our procedures were limited to the applicable procedures described in the OMB’s Compliance Supplement for Single Audits of State and Local Governments [or describe alternative procedures performed]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [name of entity]’s compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the first paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body or other third party]. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Exhibit 7

Example Report on
Compliance—Nonmajor Programs

In connection with our audit of the 19X1 general purpose financial statements of the City of Example, Any State, and with our study and evaluation of the City’s internal control systems used to administer federal financial assistance programs, as required by OMB Circular A-128, Audits of State and Local Governments, we selected certain transactions applicable to certain nonmajor federal financial assistance programs for the year ended June 30, 19X1. As required by OMB A-128, we have performed auditing procedures to test compliance with the requirements governing types of services allowed or unallowed; eligibility; and [describe any special tests and provisions] that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on the City’s compliance with these requirements. Accordingly, we do not express such an opinion.
Exhibit 7 (continued)

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that the City of Example had not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

The fourth additional report that the Single Audit Act of 1984 requires the auditor to issue is a report on the supplementary schedule of federal financial assistance. The fifth report is on the internal control structure relevant to federal financial assistance programs.

IMPLEMENTATION ISSUES

Government Contracts. SAS 63 applies to state or local governmental units, or nongovernmental entities that receive financial assistance from governmental agencies. A government contract for goods or services (for example, a city contract to a builder for construction that is part of a community development program) is not "financial assistance." The SAS does not apply to the audit of the builder's financial statements; SAS 53 on errors and irregularities and SAS 54 on illegal acts apply, as they do for all audits in accordance with GAAS.

Nonprofit Organizations. SAS 63 does not apply to the audits of all nonprofit organizations. It applies only to those that receive direct financial assistance from federal, state or local governments, or that receive governmental financial assistance passed through from a level of government. For example, a city receives a grant from a federal program. The city provides funds to a nonprofit corporation as a part of the efforts of the program. The SAS applies to the audits of both
the city and the nonprofit corporation. The audit of a nonprofit corporation supported entirely from private contributions would not be subject to the requirements of the SAS.

Working Papers. In defining documentation requirements, SAS 63 refers to SAS 41, Working Papers, for the guidance on documentation of the procedures performed to evaluate compliance with laws and regulations. SAS 63 also refers to SAS 55 for guidance on the documentation of the understanding of the internal control structure as it pertains to compliance with laws and regulations.

No Reportable Conditions Report. Paragraph 17 of SAS 60 prohibits the auditor from issuing a report stating that no reportable conditions were noted during the audit. However, for audits in accordance with GAGAS, Government Auditing Standards require the issuance of a report on internal control. What should the report say if no reportable conditions were noted? Exhibit 8 illustrates such a report.

Exhibit 8  Example—No Reportable Conditions Report

We have audited the financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of [name of entity] for the year ended June 30, 19X1, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of [name of entity] is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide man-
Compliance Auditing

Exhibit 8 (continued)

agement with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories [identify internal control structure categories].

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

However, we noted certain matters involving the internal control structure and its operation that we have reported to the management of [name of entity] in a separate letter dated August 15, 19X1.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. This restriction is not intended to limit the distribution of this report, which is a matter of public record.
SUMMARY

SAS 63 on compliance auditing applies to all audits of state or local governmental units and to audits of nonprofit organizations and business enterprises that receive financial assistance from federal, state, or local governmental agencies.

According to SASs 53 and 54, the auditor should design the audit to provide reasonable assurance of detecting material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

This means that in an audit of financial statements in accordance with generally accepted auditing standards (financial audit), the auditor should test compliance with laws and regulations that have a direct and material effect on the financial statements (except for the effect of disclosure of contingencies). In the audit of a nonprofit organization or business enterprise, the types of laws and regulations that ordinarily must be tested for compliance relate to the allowability of costs charged to financially assisted programs or the eligibility of recipients of services and the entity providing the services.

In an audit in accordance with GAGAS (GAO standards), the auditor should also issue reports on controls and compliance with laws and regulations.

In an audit in accordance with OMB A-128 (Single Audit), the auditor should also test for compliance with the general and specific requirements of the Compliance Supplement for major programs; allowability and eligibility requirements for a representative number of transactions charged to major programs, and any transactions selected for other audit purposes; matching, levels of effort, and earmarking requirements; requirements related to federal financial reports; and claims for advances and reimbursements. In addition, in a single audit, the auditor should issue the following reports: report on supplementary schedule of federal financial assistance; opinion on compliance with specific requirements applicable to major programs; report on general requirements applicable to major programs; report on compliance with laws and regulations applicable to nonmajor programs; and report on controls over federal financial assistance.
CHAPTER 4
Prospective Financial Information

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CHAPTER 4
Prospective Financial Information

This chapter reviews a proposed and a final Statement of Position (SOPs) that modify the AICPA’s Guide for Prospective Financial Statements (the Guide) issued in 1986. Prospective financial statements include forecasts, which are presentations of management’s expectations, and projections, which are presentations of a what-if scenario that management does not necessarily believe will happen. The Guide contains the presentation guidelines for prospective financial statements and provides guidance on the accountant’s procedures and reports. The following topics are covered in the new pronouncements:

- Partial presentations of prospective financial information
- Prospective financial statements for internal use only
- Questions concerning accountant’s services on prospective financial statements on a variety of specific issues that have arisen as the Guide was implemented in practice

This chapter explains when prospective financial information is considered to be a “partial presentation,” and describes the accountant’s procedures related to partial presentations and required elements of a standard report on a partial presentation. This chapter describes the reporting requirements when the accountant decides to issue a report on prospective financial statements for internal use only. Also, this chapter identifies the topics covered by the SOP, Questions Concerning Accountants’ Services on Prospective Financial Statements.

Sections 900 and 1000 of the Guide, as codified in Professional Standards, currently provide some guidance on the topics of partial presentations and internal-use-only prospective financial statements. However, that guidance was based on rule 201(e) of the old AICPA Code of Professional Ethics and the related interpretation 201-2. The interpretation applied to both internal-use-only and partial presentations and addressed the disclosure of assumptions, disclosure of the character of the accountant’s work, and the degree of
Prospective Financial Information

responsibility taken by the accountant. Both rule 201(e) and its interpretation were made obsolete in January 1988 when the new Code of Professional Conduct was adopted. These new SOPs replace the obsolete guidance and provide additional new guidance in the area of services for partial presentations.

The guidance in the SOPs on partial presentations and internal-use-only prospective financial statements applies to both forecasts and projections, even though the SOP may use only the word "forecast." The exceptions to this are clearly designated in the SOPs.

This chapter is organized as follows:

- Partial presentations
- Prospective financial statements for internal use only
- Questions concerning accountants' services on prospective financial statements
- Summary

PARTIAL PRESENTATIONS

The proposed SOP would replace section 1000 of the Guide. It provides guidance on the definition of partial presentations and the applicability of the SOP, on preparation and presentation of the partial presentation, accountants' procedures related to partial presentations, and on reports on partial presentations.

Applicability

The SOP is applicable to an accountant who is engaged to issue or who issues a written communication that expresses a conclusion about the reliability of a written partial presentation that is the responsibility of another party. The SOP also provides guidance to an accountant who is engaged to compile a partial presentation.

Definition

A partial presentation is "a presentation of prospective financial information that excludes one or more of the items required for prospective financial statements as described in section 400.06 of the
Prospective Financial Information

Section 400.06 specifies the following minimum items required for presentation:

- Sales or gross revenues
- Gross profit or cost of sales
- Unusual or infrequently occurring items
- Provision for income taxes
- Discontinued or extraordinary items
- Income from continuing operations
- Net income
- Primary and fully diluted earnings per share
- Significant changes in financial position

If the omitted information is derivable from the information presented, it would not be a partial presentation. Estimates in historical financial statements and notes required by generally accepted accounting principles (GAAP) are also not considered partial presentations.

A partial presentation may be of either forecasted or projected information and may be either an extract of a full presentation or be specially prepared to meet a specific need. Example circumstances in which a limited-use partial presentation may be appropriate are in analyzing whether to lease or buy a piece of equipment, or in evaluating the income tax implications of a given election.

Partial presentations are not ordinarily appropriate for general use. The SOP states, “a partial presentation ordinarily should not be distributed to third parties who will not be negotiating directly with the responsible party (for example, in an offering document for an entity’s debt or equity interests) unless the partial presentation is used to supplement a financial forecast for a period covered by the forecast.” The phrase negotiating directly means that the third party user can ask questions and negotiate the terms or structure of the transaction directly.

For limited-use circumstances, the presentation must be either complete for what it purports to present considering its intended use, or be the subject of an agreement between the responsible party presenting the forecast or projection and the potential users. The agreement specifies the content of the presentation. For example, a partial
presentation of a statement of forecasted receipts and disbursements that does not include certain existing commitments of the entity may be inappropriate. Similarly, a forecast of net income that does not include disclosure of changes in financial position, when such disclosures would indicate the need for additional capital to sustain operations, may be inappropriate.

When the accountant is engaged to obtain the information and prepare a financial analysis of a potential project, the accountant is the asserter and the analysis is not a "partial presentation."

**Preparation and Presentation of Partial Presentations**

The SOP explains how much of the guidance in the Guide is applicable to partial presentations. Some partial presentations are prepared specially without preparation of full prospective financial statements. If so, the responsible party should consider key factors affecting elements, accounts, or items that are interrelated with those presented. An example of a key factor in a sales forecast is whether productive capacity is sufficient to support the forecasted sales. Some partial presentations are extracted from prospective financial statements, and the effects of interrelationships among elements should have been already determined.

The title of the partial presentation should be descriptive and indicate its limited nature. The title should not state that it is a "financial forecast" or a "financial projection." Appropriate titles include, "forecast of production capacity" and "projected operating income assuming a new plant facility."

Significant accounting policies should be disclosed. Also, the basis of accounting used may sometimes differ from that used for the historical financial statements. If so, the differences that result should be described but do not have to be quantified.

The measure of materiality should be in relation to the partial presentation taken as a whole.

Significant assumptions should be disclosed. In determining what is significant to the partial presentation, one should consider those assumptions directly related to the presentation (for example, selling price in a sales forecast) and indirectly-related assumptions.
(for example, productive capacity in a sales forecast) that have a reasonable possibility that a variation may significantly affect the prospective results. In some situations (for example, forecasted operating results), the assumptions that need to be disclosed for a partial presentation may include all the assumptions needed for a full presentation.

The SOP provides example language for introductions to partial presentations.

**Accountant’s Involvement With Partial Presentations**

An accountant may compile, examine, or perform agreed-upon procedures related to the partial presentation. The SOP states that it does not address partial presentations used solely in connection with litigation support services.

The procedures for compilation and examination of prospective financial statements are generally applicable to partial presentations. When reporting on a partial presentation, the accountant should also consider completeness, key factors and interrelationships, and disclosure of assumptions. In addressing completeness, the accountant considers whether the partial presentation follows the format requirements specified in the agreement between the responsible party and the potential users. If there is no agreement, the accountant considers whether the presentation is complete for its intended use. In addressing disclosure of assumptions, the accountant should include consideration of both directly related and indirectly related assumptions that have a reasonable possibility that a variation may significantly affect the prospective information. An accountant should not report on a partial presentation that excludes disclosure of the summary of significant assumptions or, for a projection, excludes identification of the hypothetical assumptions.

When the accountant is engaged to apply agreed-upon procedures to a partial presentation, the specified users should participate in establishing the nature and scope of the engagement and accept responsibility therefore. Report distribution should be limited to the specified users. Also, the partial presentation should include a summary of significant assumptions.
Prospective Financial Information

Reporting on Partial Presentations

Exhibits 1 and 2 illustrate standard reports on partial presentations. Such a report should include the following, among other things:

- Identification of the partial presentation
- A caveat that the forecasted or projected results may not be achieved
- A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report
- A description of any limitations on the usefulness of the presentation

In addition to the above, a report on a compilation of a partial presentation should include a statement that the accountant has compiled the partial presentation in accordance with standards established by the AICPA, and a statement that a compilation is limited in scope and does not enable the accountant to express an opinion or any other form of assurance on the partial presentation or the assumptions.

Exhibit 1  
Compilation Report on a Partial Presentation of Forecasted Information

We have compiled the accompanying forecasted statement of net operating income before debt service, depreciation, and income taxes of AAA Hotel for the year ending December 31, 19X1 (the forecasted statement) in accordance with standards established by the American Institute of Certified Public Accountants.

The accompanying forecasted statement presents, to the best of management’s knowledge and belief, the net operating income before debt service, depreciation, and income taxes of AAA Hotel for the forecast period. It is not intended to be a forecast of financial position, results of operations, or cash flows. The accompanying forecasted statement and this report were prepared for the ABC Bank for the purpose of negotiating a proposed construction loan to be used to finance expansion of the hotel and should not be used for any other purpose.
Exhibit 1 (continued)

A compilation is limited to presenting forecasted information that is the representation of management and does not include evaluation of the support for the assumptions underlying such information. We have not examined the forecasted statement and, accordingly, do not express an opinion or any other form of assurance on the accompanying statement or assumptions. Furthermore, there will usually be differences between forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Exhibit 2

Examination Report on a Partial Presentation of Projected Information

We have examined the accompanying sales projection of XYZ Company for each of the years in the three-year period ending December 31, 19X1. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the projected statement.

The accompanying sales projection presents, to the best of management’s knowledge and belief, the Company’s expected sales during the projection period that would result if the Company achieved a 15 percent market share of the electric toaster market, as disclosed in items b and c of the summary of significant assumptions. The sales projection and this report were prepared for presentation to the Board of Directors of XYZ Company for its consideration of what sales would be if a 15 percent market share of the electric toaster market were attained and should not be used for any other purpose.

In our opinion, the sales projection referred to above is presented in conformity with the guidelines for a presentation of projected information established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management’s projection of expected sales during the period assuming the Company were to achieve a 15 percent market share of the electric toaster market. However, even if the Company achieves a 15 percent market share, there will usually (continued)
Prospective Financial Information

Exhibit 2 (continued)

be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

A report on an examination of a partial presentation should include a statement that the examination of the partial presentation was made in accordance with AICPA standards and give a brief description of the nature of such an examination. If the partial presentation is a forecast, the report should state the accountant’s opinion that the partial presentation is presented in conformity with AICPA presentation guidelines and that the underlying assumptions provide a reasonable basis for the forecast. If the partial presentation is a projection, the report should state the accountant’s opinion that the partial presentation is presented in conformity with AICPA presentation guidelines and that the underlying assumptions provide a reasonable basis for the projection given the hypothetical assumptions.

For an agreed-upon procedures engagement, the report should include a statement that the report is intended solely for the specified users and should not be used by others. It should also enumerate the procedures performed and refer to conformity with the arrangements made with the specified users. The report should reflect the accountant’s findings based on the agreed-upon procedures. If the agreed-upon procedures are less than those performed in an examination, the report should state that the work performed was less in scope than an examination of a partial presentation in accordance with AICPA standards. If the partial presentation is a forecast, the accountant should disclaim an opinion on whether the presentation is in conformity with AICPA presentation guidelines and on whether the underlying assumptions provide a reasonable basis for the forecast. If the partial presentation is a projection, the accountant should disclaim an opinion on whether the presentation is in conformity with AICPA presentation guidelines and on whether the underlying assumptions provide a reasonable basis for the projection given the hypothetical assumptions.
PROSPECTIVE FINANCIAL STATEMENTS FOR INTERNAL USE ONLY

This proposed SOP would replace section 900 of the Guide. It provides accountants with guidance on procedures to be performed in providing services on financial forecasts and projections for internal use only. It reflects the changes in guidance due to deletion of rule 201(e) and the related interpretation, and expands on the guidance in section 900 when an accountant decides to issue a report.

Procedures Related to Prospective Financial Statements for Internal Use Only

An accountant may compile, examine, or perform agreed-upon procedures on a forecast or projection that is restricted to internal use only. The Guide provides guidance on the types of procedures an accountant performs for these services.

In addition, when the forecast or projection is restricted to internal use only, the accountant may provide "any of a spectrum of services on it." In this case, the accountant should establish an understanding, preferably in writing, with the client regarding the services to be performed. The understanding should also include restriction of the distribution of the prospective information and report. In such an engagement, the accountant should be satisfied that the prospective financial statements are restricted to internal use only. The accountant may rely on the oral or written representation of the responsible party unless contradictory information comes to his or her attention. Also, the accountant should consider the degree of consistency of interest between the responsible party and the user regarding the prospective information. If their interests are the same (for example, both are employees of the entity), the use would be considered internal use. If, on the other hand, the responsible party is a nonowner manager and the user is an absentee owner, the use would not be considered internal use.

Reporting on Prospective Financial Statements for Internal Use Only

The accountant is not required to report on prospective financial statements for internal use only. For example, an accountant can
submit a computer-generated financial forecast to a client without reporting on it when the forecast is for internal use only. However, when it is included with a written communication, such as a transmittal letter, the communication should include a caveat that the prospective results may not be achieved and state that the forecast or projection is for internal use only. Any type of transmittal letter creates the need for the caveat to be written.

If the accountant decides to issue a report, there is flexibility in the report form and content. However, the accountant should not issue a report if the prospective financial statements do not include a summary of significant assumptions.

Exhibit 3 is an example report on a financial forecast limited to internal use only. The SOP states that any such report preferably would —

- Be addressed to the responsible party
- Identify the statements being reported on
- Describe the character of the work performed and the degree of responsibility taken with respect to the financial forecast or projection, in a manner that does not appear to vouch for the achievability of the forecast or projection
- Indicate the restrictions regarding the distribution of the prospective financial statements and report
- Be dated as of the date of the completion of the accountant’s procedures
- If a financial projection, describe the limitations on the usefulness of the presentation

**Exhibit 3**

*Report on Financial Forecast*

*Limited to Internal Use Only*

To: Mr. John Doe, President  
RXZ Company

We have assembled, from information provided by management, the accompanying forecasted balance sheet, statements of income, retained earnings, and cash flows and summaries of significant assumptions and
Exhibit 3 *(continued)*

accounting policies of XYZ Company as of December 31, 19XX, and for the year then ending. (This financial forecast omits the summary of significant accounting policies.) We have not compiled or examined the financial forecast and express no assurance of any kind on it. Further, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. In accordance with the terms of our engagement, this report and the accompanying forecast are restricted to internal use and may not be shown to any third party for any purpose.

If the accountant is not independent with respect to the entity, the accountant should not provide any assurance with respect to the prospective information.

If any omitted disclosures come to the accountant’s attention, they should be described in the report or the report should simply state that there are omissions of disclosures required under the guidelines.

**QUESTIONS CONCERNING ACCOUNTANTS’ SERVICES ON PROSPECTIVE FINANCIAL STATEMENTS**

This SOP was issued April 25, 1989. It was developed in response to questions raised by practitioners about some of the procedural and reporting guidance contained in the Guide. Six topics are covered.

**Reporting on Financial Forecasts That Include a Projected Sale of an Entity’s Real Estate Investment**

Several implementation issues have arisen surrounding section 400.33 of the Guide. It states that it may not be practical in all situations to present financial forecasts for enough future periods to demonstrate the long-term results of an investment decision. In those cir-
cumstances, the presentation should include a description of the potential effect of such results. For example, the Guide indicates that if a real estate entity’s forecast does not extend to the period in which the entity’s investment is expected to be liquidated, the forecast should include a discussion of the effects of a liquidation at the end of the forecast period.

The implementation issue raised by practitioners is: Isn’t that discussion of the effect of a liquidation actually a projection? How should the accountant report on a financial forecast that includes a hypothetical sale of an entity’s real estate investment at the end of the forecast period?

The hypothetical sale is sometimes presented in the notes to the financial forecast and is sometimes presented in a separate statement. When in a note, the disclosure is part of the forecast and is covered in the accountant’s standard report on the forecast. When in a separate statement, the accountant’s report should be modified to report specifically on the statement. Examples of an examination report with an additional paragraph about the projected statement and a similar compilation report are provided in the SOP.

Sales Prices Assumed in a Projection of the Sale of an Entity’s Real Estate Investment

This is the second implementation issue raised about section 400.33 of the Guide. In that discussion of the liquidation at the end of the forecast period, what are the appropriate assumptions for the sales price?

The sales price used should be consistent with the purpose of the projection, that is, to provide users with meaningful information about the long-term results of their investment decisions. The SOP discusses two example approaches. First, if the sales price is based on a specified capitalization rate of forecasted cash flows, the capitalization rate used should be consistent with the assumptions used in the forecast as well as with the entity’s and the industry’s experience. Second, if significant nonrecourse debt is involved, the sales price used is often the existing mortgage balance or the existing mortgage balance plus original capital contributions.
Prospective Financial Information

Reporting on Information Accompanying a Financial Forecast in an Accountant-Submitted Document

An entity may sometimes request that additional details or explanations of items in a financial forecast be included in an accountant-submitted document that contains the forecast and the accountant’s report. If the accountant is not engaged to examine the additional information that is not required, how should the accountant report?

The accountant’s report on the accompanying information would ordinarily include —

- A statement that (1) the examination has been made for the purpose of forming an opinion on whether the financial forecast is presented in conformity with AICPA guidelines for the presentation of a forecast and (2) the underlying assumptions provide a reasonable basis for the forecast
- Identification of the accompanying information
- A statement that the accompanying information is presented for purposes of additional analysis and is not a required part of the financial forecast
- An opinion on whether the accompanying information is fairly stated in all material respects, in relation to the financial statements taken as a whole or a disclaimer of opinion, depending on whether the information has been subjected to procedures applied in the examination of the financial forecast. The accountant may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder
- A caveat that the prospective results may not be achieved

An example report is provided in the SOP. If the accountant determines, on the basis of known facts, that any accompanying information is materially misstated, or if the accountant believes the disclosures are insufficient, the accountant should modify the report or refuse to include the information.

The report may be added to the report on the financial forecast or may be presented with the accompanying information.
Prospective Financial Information

Financial Projections Included in General-Use Documents

The Guide indicates that any projection included in a general-use document should supplement a financial forecast for the period covered by the forecast.

What is an accountant’s responsibility for a projection (without appropriate accompanying forecast) included in a client-prepared general-use document when historical financial statements and the accountant’s report thereon are included in the same document? The projection should be accompanied by an indication that the accountant has not examined, compiled, or applied agreed-upon procedures to the projection and that the accountant provides no assurance for it. The SOP states in a footnote: “In a document filed with the SEC, the responsible party should make this statement since the SEC does not accept an accountant’s disclaimer. In addition, the presentation of the financial projection should be labeled supplemental and unaudited.” If the accountant audited the historical statements, SAS No. 8, Other Information in Documents Containing Audited Financial Statements, also applies.

The guidance is similar if a forecast is included along with the accountant’s report thereon, but the projection is not appropriate or does not cover the correct period (the period covered by the forecast).

Support for Tax Assumptions

When tax assumptions are in a tax opinion prepared by the entity’s tax counsel or another accountant, what responsibility does the accountant examining a forecast have for those tax assumptions, if significant?

The accountant is viewed as one who, by technical training and experience, is knowledgeable of income tax matters. To determine whether the tax opinion provides suitable support for the assumptions, the accountant should obtain a copy of the tax opinion to be issued and apply the procedures from SAS No. 11, Using the Work of a Specialist, paragraphs 5 through 8. These procedures include considering the qualifications and reputation of the specialist and his or her relationship to the responsible party issuing the forecast; obtain-
ing an understanding of the nature of the work performed and the
methods or assumptions used (considering their consistency with the
forecast); and testing any accounting data used. The accountant
should consider whether the other practitioner’s findings support the
representations in the prospective statements, including consistency
of facts used in the tax opinion, reasonableness of its assumptions
and arguments, and whether the assumptions, facts, and arguments
used in the tax opinion support its conclusions.

Periods Covered by an Accountant’s Report on
Prospective Financial Statements

The Guide gives an example of a financial forecast for the annual
periods ending December 31, 19X2, through 19X6. Does the
accountant’s report on such a forecast apply to the forecast taken as a
whole or to each of the discrete periods presented in the forecast?

If the forecast is presented with columns for each period, the
accountant’s report applies to each period presented. If the presenta-
tion had a single column (for example, entitled “for the four years
ending December 31, 19X6”), the accountant’s report would apply
to the entire period taken as a whole. When the report applies to each
period, the accountant should evaluate the support for the under-
lying assumptions used for each period.

SUMMARY

The proposed SOP indicates that a “partial presentation” is a presen-
tation of prospective financial information that omits one or more of
the minimum items required by the Guide. A partial presentation
ordinarily should not be distributed to third parties who will not be
negotiating directly with the responsible party unless the partial pre-
sentation is used to supplement a financial forecast for a period cov-
ered by the forecast.

For limited-use circumstances, the presentation must be either
complete for what it purports to present considering its intended use
or be the subject of an agreement between the responsible party pre-
senting the forecast or projection and the potential users.
An accountant may compile, examine, or perform agreed-upon procedures related to the partial presentation. The procedures for compilation and examination of prospective financial statements are generally applicable to partial presentations. When reporting on a partial presentation, the accountant should also consider completeness, key factors and interrelationships, and disclosure of assumptions.

An accountant may compile, examine, or perform agreed-upon procedures on a forecast or projection that is restricted to internal use only. Also, when the forecast or projection is restricted to internal use only, the accountant may provide “any of a spectrum of services on it,” based on an understanding with the client regarding the services to be performed. The understanding should include restriction of the distribution of the prospective information and report to outsiders.

The accountant is not required to report on prospective financial statements for internal use only. However, when the prospective information is included with a written communication, such as a transmittal letter, the communication should include specified caveats.

Also, an SOP has been issued that addresses a variety of implementation issues and is entitled, Questions Concerning Accountants' Services on Prospective Financial Statements.
CHAPTER 5
Other Current Developments in Auditing

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CHAPTER 5
Other Current Developments in Auditing

This chapter addresses the proposed changes in bank confirmation procedures and forms, reviews the proposed revisions in guidance on using the work and reports of internal auditors, and explains the proposed revisions to SAS 44 regarding controls at service organizations.

The first three sections of this chapter review the AICPA’s proposed new Standard Form to Confirm Account Balance Information With Financial Institutions. They describe the reasons why the AICPA is proposing a new standard form for confirmation and the matters covered by the proposed new form. These sections also review other matters that may need to be confirmed with financial institutions and the form of those confirmation requests. This chapter identifies those circumstances in which it would be appropriate to confirm transactions, arrangements, or information in addition to deposits and loans. When this book went to press the release date of the revised confirmation form was not available.

This chapter also reviews two circumstances in which an independent auditor may find it useful or necessary to use the work of other auditors. The section on internal auditors reviews proposed revised guidance on using the work and reports of internal auditors. When this book went to press, the Auditing Standards Board was expected to issue an exposure draft on this topic in early 1990. The purpose of the revision is to update SAS 9, the existing guidance on the topic, to reflect the audit risk model, the concepts and terminology of SAS 55, and current practice. The section on outside service organizations reviews a proposed revision of SAS 44 on special-purpose reports on internal accounting control at service organizations. The purpose of the revision is to conform the existing guidance to the concepts and terminology of SAS 55 and to meet the needs of auditors of organizations using EDP service centers.
STANDARD FORM TO CONFIRM ACCOUNT BALANCE INFORMATION

The Bank Administration Institute (BAI) and the American Bankers Association (ABA) are considering drafts of the AICPA's proposed revisions to the confirmation process, the new standard confirmation form, and illustrative letters for confirmation of other transactions and arrangements with financial institutions. The new Standard Form to Confirm Account Balance Information With Financial Institutions will be reproduced in the AICPA Audit and Accounting Manual upon receipt of approval from the Auditing Standards Board and the banking groups. The new form will also be available for order from the AICPA order department at that time.

Reasons for Revisions of Confirmation Form

New types of transactions and arrangements with financial institutions have arisen. Since the standard confirmation form was last revised in 1966, financial institutions have created a variety of new services and financial arrangements. An auditor may decide that it is necessary to confirm certain types of transactions and arrangements with financial institutions, such as compensating balance arrangements, currency transactions and other financial instruments and transactions, which the older form was not designed to address.

Another reason for revision is the inherent limitations of organizational structure of financial institutions. Most financial institutions are organized to provide information readily on an entity's deposit and loan balances. The standard confirmation form is generally completed by employees who work primarily with systems that register the dollar amount of deposit and loan balances. However, these employees may be unaware of other arrangements about which the auditor seeks information.

The third reason for revision was a request by the ABA. With the increase in the number of services provided and in the number of organizations providing these services, proper completion of the standard confirmation form, for other than deposit and loan balances, has become difficult. As a result, the ABA asked the Auditing Standards Division to revise the standard confirmation form.
Proposed Changes in the Confirmation Process and Form

The proposed standard confirmation form addresses only deposit and loan balances. One of the changes requested by the ABA was to revise the method of confirming transactions and arrangements other than deposit and loan balances.

The proposed form also has a new title. The original form was titled "Standard Bank Confirmation Inquiry." The proposed new form is titled "Standard Form to Confirm Account Balance Information With Financial Institutions" to more accurately reflect the scope of transactions that will be confirmed by financial institutions on this form.

The new form has expanded instructions. The original form contained instructional information directed only to financial institutions. The proposed new form includes instructions to auditors as well as to financial institutions. The auditor is requested to ascertain that as much information as possible is provided, including the account name, number, and balance to identify the appropriate deposit or loan balance being confirmed. The financial institutions are requested to indicate any exceptions to the information noted and to confirm any additional account or loan balance information of which they are aware.

Generally Accepted Auditing Standards and Confirmation With Financial Institutions

How does the Standard Form to Confirm Account Balance Information With Financial Institutions help the auditor fulfill generally accepted auditing standards (GAAS)? The new standard confirmation form may be useful in providing evidential matter about deposit and loan balances. Evidential matter about other transactions and arrangements may be obtained by direct inquiry of the appropriate financial institution official.

The need to use confirmation as a means of obtaining evidence is a matter of judgment. The auditor considers such factors as knowledge of the client, the industry in which the client operates, and the assessments of inherent and control risk. Auditing standards do not require use of this form in audit engagements.

Exhibit 1 illustrates the form for confirmation or deposit and loan balances with financial institutions.
Exhibit 1  

Standard Form to Confirm Account Balance Information With Financial Institutions

[Customer name]  
[Name of financial institution]  
[Address]  
By ____________________________  
Authorized Signature

Please confirm the following information as of the close of business on [date], and note any additional deposit or loan balances that you are aware of, or any exceptions to the information provided. The account name and number for each account to be confirmed are shown below. If the balances have been left blank, please complete this form by furnishing the balance in the appropriate box. Please use the enclosed envelope to return the original directly to our accountant (see name below).

1. At the close of business on the date listed above, the financial institution showed the following deposit balance(s) of the above named customer.

<table>
<thead>
<tr>
<th>Account Name</th>
<th>Account No.</th>
<th>Interest Rate</th>
<th>Balance*</th>
</tr>
</thead>
</table>

2. The above named customer was directly liable to the financial institution with respect to loans at the close of business on the date listed above as follows:

<table>
<thead>
<tr>
<th>Account No./ Description</th>
<th>Balance*</th>
<th>Date Due</th>
<th>Interest Rate</th>
<th>Paid to</th>
<th>Description of Collateral</th>
</tr>
</thead>
</table>

The foregoing is in agreement with our records except as noted below.

__________________________________________  
[Name of financial institution]  
__________________________________________  
Authorized Signature  
__________________________________________  
Date _____________  

Exceptions and/or Comments

[Name of CPA firm]  
[Address]

*Ordinarily, balances are intentionally left blank if they are not available at the time the form is prepared.

Revised 1989.
CONFIRMATION OF OTHER TRANSACTIONS OR ARRANGEMENTS WITH FINANCIAL INSTITUTIONS

An understanding of arrangements with financial institutions and the underlying transactions are key to obtaining confirmation of those transactions. The following are examples of other transactions, arrangements, or information subject to confirmation:

- Automatic investment services
- Bankers’ acceptances
- Commitments to purchase foreign currencies and U.S. dollar exchange (spot and forward)
- Compensating balance requirements or restrictions on withdrawals of funds
- Contingent liabilities, including oral and written guarantees, letters of indemnity, acceptance, and endorsements
- Futures and forward contracts
- Import/export letters of credit
- Interest rate swaps/loan swaps
- Loan agreements and related covenants
- Repurchase/reverse repurchase transactions
- Securities and other items held in safekeeping on behalf of the client
- Standby contracts, letters of credit, lines of credit, and other option arrangements
- Cut-off account statements
- Listings of authorized account signers

To confirm these types of transactions and arrangements, the auditor sends a separate letter to the financial institution official who is responsible for the client or knowledgeable about the arrangements. If direct inquiries are made to financial institutions for any of these types of transactions, the auditor should be specific within each category about the information that is to be confirmed.

Illustrative letters for confirming several common types of arrangements are presented in Exhibits 2 through 4.
• Exhibit 2 illustrates the proposed form of request that may be used for contingent liabilities
• Exhibit 3 illustrates the proposed form of request that may be used for compensating balance arrangements
• Exhibit 4 illustrates the proposed form of request that may be used for lines of credit

The need to confirm this information is a matter of audit judgment.

Exhibit 2

Illustrative Letter for Confirmation of Contingent Liabilities

[Date of mailing]

Financial Institution Official*
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of [name of company] as of [balance-sheet date] and for the [period] then ended, please confirm that we were contingently liable as to the following and return the enclosed copy of this letter directly to our independent auditors, [name and address of CPA firm].

<table>
<thead>
<tr>
<th>Current Balance</th>
<th>Name of Maker</th>
<th>Date of Note</th>
<th>Due Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate</td>
<td>Interest Paid to Date</td>
<td>Description of Collateral</td>
<td>Description of Purpose of Note</td>
</tr>
</tbody>
</table>

In addition to the foregoing information, please inform our auditors of any other contingent liabilities, including oral and written guarantees, related to other matters of which you are aware. [If none, please so state in your response.]

*The accountant should address this letter to a financial institution official who is responsible for the client or knowledgeable about the arrangements.
Exhibit 2 (continued)

Sincerely,

[Name of company]

__________________________________________

By:_____________________________________

CONFIRMATION

[Name of CPA firm]
[Address]

The above information regarding the contingent liabilities and related matters with this financial institution is in accordance with our understanding except as noted below or in an attached letter:

__________________________________________

__________________________________________

__________________________________________

We are not aware of any other contingent liabilities, including oral and written guarantees with this financial institution, except as noted below or in an attached letter:

__________________________________________

__________________________________________

__________________________________________

[Name of financial institution]

By: ___________________________ Date _______

Officer

[If applicable, phraseology similar to the following may be added to the confirmation reply by either the company or the financial institution:]

This confirmation does not relate to arrangements, if any, with other branches or affiliates of this Financial Institution. Information should be sought separately from such branches or affiliates with which any such arrangements might exist.
Exhibit 3
Illustrative Letter for Confirmation of Compensating Balances

[Date of mailing]

Financial Institution Official*
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of [name of company] as of [balance-sheet date] and for the [period] then ended, please confirm directly to our independent auditors, [name and address of CPA firm], as of the close of business on [balance-sheet date] that there (were/were not) compensating balance arrangements for [name of company] as described in our agreement dated [date]. Withdrawal by [name of company] of the compensating balance (was/was not) legally restricted at [date]. The terms of the compensating balance arrangements at [date] were:

Selected Examples:

1. The Company has been expected to maintain an average compensating balance of 20 percent of its average bank loan outstanding, as determined from the bank’s ledger records adjusted for estimated average uncollected funds.

2. The Company has been expected to maintain an average compensating balance of $100,000 during the year, as determined from the bank’s ledger records without adjustment for uncollected funds.

3. The Company has been expected to maintain a compensating balance, as determined from the bank’s ledger records without adjustment for uncollected funds, of 15 percent of its outstanding loans plus 10 percent of its unused line of credit.

4. The Company has been expected to maintain as a compensating balance non-interest-bearing time deposits of 10 percent of its outstanding loans.

*The accountant should address this letter to a financial institution official who is responsible for the client or knowledgeable about the arrangements.
Exhibit 3 (continued)

In determining compliance with compensating balance arrangements, the Company uses a factor for uncollected funds of ________________________ (business/calendar) days and we understand this to be a reasonable method.¹

There (were the following/were no) significant changes in the compensating balance arrangements during the [period] and subsequently through the date of this letter.

The Company (was/was not) in substantial compliance with the compensating balance arrangements during the [period] and subsequently through the date of this letter.

The Company has no knowledge of any imminent sanctions by the bank because of noncompliance with compensating balance arrangements.²

During the [period], and subsequently through the date of this letter, (no/the following) compensating balances were maintained by the Company at the bank on behalf of an affiliate, director, officer, or any other third party and (no/the following) third party maintained compensating balances at the bank on behalf of the Company. (Withdrawal of such compensating balances (was/was not) legally restricted.)

In addition to the foregoing information, please inform our auditors of any other compensating balance arrangements at your institution of which you are aware. [If none, please so state in your response.]

Please confirm the above information by signing the enclosed copy of this letter and returning it directly to our independent auditors, [name and address of CPA firm].

(continued)

¹Not applicable if compensating balances are based on the bank ledger records without adjustment for uncollected funds. If some other method is used for determining collected funds for compensating balance purposes, the method actually used should be described.

²Applicable only if the response discloses noncompliance with compensating balance arrangements:
If the bank has applied sanctions during the [period] or notified the Company that sanctions may be applied, indicate details.
Exhibit 3 (continued)

Sincerely,

[Name of company]

By: __________________________________________

CONFIRMATION

[Name of CPA firm]
[Address]

The above information regarding the compensating balance arrangements with this financial institution is in accordance with our understanding except as noted below or in an attached letter:

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

We are not aware of any other compensating balance arrangements with this financial institution, except as noted below or in an attached letter:

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

[Name of financial institution]

By: ___________________________ Date __________

Officer

[If applicable, phraseology similar to the following may be added to the confirmation reply by either the company or the financial institution:]

This confirmation does not relate to arrangements, if any, with other branches or affiliates of this Financial Institution. Information should be sought separately from such branches or affiliates with which any such arrangements might exist.
Exhibit 4

Illustrative Letter for
Confirmation of Lines of Credit

[Date of mailing]

Financial Institution Official*
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of [name of company] as of [balance-sheet date] and for the [period] then ended, please confirm directly to our independent auditors, [name and address of CPA firm], as of the close of business on [balance-sheet date] that the Company has available at the Bank a line of credit totaling [dollar amount]. The current terms of the line of credit are contained in the agreement dated [date].

The related debt outstanding at the close of business on [date] was [dollar amount].

The amount of unused line of credit, subject to the terms of the related agreement, at [date] was [dollar amount].

Interest rate at the close of business on [date] was __________ %.

Compensating balance arrangements are ___________________________.

This line of credit supports commercial paper (or other borrowing arrangements) as described below:

______________________________________________________________

______________________________________________________________

______________________________________________________________

In addition to the foregoing information, please inform our auditors of the terms of any other lines of credit at your institution of which you are aware. [If none, please so state in your response.]

Please confirm the above information by signing the enclosed copy of this letter and returning it directly to our independent auditors, [name and address of CPA firm].

*The accountant should address this letter to a financial institution official who is responsible for the client or knowledgeable about the arrangements.
Exhibit 4 (continued)

Sincerely,

[Name of company]

By: __________________________________________

CONFIRMATION

[Name of CPA firm]
[Address]

The above information regarding the line of credit arrangements with this financial institution is in accordance with our understanding except as noted below or in an attached letter:

By: __________________________

[Name of financial institution]

By: __________________________ Date ___________

Officer

[If applicable, phraseology similar to the following may be added to the confirmation reply by either the company or the financial institution:]

This confirmation does not relate to arrangements, if any, with other branches or affiliates of this Financial Institution. Information should be sought separately from such branches or affiliates with which any such arrangements might exist.
BANK CONFIRMATION IMPLEMENTATION ISSUES

Timing of Adoption of New Form

If a CPA firm has stockpiled a large quantity of standard bank confirmation forms, they may wish to continue to use the old form after the adoption of the new form, until their supply is exhausted. Is this acceptable under professional standards?

Since GAAS do not require bank confirmations, the auditor may use any form of request the auditor wishes. However, it is unrealistic to believe that it will be feasible to use the old form once the new form is issued, because financial institutions can be expected to insist on use of the new form.

Decision to Send Additional Confirmation Requests

How should an auditor decide whether to send additional confirmation requests beyond the confirmation of deposit and loan information? Should this be done in all audits? If not in all audits, when would such requests be appropriate?

The need to confirm additional transactions, arrangements, or information with a financial institution beyond deposit and loan information depends on the auditor’s knowledge of the client and the auditor’s assessment of inherent risk and control risk. If the auditor is aware that the client has a compensating balance arrangement or a line of credit with a financial institution, the auditor would generally confirm the details of those matters with the official of the financial institution responsible for the client’s affairs. More judgment is required concerning the request on contingent liabilities.

Some CPA firms may decide to routinely use the contingent liabilities request for all clients. For example, some CPA firms routinely confirm Uniform Commercial Code (UCC) information in every state in which the client does business, but other CPA firms regard this as an unusual procedure.
Determining the Need to Obtain Information About the Financial Institution

When does the auditor need to obtain information about the financial institution confirming the client information? Should the auditor obtain its audited financial statements or a report of its auditors on its internal control structure?

If the financial institution is well-known to the auditor, and the auditor is aware that it has federal deposit insurance, no additional inquiries are necessary. However, if the financial institution is not federally insured or its status is unknown, the auditor is well-advised to request the client to obtain additional information including audit reports on financial statements and reports on internal control structure. The auditor's judgment is influenced by the materiality of deposits or collateral on loans maintained with the financial institution and the evaluation the client has made of the financial institution.

INTERNAL AUDITORS

This section describes the considerations involved in using the work of internal auditors, including the significance of the standards of the internal auditing profession, the position of the internal audit department in the control environment, and the nature of procedures necessary to consider the competence and objectivity of internal auditors and evaluate their work. The section explains the effect of internal auditors on the audit plan and the steps involved in coordination of audit work with internal auditors.

Internal Auditing Profession

The Institute of Internal Auditors has issued Standards for the Professional Practice of Internal Auditing. The purpose of these standards is (1) to impart an understanding of the role and responsibilities of internal auditing to all levels of management, boards of directors, public bodies, external auditors, and related professional organizations; (2) to establish the basis for the guidance and measurement of internal auditing performance; and (3) to improve the practice of internal auditing.
These standards require the internal auditor to plan the audit, examine and evaluate information, communicate results, and follow up to ascertain that appropriate action is taken on reported audit findings. The Institute of Internal Auditors also has a Code of Ethics, a Statement of Responsibilities of Internal Auditors, a Common Body of Knowledge, a Certified Internal Auditor program, and a program of continuing education.

When an entity’s internal audit department has adopted the standards issued by the Institute of Internal Auditors, the auditor may consider these standards the benchmark against which to consider the internal auditors’ competence and objectivity. When an entity’s internal audit department does not subscribe to these standards, the auditor should consider the specific policies and procedures implemented by the department to ensure its objectives are fulfilled.

**Understanding of Control Environment Includes Internal Audit Function**

An internal audit function is one of the entity’s control methods for monitoring the performance of other controls. When obtaining an understanding of the internal control structure, the auditor should obtain an understanding of the internal audit function.

SAS 55 states that an internal audit function is part of the entity’s control environment. The extent of the understanding necessary to plan the audit depends on the nature of the internal audit activities and how these activities may affect the work of the auditor.

The scope of internal audit activities generally encompasses the examination and evaluation of the effectiveness of the entity’s control policies and procedures and the performance of audit procedures relating to the reliability and integrity of information and safeguarding of assets. The independent auditor needs to identify the internal audit activities that are relevant to the audit of the financial statements.

If the auditor concludes that the internal auditor’s activities may affect the auditor’s procedures, he or she should consider the competence and objectivity of the internal auditors and evaluate and test the work of internal auditors that affects the audit plan.
Competence and Objectivity of Internal Auditors

The auditor should consider the competence and objectivity of the internal auditors by obtaining sufficient knowledge of the department’s relevant policies and procedures and whether they have been placed in operation.

In considering competence, the auditor should inquire about the knowledge and experience of the internal audit staff and about the department’s policies and procedures for assigning individual staff to specific audit projects and for supervising and reviewing their work. Effective employment practices and continuing education programs help ensure the competence of the internal audit staff. Policies and procedures that require the long-range planning of staff assignments and adequate staff supervision help ensure the staff’s competence.

In considering internal auditors’ objectivity, the auditor should consider—

- The reporting responsibility of the internal audit department and the organizational level to which it reports. Does the director of the internal audit department report to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors? Does the director have direct access to the board or its audit committee, and does the director report regularly to that body? Was the director hired by and can the director be dismissed only with concurrence of the audit committee?

- The internal audit department’s policies requiring the staff’s independence from the personnel and functions that are being, or will be, audited. Does the director of internal audit establish procedures that include a review of the relationships of staff members that might cause a conflict of interest? Is there periodic rotation of internal audit assignments?

The auditor normally obtains sufficient knowledge and understanding of the internal audit department’s policies and procedures relevant to competence and objectivity from previous experience with the internal audit department; inquiry of appropriate management, supervisory, and staff personnel; and review of documents relevant to the design and implementation of those policies and procedures.
Evaluation of the Work of Internal Auditors

When evaluating the internal auditors’ work, the auditor should consider a number of factors, such as the following:

- Is the scope of the work appropriate to meet its objectives?
- Are the audit programs adequate?
- Do the working papers adequately document work performed?
- Are conclusions reached appropriate in the circumstances?
- Are reports prepared consistent with the results of the work performed?

The auditor should plan to test some of the internal auditors’ work by reperforming tests of similar account balances or transactions, by reviewing their working papers or audit reports, or by performing a combination of these or similar procedures.

For financial statement assertions affected by the work of internal auditors that affect the auditor’s scope, the auditor should consider the materiality of the related financial statement account balances or transaction classes, the inherent risk assessments for those assertions, and the assessed levels of control risk for those assertions.

For all significant account balances and classes of transactions, the assessed level of control risk (which may be affected by the internal auditors’ work) ordinarily will not be sufficiently low to eliminate the need for the auditor to perform substantive tests to restrict detection risk for all of the related assertions. If the internal auditors have performed audit work in these areas, the auditor should test their work and consider the need to obtain additional evidential matter to achieve the audit objectives for those assertions. The valuation assertion, for example, is generally significant to the loan accounts at a bank. For this assertion, although the internal auditors may have audited the valuation assertion, the auditor should consider the need to test their work and obtain additional evidential matter to reduce detection risk for that assertion to an acceptable level.

Effect of Internal Auditors on the Audit Plan

The work of the internal auditors may affect the audit plan at the financial-statement level or at the account-balance or class-of-transaction level.
At the financial-statement level, if the internal audit department is competent, objective, and implements an audit plan relevant to the auditor’s plan, the auditor will coordinate the audit work with the internal auditors. The goal of such coordination is to ensure adequate audit coverage while minimizing the duplication of effort. This may be accomplished through periodic meetings between the auditor and internal auditor, rotation of certain audit coverage, shared access to working papers, and exchange of audit reports and management letters. In a multilocation entity, for example, the auditor and internal auditor will plan and coordinate which locations to visit and the overall scope of the audit work at each location, such as full audit work, limited review work, or inventory observation only.

At the balance or class level, the internal auditors’ planned work on a particular account might result in a low level of assessed control risk for certain assertions and may result in the auditor reducing the extent of substantive testing for those assertions.

**Direct Assistance by Internal Auditors**

The auditor may request internal auditors to provide direct assistance in performing an audit in accordance with GAAS. When the internal auditors provide such assistance to the auditor, he or she should consider their competence and objectivity and supervise and test their work to the extent appropriate in the circumstances. When the auditor considers the internal auditors’ work in planning the scope of the audit, judgments about the effectiveness of the internal control structure, sufficiency of tests performed, materiality of transactions, and other matters affecting the auditor’s opinion on the financial statements must always be those of the auditor.

**EFFECT OF AN OUTSIDE SERVICE ORGANIZATION ON THE AUDIT**

This section identifies the effect an outside service organization can have on the assessments of inherent risk and control risk and the factors that affect the decision to obtain a so-called third-party report.
Applicability and Focus

This guidance applies when the auditor's client uses an outside service organization to process accounting data or to execute transactions and maintain accountability for related assets. Examples are service centers that provide data processing functions for other organizations, and trust departments of financial institutions.

The key issue is whether the auditor needs to obtain a so-called third-party report on the internal control structure at the service organization, that is, a report by the service organization's auditor on the effectiveness of its internal control structure.

Need for a Third-Party Report

The auditor should assess the factors that affect inherent risk and control risk in the circumstances, such as the following:

- Financial significance of the account balances or transactions processed by the servicer
- Inherent risk of misstatement in the portion of the system processed by the servicer
- Extent of understanding about the portion of the system processed by the servicer that can be derived from information available at the client
- Terms of the contract with the service organization
- Reputation of the service organization in the industry and the business community
- The internal control structure policies and procedures at the client's location that are relevant to the portion of the system processed by the servicer
- Previous experience concerning the reliability and integrity of the service organization

Even when the auditor concludes that a third-party report is not necessary, the auditor may conclude that such a report would permit an assessment of control risk below the maximum level.
SUMMARY

Bank Confirmations

Because of the variety of new services and arrangements offered by financial institutions and the organizational difficulty experienced by such institutions in confirming more than deposit and loan information, the AICPA is proposing changes to the standard bank confirmation form. The auditor should exercise judgment about whether it is necessary to confirm with financial institutions information about deposits, loans, compensating balance arrangements, lines of credit, contingent liabilities, or other matters. If the auditor concludes that confirmation is necessary or desirable, the auditor should use the standard form for deposits and loans for those balances, and, if appropriate, separate requests for other transactions, arrangements, and information.

Internal and Other Auditors

The auditor may use the standards issued by the Institute of Internal Auditors as a benchmark against which to consider the competence and objectivity of internal auditors. If the auditor concludes that the internal auditors’ activities may affect the auditors’ procedures, the auditor should consider the competence and objectivity of the internal auditors and evaluate and test the work of the internal auditors that affects the audit plan. The auditor may request internal auditors to provide direct assistance in performing the audit and, in those circumstances, the auditor should consider their competence and objectivity and supervise and test their work.

Judgments about the effectiveness of the internal control structure, sufficiency of tests performed, materiality of transactions, and other matters affecting the auditor’s opinion on the financial statements must always be those of the auditor.

When a client uses an outside service organization to process accounting data or execute transactions and maintain the related accountability, the auditor should consider whether it is necessary to obtain a third-party report on the servicer’s internal control structure. The need for a third-party report depends on the auditor’s assessment of inherent risk and control risk.
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CHAPTER 6

Accounting for Income Taxes
(FASB Statement No. 96)

OBJECTIVES

This chapter provides guidance on application of the provisions of Financial Accounting Standards Board (FASB), Statement of Financial Accounting Standards (SFAS) No. 96, Accounting for Income Taxes, including—

1. Recognition of a deferred tax liability or asset
2. Measurement of a deferred tax liability or asset
3. Accounting for operating loss and tax credit carrybacks and carryforwards
4. Utilization of tax-planning strategies in accounting for income tax
5. Allocation of income taxes within financial statements
6. Preparation of required disclosures
7. Application of transition requirements
8. Accounting for alternative minimum tax in determining deferred income taxes
9. Accounting for a change in tax rates or tax status
10. Accounting for the tax effects in business combinations

OVERVIEW

SFAS 96, issued in December 1987, retains the comprehensive allocation objective of Accounting Principles Board (APB) Opinion No. 11, and retains the exceptions in APB 23. However, SFAS 96 replaces the deferred approach with the asset and liability approach. Under the asset and liability approach, deferred taxes are viewed as
either assets or liabilities, and accordingly SFAS 96 modifies the accounting for deferred income taxes consistent with that approach.

*Tax Jurisdiction—Not Offset.* Deferred taxes are computed separately for each taxing jurisdiction, and deferred tax assets and deferred tax liabilities relating to different jurisdictions are not offset.

*Changes in Tax Rates or Tax Status.* The effects of changes in tax laws, tax rates, or the tax status of an entity are recognized when the law is enacted or when the tax status of the entity changes.

*Tax-Planning Effects.* Tax-planning strategies are used to reduce a deferred tax liability or increase a deferred tax asset by altering the period in which temporary differences are scheduled to result in taxable income or tax deductions, that is, when they reverse.

*Deferred Tax Asset Recognition.* Deferred tax assets arising from temporary differences are recognized only to the extent that taxes paid in prior periods or incurred in the current period, including deferred taxes, could be recovered through the use of carrybacks.

*Deferred Tax in Business Combinations.* Deferred tax assets and liabilities are recognized on temporary differences in business combinations.

*Current-Noncurrent Classification.* Deferred tax assets and liabilities are classified as current or noncurrent based on the period of reversal rather than on the nature of the transaction giving rise to the temporary difference.

SFAS 96, as amended by SFAS 100, is effective for fiscal years beginning on or after December 15, 1989; however, the Board has decided to further defer the effective date to fiscal years beginning after December 15, 1990.

SUPERSEDED STATEMENTS AND STATEMENTS NOT AMENDED BY SFAS 96

Comprehensive Tax Allocation Continued

SFAS 96, *Accounting for Income Taxes,* establishes financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and pre-
ceding years. SFAS 96 continues the fundamental requirements of comprehensive tax allocation with modifications and supersedes the following:

- APB 11, *Accounting for Income Taxes*
- APB 24, *Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (Other Than Subsidiaries and Corporate Joint Ventures)*
- SFAS 37, *Balance Sheet Classification of Deferred Taxes*
- Numerous related FASB Interpretations (FAS Is) and Technical Bulletins (TBs)

**Exceptions to Comprehensive Allocation**

The only exceptions to comprehensive tax allocation are those discussed in APB 23, *Accounting for Income Taxes—Special Areas*, which SFAS 96 did not amend. These exceptions include the following:

- Undistributed earnings of subsidiaries
- Bad debt reserves of savings and loan associations
- Policyholders' surplus of stock life insurance companies

The exceptions in APB 23 were retained because of perceived complexities of measurement in the case of undistributed earnings and uniformity for the others.

**Pronouncements Not Amended**

SFAS 96 does not amend accounting for leveraged leases as required by SFAS 13, *Accounting for Leases*, and FAS I 21, *Accounting for Leases in a Business Combination*.

SFAS 96 continues to preclude the recognition of deferred taxes for deposits in statutory reserve funds by U.S. steamship enterprises.

**SCOPE OF SFAS 96**

**Areas Covered**

SFAS 96 establishes financial accounting and reporting standards for income taxes that are currently payable and for the tax consequences
Accounting for Income Taxes

of (1) revenues, expenses, gains, and losses that are included in taxable income of an earlier or later year than the year they are recognized in financial income, (2) other transactions that create differences between the tax bases of assets and liabilities and their amounts for financial reporting, and (3) operating loss or tax credit carrybacks and carryforwards.

Applicability

The requirements of SFAS 96 apply to—

- Domestic federal income taxes (U.S. federal income taxes for U.S. enterprises) and to foreign, state, and local (including franchise) taxes based on income.
- An enterprise’s foreign operations that are consolidated, combined, or accounted for by the equity method.
- Foreign enterprises for purposes of preparing financial statements in accordance with U.S. generally accepted accounting principles (GAAP).

Areas Not Changed

SFAS 96, in general, does not change the accounting for the investment tax credit, intercompany tax allocation, interim reporting, the proscription of discounting, and APB 23 exceptions to tax allocation.

Investment Tax Credit. The deferral and flow-through methods continue as acceptable alternatives in accounting for the investment tax credit. However, note that the Tax Reform Act of 1986 repealed the investment tax credit and limits the use of credits of prior periods that are carried forward.

Separate Statements of Subsidiary. SFAS 96 does not prescribe any single method for recognizing and measuring income taxes in the separately issued financial statements of an entity that is part of a group filing consolidated returns. However, it does add certain disclosure requirements, which will be discussed later.

Interim Reporting. Most of the provisions of APB 28, Interim Reporting, continue in effect except that the discrete approach is now
required in implementing the effects of tax law changes. The entire effect of a change in tax rates must be recognized in the interim period of enactment.

Discounting. The proscription of discounting under APB 10, *Omnibus Opinion—1966*, continues in force. The extension of that proscription to business combinations, via the new approach to tax allocation, means that it will no longer be acceptable to discount the tax effects of fair value (book)/tax differences arising in connection with business combinations accounted for by the purchase method.

**BASIC PRINCIPLES OF SFAS 96**

SFAS 96 adopts the asset and liability approach to income tax allocation in place of the deferred approach of APB 11. Both approaches represent applications of comprehensive tax allocation, with the exceptions noted above. But there are important differences in application that would yield different results in all but the simplest of cases.

**Asset and Liability Approach**

*Focuses on Individual Future Years.* Under SFAS 96, the amount of the liability or asset for deferred taxes arising from temporary differences, including timing differences, is computed as if a tax return were prepared for the net amount of temporary differences, resulting in taxable or deductible amounts in each future year.

*Includes Effects of Temporary Differences.* A temporary difference is the difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years, when the reported amount is either recovered or settled. Thus, such originating differences as depreciation, which give rise to deferred tax liabilities, represent taxable amounts in future years’ tax returns in which they are scheduled to reverse.

*Anticipates No Future Profits or Losses.* It is assumed that the assets’ carrying amounts will be recovered on a break-even basis.
The asset and liability approach does not anticipate the tax consequences of earning income or incurring losses in future years. An originating difference, such as warranty expense, gives rise to a future deductible amount when it reverses and the cost is incurred. Again, no future earnings or losses are anticipated.

Classifies Deferred Taxes. A current and/or deferred tax liability or asset is recognized for the current and deferred tax consequences of all events that have been recognized in the financial statements.

Highlights Changes in Deferred Taxes. The income statement provision for deferred taxes is based on the year-to-year change in the balance-sheet amounts for deferred taxes. When the change in deferred taxes is either added to or subtracted from the provision for current taxes, the result is the income tax expense for the year.

Classifies Tax Effects Based on Turnaround Period. Consistent with the asset and liability approach, SFAS 96 calls for current/non-current classification based on the timing of the expected reversal rather than the classification of the related asset or liability giving rise to the timing difference.

Currently Recognizes Effect of Change in Tax Rates or Status. Additionally, the effect of a change in tax rates, tax laws, or the tax status of an entity on existing deferred tax liabilities and assets is recognized when the law is enacted or the entity’s status changes. SFAS 96 also modifies the rules of accounting for net operating loss carry-forwards.

Temporary Differences

Temporary differences include those items previously classified as timing differences, but with an emphasis now on the accrual of the appropriate balance sheet deferred tax amounts.

- Revenues or gains taxable after they are recognized in financial income. (A receivable from an installment sale will result in taxable amounts when collected.)

- Expenses or losses deductible before they are recognized in financial income. (In the case of depreciation differences, amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis, resulting in taxable income.)
• A reduction in the tax basis of depreciable assets due to tax credits (that is, taking the full ITC and reducing ACRS deduction).

• ITC accounted for by the deferral method.

• Expenses or losses deductible after they are recognized in financial income. (A product warranty liability will result in tax deductible amounts when the liability is settled.)

• Revenues or gains taxable before they are recognized in financial income. (Subscriptions received in advance necessitate the recognition of a liability; future sacrifices to provide goods or services to settle the liability result in tax deductible amounts in a future year.)

• Temporary differences also include differences between the accounting and tax bases of assets acquired in a business combination accounted for as a purchase. Previously, such differences were accounted for on a net-of-tax basis and treated as permanent differences.

• Temporary differences not identified with a particular asset or liability for financial reporting include:

  Long-term contracts that use percentage-of-completion reporting for book and completed contract basis for tax.

  Organization costs that are written off for book purposes but amortized for tax purposes.

In these cases, there is an asset or liability for tax purposes but none for financial reporting. These temporary differences will result in taxable or deductible amounts in future years.

**Subsequent Recovery or Settlement**

The amount actually recovered for a particular asset or paid to settle a particular liability in a subsequent year may be different from the amount recognized for financial reporting in the current year. The change in tax consequences resulting from the gain or loss would be recognized when the gain or loss is recognized.

**"Permanent Differences"**

Some events do not have tax consequences. For example, interest on municipal obligations is not taxable. Such items are classified as permanent differences in APB 11. SFAS 96 does not discuss permanent differences. The effects of permanent differences are not accounted for.
Recognition

SFAS 96 requires that a liability or asset be recognized for the deferred tax consequences of all temporary differences except those differences related to indefinite reversals (APB 23). (SFAS 96 eliminates the “with” and “without” approach as well as the use of gross change or net change methods.)

Assumes Only Temporary Differences. The measurement of a deferred tax liability or asset assumes that the only taxable or deductible amounts in future years are those that result from temporary differences at the end of the current year.

Future Recoveries or Settlements. Future recovery of assets and settlement of liabilities at their reported amounts are assumed events and result in taxable or deductible amounts in the future.

Anticipates No Future Profits or Losses. Recognition and measurement of taxable effects ignore the tax consequences of earnings or losses in future years. These are future events and are not anticipated regardless of probability for purposes of accounting for income taxes.

Net Change in Deferred Taxes Included With Current Tax. Deferred tax expense or benefit should be recognized for the net change during the year in an enterprise’s liability or asset for deferred tax consequences. That amount together with income taxes currently payable or refundable is the total amount of income tax expense or benefit for the year.

Computing Deferred Income Taxes

The following procedures are applied in computing and reporting current and deferred income taxes. They are illustrated in the cases to follow.

1. Current Tax. Determine the income tax currently payable or refundable based on the current year’s tax return.

2. Schedule. Schedule all temporary difference originations and reversals into future years and separate ordinary income differences from capital gains and losses.

3. Net Taxable or Deductible. Determine for each future year the net taxable or deductible amount.
4. Net Operating Loss (NOL). Deduct the NOL carryforward from each year's net taxable amounts that are within the limits of the carryforward period.

5. Carryback or Carryforward Net Deductible Amounts. Deduct the net deductible amounts for each year, after step 4, as an NOL carryback or carryforward.

6. Tax-Planning Strategies. Develop tax-planning strategies to permit the full utilization of carryforwards of net deductible amounts, thereby reducing a deferred tax liability or increasing a deferred tax asset.

7. Deferred Tax Asset. Recognize a deferred tax asset for carrybacks that reduce taxes paid in prior years or payable in the current year including deferred tax liabilities.

8. Deferred Tax Liability. Compute the taxes payable for each future year using currently enacted tax laws and rates.
   - Separate ordinary income from capital items.
   - Deduct tax credit carryforwards.

9. Deferred Tax Expense. Subtract the opening balances of deferred taxes from the closing balances to determine deferred income tax expense or benefit for the period. Combine the deferred income tax expense with the tax expense currently payable to arrive at the income tax expense for the period.

10. Intraperiod Tax Allocation. Allocate current and deferred income tax expense to the following:
    - Income from continuing operations
    - Discontinued operations
    - Extraordinary gains or losses
    - Cumulative effect of accounting changes
    - Retained earnings (Prior period adjustments)
    - Gains or losses carried directly to equity accounts


12. Footnote Disclosure. Comply with footnote disclosure requirements.
Scheduling

Conditions Requiring Scheduling
The scheduling of temporary differences (that is, assigning the differences to the years in which they become taxable or deductible) generally is required if any of the following conditions are present:

- There are both temporary taxable differences and deductible differences that may necessitate the carryback or carryforward of net deductible amounts, especially where tax-planning strategies are not available.
- Enacted tax rates significantly differ in future years.
- The effects of graduated tax rates are significant.
- Significant amounts of net operating loss or tax credit carryforwards exist.
- The alternative tax system may significantly impact the deferred tax determination.
- Deferred taxes must be classified as current or noncurrent in a classified balance sheet.
- Temporary differences exist for which tax-planning strategies are not available.
- The existence of net deductible amounts and net operating loss or tax credit carryforwards necessitates scheduling to determine whether such items can be recognized by carryback or carryforward.

Pattern of Taxable or Deductible Amounts
The particular years in which temporary differences will result in taxable or deductible amounts are determined by referring to the timing either of the recovery of the related asset or of the settlement of the related liability. Estimates may be required.

Contractual Arrangements. Scheduling is fairly evident where the recovery of the related asset or the settlement of the related liability is tied to a contractual arrangement involving collections and payments.
Inventory. LIFO inventory differences will result in taxable or deductible amounts when the reported amount of inventory is recovered—ordinarily one year. Future recovery is assumed; however, future purchases or inventory production are not assumed.

Note: The reported amount of LIFO inventory would be recoverable next year if inventory is estimated to “turn over” at least once a year. On that basis, a temporary difference for LIFO inventory would be considered taxable or deductible next year.

Depreciation. Scheduling may also be based on the systematic pattern of depreciation or amortization of long-lived assets. Differences related to depreciable assets may accumulate over several years and then eliminate over several years. Future temporary differences for existing depreciable assets (in use) are considered in determining the future years in which existing temporary differences result in net taxable or deductible amounts.

Future originating differences should not be scheduled if their subsequent reversal results in an increase in deferred tax liability greater than it otherwise would be based on consideration of only the net amount of temporary differences that exist at the date of the financial statements. The net taxable difference at the balance sheet date would be scheduled out on a FIFO pattern. The FASB’s Special Report, A Guide to Implementation of Statement 96 on Accounting for Income Taxes, 1989 (p. 20), specifies—

A first-in, first-out (FIFO) pattern should be used for all depreciable and amortizable assets in a particular tax jurisdiction if consideration of future originating differences results in creating net deductible amounts for which a tax benefit cannot be recognized and thereby either increases a deferred tax liability or reduces a deferred tax asset.

That result could occur because of limitations on the carryback or carryforward of net deductible amounts to other years, or it could occur if the deductible amounts are capital losses that can only reduce capital gains and if there are no capital gain temporary differences that can be offset.

Scheduling Estimates. Certain temporary differences, such as those that arise from allowances for obsolete inventory, loan losses, or unrealized losses on marketable equity securities long-term
require estimates for scheduling. On the other hand, unrealized losses on investments in marketable equity securities short-term are assumed to result in deductible amounts on the first day of the next period because SFAS 96 prohibits anticipating future gains that may either offset existing losses or reduce their amount.

*Indefinite Reversals.* If asset recoveries or liability settlements are not likely to occur in the foreseeable future, such differences should be scheduled in an indefinite period. Nevertheless, tax liabilities would be recognized for such taxable amounts. Tax and book basis differences related to land would qualify as indefinite temporary differences if there are no plans to dispose of the land in the foreseeable future. However, such differences do not fall under the explicit exemption of APB 23 differences.

*Present Values.* Scheduling the pattern of taxable or deductible amounts when assets and liabilities are measured at present values poses special problems.

If the book basis exceeds its tax basis, each future cash receipt or cash payment may be allocated first to interest, with the remainder being considered a recovery or settlement of a temporary difference. An alternative approach is to base the scheduling pattern on the present value of each future cash receipt or cash payment.

*Lessor.* In situations in which a lessor accounts for a lease as a direct financing lease for financial reporting but treats the lease as an operating lease for tax purposes, two temporary differences are involved. One relates to the investment in the lease, which has a zero tax basis. The other difference relates to the leased asset for tax purposes, which has a zero book basis. For the investment in the lease for book purposes, the pattern of taxable amounts should follow that discussed above for situations in which book basis exceeds tax basis. In the case of the temporary differences related to the leased asset for tax purposes, the scheduling would follow the depreciation pattern. Accounting for pension costs may also give rise to temporary differences that require the recognition of present values in dealing with the asset or liability.

*Inventory Cost Capitalization.* The Tax Reform Act of 1986 adopted uniform capitalization rules for inventory that would
require capitalizing costs for tax purposes that are expensed for financial reporting. This requirement would give rise to a temporary difference that would result in a deductible amount when the inventory is sold. The other difference results from the catch-up adjustment, which will be included in taxable income over four years.

**Intercompany Profits.** Intercompany profit on a transfer of inventory or other assets between companies that are not included in a consolidated tax return results in temporary differences. Determination of whether to recognize a tax benefit and the amount of the benefit should be based on the tax circumstances of the acquiring company and not that of the selling company. The temporary difference will result in a deductible amount on the acquiring company's tax return in the future year when the cost of the inventory, as reported in the consolidated financial statements, is recovered.

**Reduction of Scheduling.** To reduce the amount of scheduling and detailed calculations otherwise called for, identify the type of a company's temporary differences and determine for each whether the tax law precludes or effectively precludes tax-planning strategies, which could alter the years in which temporary differences fall. (Tax-planning strategies required under SFAS 96 are discussed below.) For such difference scheduling is required. For others, determine whether there is a strategy that meets the criteria of SFAS 96, and if so, such difference may be offset for deferred tax calculations. Deferred tax computations must be by ascending year and follow the ordering rules permitted or required by existing relevant tax law (related to carrybacks and carryforwards).

**Shortcutting Scheduling.** It may be possible in many cases to shortcut the scheduling process with no loss in fairness or compliance with SFAS 96. The shortcut approach is as follows:

1. Schedule all future tax deductible amounts first.
2. Schedule future taxable amounts to the extent necessary to determine whether the scheduled deductible amounts may be recognized.
3. Schedule the remaining taxable amounts in a single indefinite column.
4. Apply carrybacks and carryforwards of NOLs and then net deductible amounts, if any.
5. Determine the net taxable amounts for each year scheduled and for the indefinite column.

6. Apply appropriate tax rates.

*Offset of Taxable and Deductible Amounts.* If the tax law provides that capital losses or other items are deductible only to the extent of capital gains or other items, temporary differences that result in future deductions in the form of capital losses or other items cannot be offset against temporary differences that will result in future ordinary income.

On pages 229–236 is a tabular summary of selected accounts including a description of the nature of book and tax bases differences and identification of each difference as either a taxable or deductible amount. The table describes the approach to scheduling future taxable or deductible amounts for these differences.

**Measurement of Deferred Tax Liability or Asset**

A deferred tax liability or asset at each balance sheet date is computed by applying the provisions of the tax law to measure the tax consequences of temporary differences that will result in net taxable or deductible amounts in each future year, based on—

- Elections and options expected to be made, or that could be made, for tax purposes in future years.
- Enacted changes in tax laws or rates scheduled for a particular future year or years applied to differences arising or reversing in that year or years.

Tax laws and rates of the current year are used if no changes have been enacted for future years. Tax laws and rates of applicable prior years are used for net tax deductible amounts that will be realized based on carryback provisions.

A deferred tax liability is measured using tax rates applicable to capital gains and ordinary income, as appropriate. For example—

- Facts and circumstances (such as method of anticipated realization) would dictate whether a deferred tax on the equity in an investee’s earnings should be measured as a capital gain or as a dividend.
- A consistent policy of selling depreciable assets might indicate that capital gain rates are more appropriate to measure deferred tax for differences between tax and book basis.
## Temporary Differences — Identifying and Scheduling Future Taxable and Deductible Amounts

<table>
<thead>
<tr>
<th>Account</th>
<th>Book and Tax Bases Differences</th>
<th>Book Basis Exceeds Tax Basis</th>
<th>Tax Basis Exceeds Book Basis</th>
<th>Scheduling of Future Taxable or Deductible Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued expenses and estimated losses (discontinued operations, warranties, litigation)</td>
<td>Accrual basis for books, cash basis for tax purposes</td>
<td>√</td>
<td></td>
<td>Schedule as deductible amount in year(s) that amounts will be deducted for tax purposes. For warranties consider terms as well as historical experience.</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>Allowance method for books, specific charge-off method for tax purposes (TRA 1986)</td>
<td>√</td>
<td></td>
<td>Schedule based on estimates of future specific charge-offs or historical experience based on aging schedule.</td>
</tr>
</tbody>
</table>

*(continued)*
## Temporary Differences—Identifying and Scheduling Future Taxable and Deductible Amounts (continued)

<table>
<thead>
<tr>
<th>Account</th>
<th>Book and Tax Bases Differences</th>
<th>Book Basis Exceeds Tax Basis</th>
<th>Tax Basis Exceeds Book Basis</th>
<th>Scheduling of Future Taxable or Deductible Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC Section 481</td>
<td>for change in tax accounting</td>
<td></td>
<td></td>
<td>The existing allowance at the beginning of 1987 is “deferred income” for tax purposes to be taken into taxable income over 4 years. The account has a zero accounting basis resulting in taxable amounts.</td>
</tr>
<tr>
<td>Deferred intercompany profit in inventory</td>
<td>Tax basis of inventory will exceed consolidated financial statement basis by the amount deferred</td>
<td></td>
<td></td>
<td>Schedule as a deductible amount in year(s) the profit will be recognized for financial reporting.</td>
</tr>
<tr>
<td>Intangible assets (except goodwill)</td>
<td>Faster write-off for tax than for books</td>
<td></td>
<td></td>
<td>Schedule over years of reversal based on planned systematic amortization.</td>
</tr>
<tr>
<td>Inventory</td>
<td>Allowance for obsolescence for books only</td>
<td>✓</td>
<td>Schedule over years of reversal based on planned systematic amortization.</td>
<td></td>
</tr>
<tr>
<td>-----------</td>
<td>------------------------------------------</td>
<td>---</td>
<td>---------------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Additional costs capitalized for tax only (uniform rules)</td>
<td>✓</td>
<td>Schedule in year(s) the inventory will be disposed of and loss realized.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Excess of current value over LIFO in business combination</td>
<td>✓</td>
<td>Schedule based on turnover of physical inventory (one year or operating cycle).</td>
<td></td>
</tr>
</tbody>
</table>

(continued)
**Temporary Differences — Identifying and Scheduling Future Taxable and Deductible Amounts (continued)**

<table>
<thead>
<tr>
<th>Account</th>
<th>Book Basis</th>
<th>Tax Basis</th>
<th>Tax Basis</th>
<th>Book Basis</th>
<th>Scheduling of Future Taxable or Deductible Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC Section 481 adjustments for change in tax accounting</td>
<td>Book and Tax Bases Differences</td>
<td>Asset (Taxable)</td>
<td>Liability (Deductible)</td>
<td>Asset (Deductible)</td>
<td>Liability (Taxable)</td>
</tr>
</tbody>
</table>

| Investments in marketable securities (short-term) | Lower of cost or market for books, cost for tax | | | | | Schedule for the year following the balance sheet date. If item is a capital loss, not deductible against ordinary income, then do not include with other amounts subject to ordinary income effects. |
Investments in stock of other companies - 20%-50% owned

- Equity method for books, cost method for tax purposes (assume investee's profits exceed dividends)

Land

- Valuation assigned in business combination exceeds tax basis

Leased fixed assets (plant, equipment)

- Capital lease for books, operating lease for tax purposes

Schedule the difference in the year the investor plans to sell the investment, unless realization is expected to occur in the form of dividends. Deferred tax must be provided because it does not fall under the APB 23 exception.

Assigned to year of expected disposal. If no such plans, assign to an indefinite period.

Schedule on basis of amortization of the asset.

(continued)
### Temporary Differences—Identifying and Scheduling Future Taxable and Deductible Amounts (continued)

<table>
<thead>
<tr>
<th>Account</th>
<th>Book and Tax Bases Differences</th>
<th>Book Basis Exceeds Tax Basis</th>
<th>Tax Basis Exceeds Book Basis</th>
<th>Scheduling of Future Taxable or Deductible Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Asset (Taxable)</td>
<td>Liability (Deductible)</td>
<td></td>
</tr>
<tr>
<td>Leased asset (zero tax basis)</td>
<td>√</td>
<td></td>
<td></td>
<td>Schedule on basis of planned systematic depreciation.</td>
</tr>
<tr>
<td>Lease liability</td>
<td></td>
<td></td>
<td></td>
<td>Schedule based on amortization of principal or based on the present value of future cash flows.</td>
</tr>
<tr>
<td>(zero tax basis)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease receivable</td>
<td>Direct financing or sales-type lease for books, operating lease for tax purposes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leased asset (zero book basis)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease receivable</td>
<td>(zero tax basis)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Notes receivable</td>
<td>Accrual basis for books, installment method for tax purposes</td>
<td>Schedule deferred profit on installment sales on a recovery basis.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>------------------</td>
<td>------------------------------------------------------------</td>
<td>---------------------------------------------------------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pension costs</td>
<td>Pension asset (excess funding [expensing] for tax over book expense)</td>
<td>Schedule based on future years' pension expense for book purposes.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Pension liability (book expense exceeds tax funding [expensing])</td>
<td>Schedule based on estimated future deductible contributions measured on a present value basis.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>Faster write-off for tax than book</td>
<td>Schedule on basis of pattern of depreciation differences between book and tax including originating as well as reversing differences.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(continued)
**Temporary Differences — Identifying and Scheduling Future Taxable and Deductible Amounts (continued)**

<table>
<thead>
<tr>
<th>Account</th>
<th>Book and Tax Bases Differences</th>
<th>Book Basis Exceeds Tax Basis</th>
<th>Tax Basis Exceeds Book Basis</th>
<th>Scheduling of Future Taxable or Deductible Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Asset (Taxable)</td>
<td>Liability (Deductible)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Defer for book, write-off for tax</td>
<td>✓</td>
<td></td>
<td>Schedule as expenses are to be recognized.</td>
</tr>
<tr>
<td>Unearned income</td>
<td>Accrual basis for book, cash basis for tax purposes</td>
<td></td>
<td>✓</td>
<td>Schedule based on periods in which income will be earned.</td>
</tr>
</tbody>
</table>
CASE APPLICATIONS IN COMPUTATION OF DEFERRED TAXES

The following seven cases are designed to illustrate the computation of deferred taxes and focus on scheduling.

Case 1. Deferred tax liability
Case 2. Deferred tax asset and unused deductible amount
Case 3. Deferred tax liability—current and noncurrent
Case 4. NOL carryforward
Case 5. NOL carryback, carryforward, and disclosure of benefit
Case 6. Originating and reversing differences
Case 7. Comprehensive case—scheduling, including NOL

Case 1. Deferred tax liability

AB Corporation

AB Corporation’s tax reconciliation for the current year, Year 1, is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax financial income</td>
<td>$2,000</td>
</tr>
<tr>
<td>Estimated expenses, deductible when paid</td>
<td>2,600</td>
</tr>
<tr>
<td>Excess tax depreciation over book depreciation</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$1,600</td>
</tr>
</tbody>
</table>

Assume estimated expenses will be settled in Year 5. Depreciation differences will result in taxable amounts of $600 per year for Years 2 through 6.

Tax rate: 40 percent for all years.

Case Objectives

This case will show how to schedule taxable and deductible amounts, how to prepare the journal entry for income taxes, and how income tax expense should appear in the income statement.

As illustrated in Exhibit 1, the process requires first the scheduling of the temporary differences. The determination of deferred
income tax liability for Year 1 would require the carryback of the net deductible amount in Year 5 and carryforward of the balance to Year 6. These items are treated just as NOLs. This process leaves a balance of $400 net taxable amount in Year 6, which results in a deferred tax liability.

Note: The income tax expense is shown in two parts: current and deferred. The deferred tax expense represents the change in the year to year balances of deferred tax assets and liabilities. In this case there were no opening balances and at year-end there is a deferred tax liability of $160. The increase in the liability is the deferred tax expense.

### Exhibit 1

**AB Corporation**

*Scheduling of Taxable and Deductible Amounts*

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$1,600</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable amounts</td>
<td></td>
<td>$600</td>
<td>$600</td>
<td>$600</td>
<td>$600</td>
<td>$600</td>
</tr>
<tr>
<td>Deductible amount</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(2,600)</td>
<td></td>
</tr>
<tr>
<td>Carryback</td>
<td>1,600</td>
<td>600</td>
<td>600</td>
<td>600</td>
<td>1,800</td>
<td>600</td>
</tr>
<tr>
<td>Carryforward</td>
<td></td>
<td>(600)</td>
<td>(600)</td>
<td>(600)</td>
<td></td>
<td>(200)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>$1,600</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>$400</td>
</tr>
</tbody>
</table>

### Journal Entries

<table>
<thead>
<tr>
<th>Current tax expense</th>
<th>Income Statement Presentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>640</td>
<td>Current tax provision $640</td>
</tr>
<tr>
<td>Tax payable ($1,600 × 40 percent)</td>
<td>Increase in deferred income tax liability $160</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>Income tax expense $800</td>
</tr>
<tr>
<td>160</td>
<td>Deferred tax liability $400 × 40 percent</td>
</tr>
<tr>
<td>(Noncurrent)</td>
<td>(Noncurrent)</td>
</tr>
</tbody>
</table>
Case 2. Deferred tax assets and unused deductible amount

BC Corporation

BC Corporation’s tax reconciliation in the current year, Year 1, is as follows:

Pretax financial accounting loss $ (200)
Estimated expense, deductible when paid 4,000
Excess tax depreciation over book depreciation (2,400)
Taxable income $1,400

Assume that the estimated expense is for litigation and will be deductible when paid in Year 4. The depreciation differences will result in taxable amounts of $600 in each of Years 2 through 5. Also assume a tax rate of 40 percent for all years.

Case Objectives

This case will show how to schedule temporary differences, prepare the journal entries for income taxes, and present the income statement.

The determination of the deferred income tax for Year 1 requires scheduling as in Exhibit 2. The $3,400 net deductible amount in Year 4 is carried back to Years 1 through 3 and forwarded to Year 5, which in effect eliminates any income tax expense. The current tax expense of $560 is therefore offset by an increase in a deferred tax asset in the same amount.

Exhibit 2

<table>
<thead>
<tr>
<th>BC Corporation</th>
<th>Scheduling of Temporary Differences</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$1,400</td>
</tr>
<tr>
<td>Taxable amounts (Depreciation)</td>
<td></td>
</tr>
<tr>
<td>Deductible amount (Estimated losses)</td>
<td></td>
</tr>
<tr>
<td>Carryback</td>
<td>1,400</td>
</tr>
<tr>
<td>Carryforward</td>
<td>1,400</td>
</tr>
<tr>
<td>Loss carryforward</td>
<td>$0</td>
</tr>
</tbody>
</table>
Exhibit 2 (continued)

<table>
<thead>
<tr>
<th>Journal Entries for Year 1</th>
<th>Income Statement Presentation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current income tax expense</td>
<td>Provision for income taxes</td>
</tr>
<tr>
<td>Taxes payable</td>
<td>Current income tax</td>
</tr>
<tr>
<td>($1,400 × 40 percent)</td>
<td>$560</td>
</tr>
<tr>
<td>(To record current tax payable)</td>
<td>Less increase in deferred tax asset</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>$0</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>$560</td>
</tr>
<tr>
<td>(To record change in deferred tax)</td>
<td>$0</td>
</tr>
</tbody>
</table>

Note: The $200 loss carryforward in Year 4 does not result in recognition of a deferred tax asset and is treated in the same way as an operating loss carryforward. It is disclosed as an accounting loss carryforward.

Case 3. Deferred tax liability—current and noncurrent

CD Corporation

CD Corporation’s only temporary differences at December 31, 19X6, consist of the following:

- $60,000 excess of tax depreciation over financial statement depreciation. Taxable amounts 19X7 to 19X9: $30,000, $20,000, $10,000
- $20,000 reserve for litigation expected to be deductible in 19X9

The tax rates are 46 percent in 19X6, 40 percent in 19X7, and 34 percent for all subsequent years.

There were no taxes in periods 19X6 or prior; carryback of three years is permitted. Pretax accounting income in 19X6 is $40,000.

Case Objective

This case will show how to determine the deferred tax asset or liability at year-end.

The deferred tax amounts would be determined as in Exhibit 3.

Note: The carryback benefit is at 40 percent the rate in 19X7. The $4,000 deferred tax asset is noncurrent because it will be realized in 19X9.
The reversal of $30,000 in 19X7 gives rise to a current liability. The deferred tax provision would be based on the year-to-year change in balance sheet deferred tax accounts.

**Exhibit 3**  

<table>
<thead>
<tr>
<th></th>
<th>Balance 12/31/X6</th>
<th>Taxable 19X7</th>
<th>Deductible 19X8</th>
<th>Reversals 19X9</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Depreciation</strong></td>
<td>$60,000</td>
<td>$30,000</td>
<td>$20,000</td>
<td>$10,000</td>
</tr>
<tr>
<td><strong>Litigation reserve</strong></td>
<td>(20,000)</td>
<td></td>
<td>$20,000</td>
<td>(20,000)</td>
</tr>
<tr>
<td><strong>Carryback</strong></td>
<td>(10,000)</td>
<td></td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Deferred tax liability—current (19X7)</strong></td>
<td>$20,000</td>
<td>$20,000</td>
<td>$0</td>
<td></td>
</tr>
</tbody>
</table>

Deferred tax liability—current (19X7)  
($30,000 × 40 percent) = $12,000

Deferred tax liability—noncurrent (19X8)  
($20,000 × 34 percent) = $6,800  
**Deferred tax asset—noncurrent (19X9)**  
($10,000 × 40 percent) = $4,000  
*$2,800*

*Would be shown as net noncurrent deferred liability

**Note:** The deferred tax asset of $4,000 is based on the 19X7 tax rate of 40 percent, the carryback year. However, the net deductible amount will be realized in year 19X9, when the tax rate will be 34 percent. For SEC reporting, the difference between the recorded deferred tax asset and its potential realization at a lower rate must be disclosed in the Management Discussion and Analysis or in the notes to the financial statements.

**Case 4. NOL carryforward**

**DE Corporation**

DE Corporation’s only temporary differences at December 31, 19X6, consist of the following:

- $60,000 excess of tax depreciation over financial statement depreciation. Reversing, 19X7 to 19X9 at $30,000, $20,000, $10,000
- $20,000 reserve for litigation expected to be deductible in 19X9
The tax rates are 46 percent in 19X6, 40 percent in 19X7, and 34 percent for all subsequent years.

No tax was paid in 19X5 or prior years; pretax accounting income in 19X6 is $50,000; the enterprise has an NOL carryforward from 19X5 of $30,000; the taxing jurisdiction provides for three-year carryback and 15-year carryforward of NOLs.

**Case Objectives**

This case will show how to determine the net taxable or deductible amounts, prepare the journal entry for 19X6, and how to treat the NOL loss carryforward.

An analysis of taxable and deductible amounts and the determination of deferred taxes for the year appear in Exhibit 4.

**Note:** The NOL carryforward is scheduled before any carryback or carryforward of net deductible amounts.

### Exhibit 4

<table>
<thead>
<tr>
<th></th>
<th>DE Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Balance 12/31/X6</td>
</tr>
<tr>
<td>Pretax accounting income</td>
<td>$50,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>60,000</td>
</tr>
<tr>
<td>Litigation reserve</td>
<td>(20,000)</td>
</tr>
<tr>
<td></td>
<td>$40,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$10,000</td>
</tr>
<tr>
<td>NOL carryforward</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Balance</td>
<td>$0</td>
</tr>
<tr>
<td>Tax deduction carryback</td>
<td>(10,000)</td>
</tr>
</tbody>
</table>

- At December 31, 19X6, DE Corporation would have a noncurrent deferred tax liability of $6,800 ($20,000 × 34 percent) for the amount in year 19X8.
- A deferred tax asset—noncurrent of $4,000 ($10,000 carryback from year 19X9 × 40 percent tax rate in 19X7).
- The net result is a noncurrent deferred tax liability of $2,800.
• In addition, the company would have a deferred tax liability—current of $4,000. [19X7 ($30,000 - 20,000 NOL carryforward) x 40 percent]

• For year 19X6, the journal entry would be as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>19X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax expense</td>
<td>6,800</td>
</tr>
<tr>
<td>Current tax expense</td>
<td>4,600</td>
</tr>
<tr>
<td>Deferred tax liability—current</td>
<td>4,000</td>
</tr>
<tr>
<td>Deferred tax liability—noncurrent</td>
<td>2,800</td>
</tr>
<tr>
<td>Benefit of carryforward</td>
<td>4,600</td>
</tr>
</tbody>
</table>

• The NOL carryforward is $20,000 for tax purposes.

Case 5. NOL carryback, carryforward, and disclosure of benefit

Case 5 carries forward an illustration for two years and is designed to show the deferred tax benefit of an NOL carryforward, excluding current/noncurrent classification considerations. The solution is incorporated in the development of the case.

DEE Corporation, at the end of 19X1, has temporary differences that arose in 19X1 of $1,050 from depreciable assets that will result in future taxable income and $100 from an allowance for bad debts that will result in future tax deductions.

Assume that 19X1 is the first year of operations and that pretax operating income is $5,000, and taxable income is $4,050 ($5,000 - net taxable temporary differences of $950). There are no other temporary differences.

The deferred tax liability at the end of 19X1 is $221 as determined by the schedule on page 245. (Tax rates 19X1 − 40 percent; 19X2 through 19X7 − 34 percent.)

In 19X2 the company reported a pretax operating loss of $10,000. Included in this amount is bad debt expense of $35; bad debts actually written-off were $25, so that the year-end allowance for bad debts is $110. (In order to avoid additional complexity, assume that the entire $100 allowance for bad debts at the end of 19X1 arose from charges against accounting income for that year.)

The amount of taxes currently refundable for the year 19X2 is determined as shown on the following page.
Accounting for Income Taxes

19X2:
- Pretax accounting loss: $(10,000)
- Depreciation differences—taxable: (1,380)
- Bad debt difference—deductible: 10

Tax loss available for carryback or carryforward: $(11,370)

19X1:
- Pretax accounting income: $5,000
- Depreciation differences—taxable: (1,050)
- Bad debt difference—deductible: 100

Taxable income: $4,050
Loss carryback (smaller of above amounts): $4,050
Tax rate: x .40
Tax refundable: $1,620
## Schedule of Taxable and Deductible Amounts — 19X1

<table>
<thead>
<tr>
<th></th>
<th>Current Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>19X1</td>
</tr>
<tr>
<td>(Originating) or reversing amount</td>
<td></td>
</tr>
<tr>
<td>Depreciable assets</td>
<td>$(1,380)*</td>
</tr>
<tr>
<td>Bad debts</td>
<td>(30)**</td>
</tr>
<tr>
<td>Total reversal</td>
<td>(1,410)</td>
</tr>
<tr>
<td>Carryback to 19X1</td>
<td>(1,698)</td>
</tr>
<tr>
<td>(Loss) or taxable amount</td>
<td></td>
</tr>
<tr>
<td>Tax rate</td>
<td>.40</td>
</tr>
<tr>
<td>Deferred tax liability or (asset)</td>
<td>$ (679)***</td>
</tr>
</tbody>
</table>

* 1050 = (1380) + (228) + 463 + 463 + 982 + 750

** (100) = (30) + (60) + (10)

*** 221 = (679) + 154 + 157 + 334 + 255
### Schedule of Taxable and Deductible Amounts — 19X2

<table>
<thead>
<tr>
<th>Prior Year</th>
<th>Current Year</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td><strong>19X3</strong></td>
</tr>
<tr>
<td><strong>Taxable Income (Loss)</strong></td>
<td>$4050</td>
</tr>
<tr>
<td><strong>Temporary Differences</strong></td>
<td>$2430</td>
</tr>
<tr>
<td><strong>Depreciable assets</strong></td>
<td>$463</td>
</tr>
<tr>
<td><strong>Bad debts</strong></td>
<td>$2320</td>
</tr>
<tr>
<td><strong>Taxable or Deductible Amounts</strong></td>
<td>$2320</td>
</tr>
<tr>
<td><strong>NOL Carryback</strong></td>
<td>(4050)</td>
</tr>
<tr>
<td><strong>Tax Loss C/F</strong></td>
<td>$0</td>
</tr>
<tr>
<td><strong>NOL Carryforward to Future Taxable Amounts</strong></td>
<td>2581</td>
</tr>
<tr>
<td><strong>Balance</strong></td>
<td>$ (4739)</td>
</tr>
<tr>
<td><strong>Accounting Loss C/F</strong></td>
<td>$ 5000</td>
</tr>
</tbody>
</table>
As a result, the remaining tax loss of $7,320 ($11,370 - $4,050) must be a carryforward to future years.

The deferred tax liability at the end of 19X2 is zero and is determined as shown in the schedule on page 246. The remaining $5,000 ($7320 - 2581 + 261) of the operating loss carryforward for accounting cannot be realized because there is no additional net taxable income based on existing temporary differences.

SFAS 96 requires disclosure of the amount and expiration date of such unrealized tax loss carryforwards, both accounting $5,000 and tax $7,320.

The amount of the income tax benefit for 19X2 appears in the following schedule:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax currently refundable</td>
<td>$1,620</td>
</tr>
<tr>
<td>Deferred tax liability January 1</td>
<td>221</td>
</tr>
<tr>
<td>Deferred tax liability December 31</td>
<td>0</td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td>221</td>
</tr>
<tr>
<td>Income tax benefit</td>
<td>$1,841</td>
</tr>
</tbody>
</table>

As a result, the company will report a net loss of $8,159, the pretax loss of $10,000 less the income tax benefit of $1,841.

To determine the amount of the benefit due to the operating loss carryforward that must be disclosed separately, it is necessary to determine the change in the deferred tax liability with and without the carryforward.

Without the benefit of the NOL carryforward, the deferred tax liability would have been $789. (See page 248.)

The deferred tax benefit due to the operating loss carryforward is the difference in the change in deferred tax liability with and without the carryforward, not the difference in the liability itself.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>With loss carryforward:</td>
<td></td>
</tr>
<tr>
<td>Decrease in deferred tax liability</td>
<td>$221</td>
</tr>
<tr>
<td>(from above)</td>
<td></td>
</tr>
<tr>
<td>Without loss carryforward:</td>
<td></td>
</tr>
<tr>
<td>Deferred tax liability January 1</td>
<td>$221</td>
</tr>
<tr>
<td>Deferred tax liability December 31</td>
<td>$789</td>
</tr>
<tr>
<td>Increase in deferred tax liability</td>
<td>568</td>
</tr>
<tr>
<td>Deferred tax benefit from loss carryforward</td>
<td>$789</td>
</tr>
</tbody>
</table>
Accounting for Income Taxes

Schedule of Taxable and Deductible Amounts in 19X2 Without Benefit of NOL Carryforward

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>19X3</th>
<th>19X4</th>
<th>19X5</th>
<th>19X6</th>
<th>19X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciable assets</td>
<td>$2,430</td>
<td>($228)</td>
<td>$463</td>
<td>$463</td>
<td>$982</td>
<td>$750</td>
</tr>
<tr>
<td>Bad debts</td>
<td>(110)</td>
<td>(33)</td>
<td>(66)</td>
<td>(11)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subtotal</td>
<td>2,320</td>
<td>(261)</td>
<td>397</td>
<td>452</td>
<td>982</td>
<td>750</td>
</tr>
<tr>
<td>Carryforward</td>
<td></td>
<td>261</td>
<td>(261)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable amount</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax rate</td>
<td>.34</td>
<td>.34</td>
<td>.34</td>
<td>.34</td>
<td>.34</td>
<td>.34</td>
</tr>
<tr>
<td>Tax payable</td>
<td>$789</td>
<td>$0</td>
<td>$46</td>
<td>$154</td>
<td>$334</td>
<td>$255</td>
</tr>
</tbody>
</table>

Note: In this situation, the difference in the change is equal to what the deferred tax liability would have been without the carryforward because the loss carryforward eliminated the deferred tax liability at year-end.

Case 6. Originating and reversing differences

In EF Corporation’s first year of operations, it has pretax financial income of $1,400, taxable income of $1,000, and taxes payable—current of $400 (40 percent rate).

Temporary differences in Year 1 are as follows:

- Installment sale difference (taxable in Year 2) $600
- Depreciation difference—net* 200
- Estimated expense (deductible in Year 7) (400)

*Future recovery of depreciation differences is as follows:

- Year 2 $1,800 deductible
- Year 3 1,200 taxable
- Year 4 800 taxable

Tax rates: Year 1—40 percent, Years 2 through 4—30 percent.

Case Objectives

This case will show how to schedule temporary differences and determine deferred tax asset and liability at year-end.

The analysis in Exhibit 6 shows that the originating difference in Year 2, which gives rise to a net deductible amount of $1,200, is carried back as well as carried forward.
The net result is a current tax provision of $400 and a deferred tax provision of $20.

\[
\begin{align*}
\text{Current tax provision (}$1,000 \times 40\%$) & \quad 400 \\
\text{Deferred tax provision (}$420 - $400$) & \quad 20 \\
\text{Total income tax expense} & \quad 420
\end{align*}
\]

*Note:* Under APB 11, the tax provision would have been $1,400 \times 40\% = 560. The deferred tax liability would have been $160. Under SFAS 96, the lower tax rates in Years 3 and 4 reduce that balance by $140 ($1,400 \times 10\%$).

**Exhibit 6**

*EF Corporation*

*Schedule of Temporary Differences*

<table>
<thead>
<tr>
<th>Temporary differences</th>
<th>Current Year</th>
<th>Future Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$1,000</td>
<td></td>
</tr>
<tr>
<td>Installment sales</td>
<td>$600</td>
<td>$1,200</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(1,800)</td>
<td>$800</td>
</tr>
<tr>
<td>Estimated expenses</td>
<td></td>
<td>$(400)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,000</td>
<td>(1,200)</td>
</tr>
<tr>
<td>Loss carryback</td>
<td>(1,000)</td>
<td>1,200</td>
</tr>
<tr>
<td>Loss carryforward</td>
<td>200</td>
<td>(400)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$(1,000)</td>
<td>$0</td>
</tr>
<tr>
<td>Tax rate</td>
<td>40%</td>
<td>30%</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>$(400)</td>
<td></td>
</tr>
<tr>
<td>(asset) current</td>
<td></td>
<td>$300</td>
</tr>
<tr>
<td>noncurrent</td>
<td></td>
<td>$120</td>
</tr>
</tbody>
</table>

**Case 7. Comprehensive case—scheduling**

Company A has the following temporary differences at December 31, 19X1.

Fleet of trucks acquired January 1, 19X1, expected useful life six years, zero salvage value. Cost $4,500,000. Depreciation—for books, straight-line, six years; for tax 200 percent, five-year life. For the year 19X1, depreciation for books is $750,000, for tax $1,800,000. The book basis of the asset exceeds the tax basis at December 31, 19X1, in the amount of $1,050,000, giving rise to a
future taxable amount. Based on future depreciation differences the amount is scheduled to reverse as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Books</th>
<th>Tax</th>
<th>Future Taxable (Deductible) Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>19X2</td>
<td>$750,000</td>
<td>$1,080,000</td>
<td>$(330,000)</td>
</tr>
<tr>
<td>19X3</td>
<td>750,000</td>
<td>648,000</td>
<td>102,000</td>
</tr>
<tr>
<td>19X4</td>
<td>750,000</td>
<td>486,000</td>
<td>264,000</td>
</tr>
<tr>
<td>19X5</td>
<td>750,000</td>
<td>486,000</td>
<td>264,000</td>
</tr>
<tr>
<td>19X6</td>
<td>750,000</td>
<td>750,000</td>
<td>750,000</td>
</tr>
<tr>
<td></td>
<td>$3,750,000</td>
<td>$2,700,000</td>
<td>$1,050,000</td>
</tr>
</tbody>
</table>

An allowance for bad debts is used for financial accounting but the specific charge-off method is used for tax in accordance with requirements of the Tax Reform Act of 1986. The allowance for bad debts at December 31, 19X1, is $200,000. This gives rise to a temporary deductible amount. The tax basis is zero. It is estimated that specific charge-off of existing receivables will be $150,000 in 19X2 and $50,000 in 19X3.

Estimated losses at December 31, 19X1, on a discontinued operation are reflected for financial reporting in the amount of $500,000. Such losses are not deductible for tax purposes until realized. The tax basis of the allowance is zero. Therefore this difference results in a deductible amount scheduled in the period when it is anticipated that the related assets will be disposed of. It is assumed that the assets will be sold in 19X3.

Inventory is written down by $100,000 for obsolescence. The write-down is not recognized for tax purposes. Therefore, the tax basis of the inventory is higher than the book basis giving rise to a future deductible amount when the inventory is sold. It is anticipated that the entire inventory will be sold in 19X2.

Investments in marketable securities—short-term, are written down to the lower of cost or market. The amount of the write-down is $150,000. The tax basis of the investments is higher than the book basis. This difference will give rise to a future deductible amount when the securities are sold. It is assumed, for scheduling purposes, that the temporary difference will turn around in 19X2. For simplicity, it is further assumed that the amount is deductible from ordinary income.
Rent is received in advance for two years and is shown as unearned income for financial reporting in the amount of $200,000. The tax basis of the unearned income is zero because the amount is all taxable in the year 19X1, when the amount was received. The difference gives rise to a future deductible amount.

Machinery was acquired under a long-term noncancellable lease, which, for tax purposes, is treated as an operating lease. The annual rental for five years, starting January 1, 19X1, exclusive of executory costs, is $100,000. Implicit interest rate, which is lower than the incremental borrowing rate, is 10 percent. There is no guaranteed residual value. For tax purposes the leased asset and lease liability have zero tax bases. Therefore, the capitalized lease asset gives rise to a future taxable amount based on future book depreciation. The lease obligation will give rise to future deductible amounts based on future reductions in principal. (Present value of annuity of one dollar, five periods at 10 percent, annuity due, 4.170.)

The asset is recorded in the amount of $417,000 for book purposes. The liability is amortized as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Payment</th>
<th>Interest</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/X1</td>
<td>100,000</td>
<td></td>
<td>417,000</td>
</tr>
<tr>
<td>1/1/X1</td>
<td></td>
<td>31,700</td>
<td>317,000</td>
</tr>
<tr>
<td>12/31/X1</td>
<td></td>
<td></td>
<td>348,700</td>
</tr>
<tr>
<td>1/1/X2</td>
<td>100,000</td>
<td></td>
<td>248,700</td>
</tr>
<tr>
<td>12/31/X2</td>
<td></td>
<td>24,870</td>
<td>273,570</td>
</tr>
<tr>
<td>1/1/X3</td>
<td>100,000</td>
<td></td>
<td>173,570</td>
</tr>
<tr>
<td>12/31/X3</td>
<td></td>
<td>17,357</td>
<td>190,927</td>
</tr>
<tr>
<td>1/1/X4</td>
<td>100,000</td>
<td></td>
<td>90,927</td>
</tr>
<tr>
<td>12/31/X4</td>
<td></td>
<td>9,073</td>
<td>100,000</td>
</tr>
<tr>
<td>1/1/X5</td>
<td>100,000</td>
<td></td>
<td>0</td>
</tr>
</tbody>
</table>

The asset will be depreciated over five years on a straight-line basis.

Investment in stock of B Corporation represents a 23 percent interest. The investment carried at equity for financial reporting exceeds the tax basis by $300,000. Realization is expected to occur in the form of cash dividends of $200,000 for 19X2 and $100,000 for 19X3, ignoring the dividend received deduction.

The excess book basis over the tax basis gives rise to taxable amounts in 1988 and 1989.

Assume that Company A has no net operating loss carryforwards. Pretax accounting income is $600,000. Assume a tax rate for all years of 40 percent.
Case Objectives
This comprehensive case will show how to schedule temporary differences and determine net taxable or deductible amounts, and how to prepare the journal entry to record taxes. (See Exhibit 7.)

**Journal Entries 19X1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax expense</td>
<td>166,040</td>
</tr>
<tr>
<td>Taxes payable</td>
<td>166,040</td>
</tr>
<tr>
<td>Deferred tax asset*</td>
<td>166,040</td>
</tr>
<tr>
<td>Deferred tax expense**</td>
<td>73,960</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>240,000</td>
</tr>
</tbody>
</table>

*The deferred tax asset is a current asset based on the carryback of net deductible amount from 19X2.
**The deferred tax expense is based on the change in the net deferred tax liability.

**Comprehensive Case (NOL Carryforward)**
The following case is based on the facts in the previous case and assumes that Company A had a net operating loss carryforward in 19X0 in the amount of $500,000. In that event, the scheduling would appear as shown on page 256.

**Journal Entries 19X1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred income tax expense</td>
<td>40,000</td>
</tr>
<tr>
<td>Deferred tax payable</td>
<td>40,000</td>
</tr>
</tbody>
</table>

*Note:*  
- The NOL for tax purposes is $84,900.
- The carryforward for accounting purposes is zero.
- In accordance with SFAS 96 tax NOLs are scheduled before net deductible amounts are scheduled.

**Comprehensive Case (NOL Carryforward)**
The following case is based on the facts in the immediately preceding case, except that it assumes that the NOL carryforward in 19X0 is $700,000. The scheduling would appear as shown on page 42.

In this case the NOL for tax purposes is $284,900, whereas the NOL for accounting purposes is $100,000.
**Exhibit 7**

*Company A Schedule of Temporary Differences*

*December 31, 19X1*

<table>
<thead>
<tr>
<th>Years—Taxable (Deductible)</th>
<th>12/31/X1</th>
<th>19X2</th>
<th>19X3</th>
<th>19X4</th>
<th>19X5</th>
<th>19X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Depreciation on equipment</td>
<td>$(1,050,000)</td>
<td>$(330,000)</td>
<td>$102,000</td>
<td>$264,000</td>
<td>$264,000</td>
<td>$750,000</td>
</tr>
<tr>
<td>2. Allowance for bad debts</td>
<td>200,000</td>
<td>(150,000)</td>
<td>(50,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Allowance for losses-discontinued operations</td>
<td>500,000</td>
<td></td>
<td>(500,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Inventory write-down obsolescence</td>
<td>100,000</td>
<td>(100,000)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Investment in marketable securities—write-down to lower of cost or market</td>
<td>150,000</td>
<td>(150,000)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Unearned rent income</td>
<td>200,000</td>
<td>(100,000)</td>
<td>(100,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Leased asset, future depreciation</td>
<td>(333,600)</td>
<td>83,400</td>
<td>83,400</td>
<td>83,400</td>
<td>83,400</td>
<td>83,400</td>
</tr>
<tr>
<td>Lease liability, future amortization</td>
<td>348,700</td>
<td>(75,130)</td>
<td>(82,643)</td>
<td>(90,927)</td>
<td>(100,000)</td>
<td></td>
</tr>
<tr>
<td>Net deductible amount</td>
<td>15,100</td>
<td>8,270</td>
<td>757</td>
<td>(7,527)</td>
<td>(16,600)</td>
<td></td>
</tr>
<tr>
<td>8. Investment in stock of B Corporation</td>
<td>(23 percent owned)</td>
<td>(300,000)</td>
<td>200,000</td>
<td>100,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net temporary differences</td>
<td>$ (184,900)</td>
<td>(621,730)</td>
<td>(447,243)</td>
<td>256,473</td>
<td>247,400</td>
<td>750,000</td>
</tr>
</tbody>
</table>

(continued)
### Exhibit 7 (continued)

<table>
<thead>
<tr>
<th>Pretax accounting income December 31, 19X1</th>
<th>12/31/X1</th>
<th>19X2</th>
<th>19X3</th>
<th>19X4</th>
<th>19X5</th>
<th>19X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net deductible amounts</td>
<td>(184,900)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable income</td>
<td>415,100*</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carryback</td>
<td>(415,100)**</td>
<td>415,100</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carryforward</td>
<td>206,630</td>
<td></td>
<td>(206,630)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carryforward</td>
<td></td>
<td>447,243</td>
<td>(49,843)</td>
<td>(247,400)</td>
<td>(150,000)</td>
<td></td>
</tr>
<tr>
<td>Tax Rate is 40 percent</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Taxes payable: $415,100 \times 40\% = $166,040

** Deferred tax asset: $415,100 \times 40\% = $166,040

Deferred tax liability: $240,000

Deferred tax liability is calculated as a result of the tax rate being applied to the taxable income figures for each year.
## Company A
### Schedule of Temporary Differences With NOL and Taxable Balance
### December 31, 19X1

<table>
<thead>
<tr>
<th></th>
<th>19X1</th>
<th>19X2</th>
<th>19X3</th>
<th>19X4</th>
<th>19X5</th>
<th>19X6</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net temporary</strong></td>
<td>(184,900)</td>
<td>(621,730)</td>
<td>(447,243)</td>
<td>256,473</td>
<td>247,400</td>
<td>750,000</td>
</tr>
<tr>
<td>differences</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Pretax accounting</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>income</td>
<td>600,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td>415,100</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>NOL carryforward</strong></td>
<td>(415,100)</td>
<td></td>
<td></td>
<td>(84,900)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance</td>
<td>$0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Carryforward</strong></td>
<td></td>
<td>621,730</td>
<td>(171,573)</td>
<td>(247,400)</td>
<td>(202,757)</td>
<td>(447,243)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Carryforward</strong></td>
<td></td>
<td>447,243</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Deferred tax</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>liability</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$40,000</td>
</tr>
</tbody>
</table>

*Note: The table shows the schedule of temporary differences with NOL and taxable balance for the years 19X1 through 19X6.*
<table>
<thead>
<tr>
<th></th>
<th>Current Year 19X1</th>
<th>19X2</th>
<th>19X3</th>
<th>19X4</th>
<th>19X5</th>
<th>19X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net temporary differences</td>
<td>$(184,900)</td>
<td>$(621,730)</td>
<td>$(447,243)</td>
<td>$256,473</td>
<td>$247,400</td>
<td>$750,000</td>
</tr>
<tr>
<td>Pretax accounting income</td>
<td>600,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable income</td>
<td>415,100</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NOL carryforward</td>
<td>(415,100)</td>
<td></td>
<td>(256,473)</td>
<td>(28,427)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance</td>
<td>$ 0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carryforward</td>
<td>621,730</td>
<td>347,243</td>
<td>(218,973)</td>
<td>(402,757)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carryforward Carryforward</td>
<td>$ 0</td>
<td>$(100,000)</td>
<td>$ 0</td>
<td>$ 0</td>
<td>$ 0</td>
<td>$ 0</td>
</tr>
</tbody>
</table>
TAX-PLANNING STRATEGIES

Under SFAS 96, the annual computation of a deferred tax liability or asset may be affected by tax-planning strategies that determine the years in which temporary differences will result in taxable or deductible amounts. Tax planning is required by SFAS 96, it is not elective.

*Deductible in a Different Year.* Amounts may become deductible in a different year and provide a tax benefit by offsetting taxable amounts as a carryback or carryforward, or by recognizing a deferred tax asset by loss carryback.

*Taxable in a Different Year.* Amounts may become taxable in a different year before a loss or tax credit carryforward expires, or in a particular year that maximizes the benefit of tax credits.

Criteria for Tax Planning

Tax-planning strategies that would change the future years in which temporary differences result in taxable or deductible amounts may be taken into account if they meet the following tests:

*Recognition.* The deferred tax consequences must be recognized at the balance sheet date.

*Permitted by Law and Feasible.* The strategy must be prudent, feasible, and permitted by tax law, and management must have the discretion, control, ability, and intent to implement the strategy if necessary, to reduce taxes. Management does not need to carry out the strategy in the future if income earned in a following year permits realization of the entire tax benefit of a loss or tax credit carryforward from the current year. The criterion for utilization of a tax-planning strategy is not that management expects to use it but rather the intent to use it, if necessary, to reduce taxes.

*No Significant Costs to the Enterprise.* The strategy must not involve significant cost to the enterprise. The tax benefit derived from the strategy is not to be viewed as a cost reduction. The limitation includes costs that give rise to assets, for example, purchases of inventory.
Not Applied to Future Events

Tax-planning strategies do not apply to future events that are not inherently assumed in the financial statements, including those that result in generating profits or incurring losses in future years. Future events that are inherently assumed in the financial statements are those that result in the recovery or settlement of an enterprise’s assets or liabilities.

Tax-Planning Actions

The actions considered here primarily involve accelerating or delaying the recovery of an asset or the settlement of a liability to minimize taxes.

Accelerate Taxable Amounts. Examples of tax-planning strategies that permit the recognition of a tax benefit for operating loss and tax credit carryforwards might be to accelerate taxable amounts to years before the carryforward periods expire.

- A “sale” of equipment for tax purposes and a leaseback under a capital lease accounted for as a financing arrangement would accelerate taxable amounts for a difference between the tax basis and the reported amount of the equipment. (Sale and leaseback at a loss would not be acceptable.)
- A transfer (a “sale” for tax purposes) of installment sale receivables, with recourse, accounted for as a financing arrangement for financial reporting, would accelerate taxable amounts for the gains in the installment sales.

Accelerate Deductible Amounts. A tax-planning strategy that would accelerate deductible amounts to an earlier future year would include making a larger-than-usual annual payment to reduce a long-term pension obligation recognized as a liability in the financial statements.

Elections. Tax-planning strategies include elections such as the following:

- Election to file consolidated tax returns
- Election to claim either a deduction or a tax credit for foreign taxes paid
• Election to forego a tax loss carryback
• Election to use the subsidiary’s (80 percent or more owned) tax basis of its net assets rather than parent’s tax basis for the stock of the subsidiary to determine taxable gain or loss on sale or liquidation
• Election to forego a carryback to preclude reopening prior tax years otherwise closed

Changes Are Not Strategies. A change in tax status is not a tax strategy but is recognized as a discrete event. Income shifting or termination of a pension plan are also not acceptable tax-planning strategies.

The following simple case, which involves the assumed early settlement of a litigation obligation in tax planning, reduces the overall tax liability and the amount classified as a current liability.

Case 8. Tax-planning strategies

FG Corporation

FG Corporation’s only temporary differences at December 31, 19X6, consist of the following:

• $60,000 excess of tax depreciation over financial statement depreciation. Reversing 19X7 through 19X9 at $30,000, $20,000, $10,000.
• $20,000 reserve for litigation expected to be deductible in 19X9.

The tax rates are 46 percent in 19X6, 40 percent in 19X7, and 34 percent for all subsequent years.

As a tax-planning strategy, management adopts an assumed “settlement” of its litigation in 19X7. (Management has discretion and control over timing of the payment.)

Case Objective

This case will show how to calculate deferred tax liabilities current and noncurrent with tax planning and without tax planning.

An analysis of taxable and deductible amounts and the computation of the liabilities for deferred taxes, both with and without tax-planning strategy, appear in Exhibit 8. Under tax planning, the company moved the deductible amount of $20,000 from year 19X9
to 19X7. As a consequence, it was also able to reduce its overall deferred tax accrual by $600.

\[ 10,000 \times (40 \text{ percent} - 34 \text{ percent}) = 600 \]

Additionally, it reduced the current balance by $8,000.

<table>
<thead>
<tr>
<th>Exhibit 8</th>
<th>FG Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Balance 12/31/X6</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$60,000</td>
</tr>
<tr>
<td>Litigation reserve</td>
<td>(20,000)</td>
</tr>
<tr>
<td></td>
<td><strong>$40,000</strong></td>
</tr>
</tbody>
</table>

Using Tax Planning

Deferred tax liability
- Current: \( (10,000 \times 40 \text{ percent}) = 4,000 \)
- Noncurrent: \( (30,000 \times 34 \text{ percent}) = 10,200 \)

No Tax Planning

Deferred tax liability
- Current: \( (30,000 \times 40 \text{ percent}) = 12,000 \)
- Noncurrent: \( \text{(net of asset)} = 2,800 \)

(see Exhibit 3)

OPERATING LOSS AND TAX CREDIT CARRYBACKS AND CARRYFORDERS

Carryback. An asset is recognized for prior years' taxes that are refundable by carryback of an operating loss or unused tax credits of the current year.

Carryforward. An operating loss or tax credit carryforward is recognized as a reduction of a deferred tax liability for temporary differences that will result in taxable amounts during the operating loss or tax credit carryforward period. If not so recognized, the benefit cannot be recognized regardless of the probability of profits in future years.
Case 9 illustrates the treatment of a net operating loss carryback and carryforward under SFAS 96.

**Case 9. Net Operating Loss (NOL)**

*IJ Company*

Assume that IJ Company has an operating loss of $16,000 in Year 5. Temporary differences in Years 1 through 7 relate to depreciation and are all deductible amounts. The temporary differences will result in taxable amounts before the end of the carryforward period from Year 5.

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 1</th>
<th>Years 2 to 4 (3 years)</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax financial income</td>
<td>$4,000</td>
<td>$10,000</td>
<td>$(16,000)</td>
<td>$4,000</td>
<td>$14,000</td>
</tr>
<tr>
<td>Depreciation differences</td>
<td>(1,600)</td>
<td>(4,400)</td>
<td>(1,200)</td>
<td>(1,600)</td>
<td>(1,200)</td>
</tr>
<tr>
<td>Cumulative depreciation differences</td>
<td>(1,600)</td>
<td>(6,000)</td>
<td>(7,200)</td>
<td>(8,800)</td>
<td>(10,000)</td>
</tr>
</tbody>
</table>

Tax rate for Years 1 through 7 is 40 percent

**Case Objective**

This case will show how to compute the taxable income and tax payable, temporary differences and deferred tax liability balances, and tax expense for several years where there is an interaction between an NOL and deferred tax liabilities.

In Year 1, a deferred tax liability of $640 is recognized. Years 2 through 4, the deferred tax liability increases to $2,400, an increase of $1,760. The temporary taxable differences at the end of Year 4 total $6,000. In Year 5, an NOL of $17,200 is incurred, of which $5,600 is carried back to reduce taxable income in Years 2 through 4 and $2,240 of taxes paid is refunded. The $11,600 NOL carryforward exceeds the $7,200 of temporary differences that will result in taxable amounts in future years. Therefore, the $2,400 deferred tax liability at the beginning of Year 5 is eliminated. Tax expense in Year 5 is $(4,640).

In Year 6, $2,400 of the NOL carryforward is used to offset taxable income earned in Year 6. The balance of the NOL carryforward
of $9,200 exceeds the $8,800 of cumulative temporary difference, and there is no deferred tax liability.

In Year 7, the NOL carryforward of $9,200 is used up to partially offset income of $12,800. Therefore, $1,440 of taxes are payable on net taxable income of $3,600. No loss carryforward offsets the $10,000 of cumulative temporary differences that will result in taxable amounts in future years, and the $4,000 of deferred tax liability must be reinstated.

**Exhibit 9**

<table>
<thead>
<tr>
<th>If Company</th>
<th>Taxable Income and Tax Payable</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
</tr>
<tr>
<td>Pretax financial income</td>
<td>$4,000</td>
</tr>
<tr>
<td>Depreciation difference</td>
<td>(1,600)</td>
</tr>
<tr>
<td>Loss carryback</td>
<td>2,400</td>
</tr>
<tr>
<td>Loss carryforward</td>
<td></td>
</tr>
<tr>
<td>Taxable income</td>
<td>$2,400</td>
</tr>
<tr>
<td>Tax payable (refundable)</td>
<td>$ 960</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>If Company</th>
<th>Temporary Differences and Deferred Tax Liability Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
</tr>
<tr>
<td>Unreversed differences</td>
<td></td>
</tr>
<tr>
<td>Opening balance</td>
<td>—</td>
</tr>
<tr>
<td>Additions</td>
<td>$1,600</td>
</tr>
<tr>
<td>Tax loss carryforward</td>
<td>1,600</td>
</tr>
<tr>
<td>Net taxable amount</td>
<td>$1,600</td>
</tr>
</tbody>
</table>

Deferred tax liability

<table>
<thead>
<tr>
<th>If Company</th>
<th>End of year balance</th>
<th>Opening balance</th>
<th>Tax expense (benefit)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
<td>Years 2 to 4</td>
<td>Year 5</td>
</tr>
<tr>
<td>End of year balance</td>
<td>640</td>
<td>2,400</td>
<td>0</td>
</tr>
<tr>
<td>Opening balance</td>
<td>0</td>
<td>640</td>
<td>2,400</td>
</tr>
<tr>
<td>Tax expense (benefit)</td>
<td>$ 640</td>
<td>$1,760</td>
<td>$(2,400)</td>
</tr>
</tbody>
</table>
Accounting for Income Taxes

Exhibit 9 (continued)

<table>
<thead>
<tr>
<th>Tax Expense</th>
<th>Year 1</th>
<th>Years 2 to 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payable</td>
<td>$960</td>
<td>$2,240</td>
<td>$(2,240)</td>
<td>0</td>
<td>$1,440</td>
</tr>
<tr>
<td>Deferred</td>
<td>640</td>
<td>1,760</td>
<td>$(2,400)</td>
<td>0</td>
<td>4,000</td>
</tr>
<tr>
<td>Total</td>
<td>$1,600</td>
<td>$4,000</td>
<td>$(4,640)</td>
<td>0</td>
<td>$5,440</td>
</tr>
</tbody>
</table>

Notes:  
• In Year 5: $5,600 is carried back to reduce taxable income in Years 2 through 4, and $2,240 of tax would be refundable.
• In Year 6: A portion of the loss carryforward is used to offset taxable income earned in Year 6.
• In Year 7: The loss carryforward is used up.

Carryforward for Tax Purposes and for Financial Reporting

If there is an operating loss carryforward for tax purposes, an operating loss carryforward for financial reporting is determined by taking the amount for tax purposes—

1. Reduced by the amount that offsets temporary differences that will result in net taxable amounts during the carryforward period.
2. Increased by the amount of temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements.

Illustrations of the Interaction of Carryforwards for Tax and Financial Reporting

Situation 1

An operating loss carryforward for financial reporting when a tax loss carryforward is reduced by temporary differences that will result in
taxable amounts during the carryforward period. Year 1 is the first year of operations. The enterprise’s only temporary differences are depreciation differences.

<table>
<thead>
<tr>
<th></th>
<th>Years 1 to 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax financial income (loss)</td>
<td>$800</td>
<td>$(1,200)</td>
</tr>
<tr>
<td>Depreciation differences</td>
<td>(160)</td>
<td>(40)</td>
</tr>
<tr>
<td>Taxable income (loss)</td>
<td>640</td>
<td>(1,240)</td>
</tr>
<tr>
<td>Loss carryback for tax purposes</td>
<td>(640)</td>
<td>640</td>
</tr>
<tr>
<td>Loss carryforward for tax purposes</td>
<td>$0</td>
<td>$(600)</td>
</tr>
<tr>
<td>Loss applied to offset depreciation differences ($160 + $40)</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Loss carryforward for financial reporting</td>
<td>$ (400)</td>
<td></td>
</tr>
</tbody>
</table>

**Situation 2**

An operating loss carryforward for financial reporting when a tax carryforward is increased by temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements. Year 1 is the first year of operations. The enterprise’s only temporary differences are warranty expense differences that will result in deductible amounts in future years.

<table>
<thead>
<tr>
<th></th>
<th>Years 1 to 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax financial income (loss)</td>
<td>$800</td>
<td>$(1,600)</td>
</tr>
<tr>
<td>Warranty expense differences</td>
<td>160</td>
<td>40</td>
</tr>
<tr>
<td>Taxable income (loss)</td>
<td>960</td>
<td>(1,560)</td>
</tr>
<tr>
<td>Loss carryback for tax purposes</td>
<td>(960)</td>
<td>960</td>
</tr>
<tr>
<td>Loss carryforward for tax purposes</td>
<td>$0</td>
<td>$(600)</td>
</tr>
<tr>
<td>Warranty expense differences ($160 + $40)</td>
<td>(200)</td>
<td></td>
</tr>
<tr>
<td>Loss carryforward for financial reporting</td>
<td>$ (800)</td>
<td></td>
</tr>
</tbody>
</table>
Carryforward for Accounting Purposes. If there is no operating loss carryforward for tax purposes, an operating loss carryforward for financial reporting is the amount of temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements.

Subsequent Recognition of NOL Carryforward. The tax benefit of an operating loss carryforward that is recognized subsequent to the year of the loss is reported in the same manner as the source of income that gave rise to the use of the operating loss carryforward. Under APB 11, the amount was treated as an extraordinary item.

INTRAPERIOD ALLOCATION OF INCOME TAXES

Income taxes should be allocated to the following:

- Continuing operations
- Discontinued operations
- Extraordinary items
- The cumulative effect of accounting changes
- Prior-period adjustments
- Gains or losses included in comprehensive income but excluded from net income
- Capital transactions

Allocation to Continuing Operations

The amount of income tax expense or benefit allocated to income or loss from continuing operations (in addition to adjustments for changes in tax status and tax laws or rates) is computed on pretax income or loss exclusive of any other items that occurred during the year (for example, extraordinary items).

Allocations to Other Items

The amount of tax allocated to items other than continuing operations is the incremental effect on income taxes that results from that category of items.
Allocation to Two or More Other Items

When allocated to two or more categories of items other than continuing operations, the sum of the incremental tax effects of each category of items sometimes may not equal the incremental tax effect of all categories of items because of a statutory limitation on the utilization of tax credits, for example. In those circumstances the allocation procedure is as follows:

- Determine the incremental tax benefit of the total net loss for all net loss categories and apportion that incremental benefit ratably to each net loss category.
- Apportion ratably to each net gain category the difference between the incremental tax effect of all categories other than continuing operations, and the incremental tax benefit of the total net loss for all net loss categories.

The procedure for allocating income taxes to each item within each category of items is similar to the procedure described above.

Allocation of Deferred Income Tax Expense

Deferred tax expense or benefit should be allocated to income from continuing operations and other items in the same manner as current tax expense or benefit.

When allocating a deferred tax benefit to continuing operations, a company should consider the total amount of income taxes paid during the carryback period and not just the portion of those taxes that was allocated to continuing operations.

Allocation to Effect of Accounting Change

Note that no portion of tax expense for the current year is usually allocated to an accounting change that is computed in accordance with paragraph 20 of APB 20 (cumulative effect), because a cumulative effect is ordinarily determined as of the beginning of the year of the change. If this is not the case (rarely), an allocation of a portion of the current year’s tax to the cumulative effect is appropriate.

Consider a simple situation of intraperiod tax allocation. Assume that pretax financial income and taxable income are the same.
Loss from continuing operations  
\( $(1,000) \)

Loss carryback would give rise to a refund of $200 of taxes paid on $500 of taxable income during the carryback years

Extraordinary gain  
1,800

Tax rate for all items is 40 percent

Income taxes currently payable are $320 on $800 of taxable income

**Allocation**

Tax consequences of loss from continuing operations  
\( $(200) \)

Extraordinary gain—incremental tax consequences  
520

This hypothetical computation of tax consequences of loss from continuing operations results in incremental tax of $520 on extraordinary gain.

Case 10 illustrates intraperiod tax allocation where there is more than one category other than continuing operations.

**Case 10. Intraperiod tax allocation—more than one category other than continuing operations**

**KL Corporation**

Pretax financial income includes:

- Income from continuing operations  
  \( $1,200 \)
- Discontinued operations  
  \( (200) \)
- Extraordinary items  
  1,000
- Cumulative effect of an accounting change  
  \( (400) \)

Total pretax financial income  
\( $1,600 \)

- KL Corporation has $600 of tax credits available subject to a limitation of 90 percent of taxes payable.
- There are no temporary differences.
- Tax rate is 34 percent.
**Case Objective**

This case shows how to allocate income taxes to all components of income and cumulative effect of accounting change.

Exhibit 10 shows initially that continuing operations on a stand-alone basis would have a tax of $40. The total tax, however, is $54. Therefore, the incremental effect of the other items in the income statement totals $14.

The next step is to determine the tax benefit of the loss categories, in total and for each loss category. The aggregate tax benefit is $94, which is apportioned 8/34 to discontinued operations, and 26/34 to the cumulative effect.

Finally, the tax allocated to the extraordinary gain is $108, based on a $14 overall tax to items other than continuing operations, plus a tax benefit of $94 on the sum of the loss categories.

**Exhibit 10**  
*KL Corporation  
Income Tax Expense Attributable to Continuing Operations*

<table>
<thead>
<tr>
<th></th>
<th>Continuing Operations</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax financial income</td>
<td>$1,200</td>
<td>$1,600</td>
</tr>
<tr>
<td>Tax at 34 percent</td>
<td>408</td>
<td>544</td>
</tr>
<tr>
<td>Tax credits (90-percent limitation)</td>
<td>368</td>
<td>490</td>
</tr>
<tr>
<td>Tax expense</td>
<td>$40</td>
<td>$54</td>
</tr>
</tbody>
</table>

The incremental effect of income tax from all items other than continuing operations is $14.

The allocation of the incremental effect is as follows:

<table>
<thead>
<tr>
<th>Sum of Loss Categories</th>
<th>Loss Category Discontinued Operations</th>
<th>Loss Category Cumulative Effective of Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>$1,600</td>
<td>$1,600</td>
</tr>
<tr>
<td>Loss category</td>
<td>(600)</td>
<td>(400)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$2,200</td>
<td>$2,000</td>
</tr>
<tr>
<td>without loss categories</td>
<td>$1,800</td>
<td>$1,800</td>
</tr>
<tr>
<td>Tax at 34 percent</td>
<td>748</td>
<td>680</td>
</tr>
<tr>
<td>Tax credit</td>
<td>(90-percent limitation)</td>
<td>600</td>
</tr>
</tbody>
</table>

268
### Exhibit 10 (continued)

<table>
<thead>
<tr>
<th>Sum of Loss Categories</th>
<th>Loss Category Discontinued Operations</th>
<th>Loss Category Cumulative Effective of Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax without loss categories</td>
<td>148</td>
<td>62</td>
</tr>
<tr>
<td>Total expense</td>
<td>54</td>
<td>54</td>
</tr>
<tr>
<td>Incremental effect</td>
<td>$94</td>
<td>$8</td>
</tr>
</tbody>
</table>

The $94 tax benefit is allocated on a pro-rata basis to the sum of the net loss categories:

<table>
<thead>
<tr>
<th>Each Loss Category</th>
<th>Apportioned Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discontinued operations</td>
<td>8</td>
</tr>
<tr>
<td>Cumulative effect of accounting change</td>
<td>26</td>
</tr>
<tr>
<td>$34</td>
<td>100</td>
</tr>
</tbody>
</table>

The tax allocated to the extraordinary item is $108.

This is the difference between the $14 tax expense for all other items and the $94 tax benefit for the loss categories.

Total tax expense is allocated as follows:

<table>
<thead>
<tr>
<th>Pretax Income</th>
<th>Tax Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations</td>
<td>$1,200</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td>(200)</td>
</tr>
<tr>
<td>Extraordinary items</td>
<td>1,000</td>
</tr>
<tr>
<td>Cumulative effect of accounting change</td>
<td>(400)</td>
</tr>
<tr>
<td>$1,600</td>
<td>$54</td>
</tr>
</tbody>
</table>

### Allocation of Income Tax to Stockholders’ Equity

Stockholders’ equity is charged or credited for the income tax effects of—

- Adjustments to opening retained earnings for the effect of a change in accounting principles or correction of an error.
• Gains and losses recognized in comprehensive income but not in net income.
• An increase or decrease in contributed capital (for example, tax deductible expenditures reported as a reduction in the proceeds from the issuance of capital stock).
• Expenses for employee stock options recognized differently for financial reporting and tax purposes.

*Note:* An income tax benefit for the tax deductibility of dividends paid to stockholders is recognized as a reduction of income tax expense and is not credited directly to stockholders’ equity.

**DISCLOSURE REQUIREMENTS**

**Balance Sheet**

**Classification—Current Asset**

A deferred tax liability or asset should be classified in two categories—current and noncurrent—in a classified balance sheet. The current amount is the net deferred tax consequences of—

• Temporary differences that will result in net taxable or deductible amounts during the next year.
• Temporary differences related to an asset or liability that is classified for financial reporting as current because of an operating cycle that is longer than one year.
• Temporary differences for which there is no related, identifiable asset or liability for financial reporting whenever other related assets and liabilities are classified as current because of an operating cycle that is longer than one year.

**No Offset**

Deferred tax items attributable to different tax jurisdictions should not be offset.
Disclosure

The nature or type of temporary differences that give rise to a significant portion of a deferred tax liability or asset should be disclosed.

A publicly held enterprise that is not subject to income tax because its income is taxed directly to its owners should disclose that fact and the net difference between the tax basis and the reported amounts of the enterprise's assets and liabilities.

Detailed Disclosure—APB 23 Differences

Detailed disclosures are called for whenever a deferred tax liability is not recognized for any of the areas addressed in APB 23 or for deposits in statutory reserve funds by U.S. steamship enterprises. See SFAS 96, paragraph 25.

In the following three situations the tax rate is 40 percent and the temporary differences are scheduled. The requirement is to determine the current and noncurrent amounts for deferred tax. (Assume that the enterprise has no taxable income in Year 1, the start of operations.)

<table>
<thead>
<tr>
<th>Current Year</th>
<th>Future Years</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Situation 1:</strong></td>
<td></td>
</tr>
<tr>
<td>Liability for warranties</td>
<td>$(1,000)</td>
</tr>
<tr>
<td>Installment receivables</td>
<td>1,600</td>
</tr>
<tr>
<td><strong>Temporary Differences</strong></td>
<td><strong>Future</strong></td>
</tr>
<tr>
<td>Year 2</td>
<td>Year 3</td>
</tr>
<tr>
<td>$600</td>
<td>$(1,000)</td>
</tr>
</tbody>
</table>

| Situation 2: |
| Liability for warranties | $(1,000) | $(1,000) |
| Installment receivables | 1,600 | 1,600 | $(1,000) |
| **$600** | **$1,600** | **$(1,000)** |

| Situation 3: |
| Liability for warranties | $(1,000) | $(1,000) |
| Installment receivables | 1,600 | 1,600 |
| Liquor inventory* | 1,400 | 1,400 |
| **$2,000** | **$(1,000)** | **$1,600** | **$1,400** |

*Operating cycle—5 years
Accounting for Income Taxes

In situation (1), the deductible amount in Year 2 is carried forward to Year 3. Therefore, the deferred tax liability of $240 (40 percent × $600) is noncurrent.

Situation (2) presents a noncurrent deferred tax asset of $400 (40 percent × $1,000), and a current deferred tax liability of $640 (40 percent × $1,600). The deductible amount of $1,000 can be carried back to Year 2 to offset the taxable amount of $1,600 and therefore can be recognized as an asset.

Finally, in situation (3), there would be a current liability for the inventory because the recovery falls within the operating cycle ($1,400 × 40 percent = $560). The warranty difference of $1,000 would be carried forward to Year 3 and offset against the taxable amount of $1,600, reducing the taxable balance to $600. The noncurrent deferred tax liability would be $240 ($600 × 40 percent).

Income Statement

Disclosure of Allocated Amounts

Disclosure is required of the amount of income tax expense allocated to the following:

- Continuing operations
- Discontinued operations
- Extraordinary items
- Cumulative effect of accounting changes
- Prior-period adjustments
- Gains and losses included in comprehensive income but excluded from net income
- Capital transactions

Note: SFAS 96 precludes including interest and penalties in tax expense.

Disclosure of Components of Expense

The significant components of income tax attributed to continuing operations for each year presented should be disclosed, including the following:
Accounting for Income Taxes

- Current tax expense or benefit
- Deferred tax expense or benefit
- Investment tax credit
- Government grants
- Operating loss carryforward benefits
- Adjustments of deferred tax for changes in tax laws, or rates, or change in status of entity

**Reconciliation of Reported Tax and Statutory Amounts**

Reconciliation (using percentages or dollar amounts) of the reported amount of tax expense attributable to continuing operations to the amount that would have been reported by applying the domestic federal statutory rates to pretax income from continuing operations should be disclosed. Statutory rates should be the regular rates if there is an alternative tax system.

- The estimated amount and nature of each reconciling item should be disclosed.
- Nonpublic enterprises need not list the reconciling items, but must disclose the nature of significant items.

**Carryforwards**

Disclose the amounts and expiration dates of operating loss and tax credit carryforwards for financial reporting purposes (amounts not recognized as reductions of a deferred tax liability) and for tax purposes.

If any amount of benefit will be used to reduce goodwill, it should be disclosed separately.

**Separate Statements of Subsidiary**

If a company is included in a consolidated tax return, then it should disclose in its separate statements —

- The amount of current and deferred tax expense.
- The amount of tax-related balances due to or from affiliates.
- The method of intercompany tax allocation and the nature and effects of any change in methods.
Disclosure—Implementation Issues

Current/Noncurrent Classification

Inventory is generally the only balance sheet item that can be classified as current with an operating cycle that is longer than one year. All other items are classified in relation to a one-year operating cycle.

Disclosure of Significant Components of Income Tax Expense

SFAS 96 requires the disclosure of the significant components of income tax expense attributable to continuing operations. The sum of the amounts disclosed should equal the amount of tax expense that is reported in the income statement. Separate disclosure of the tax benefit of operating loss carryforwards and tax credits that have been recognized as a reduction of current tax expense and deferred tax expense is required. But the amounts disclosed for current tax expense and for deferred tax expense can be either before or after reduction for those tax benefits.

If a tax benefit for an operating loss carryforward is recognized by reducing a deferred tax liability in Year 1 and the carryforward is realized on the tax return in Year 2, there is no effect on income tax expense in Year 2 because the reduction in current tax expense for the benefit realized in Year 2 is offset by the increase in the deferred tax expense.

Acquired Operating Loss Carryforward Benefit

If the tax benefit of an acquired operating loss carryforward is recognized after the date of a purchase business combination and is applied to reduce goodwill and intangible assets, income tax expense is increased. Disclosure is required of any increase in the current or deferred tax expense that results from applying the tax benefit of an acquired operating loss carryforward to reduce goodwill and intangible assets.

Expiration Dates for Operating Loss Carryforwards for Financial Reporting

Operating loss carryforwards for tax purposes that do not offset temporary differences that will result in taxable amounts have expiration dates as determined by tax law. The expiration dates for temporary
differences are determined by adding the length of the loss carryforward period to the particular future years in which those temporary differences will result in net deductible amounts.

**Nonrecognition of Tax Benefits in Income**

Disclosure is required of any significant amounts of tax expense that result from not recognizing certain tax benefits in the statement of earnings, including the tax benefit of an acquired NOL or tax credit carryforward that reduces goodwill and intangible assets and certain other items, such as those that may arise in quasi reorganizations and employee stock options.

**EFFECTIVE DATES AND TRANSITION**

SFAS 96, as amended by SFAS 100, is effective for fiscal years beginning on or after December 15, 1989; however, the Board has decided to further defer the effective date to fiscal years beginning after December 15, 1990. Earlier application is encouraged, and restatement of previously issued financial statements is permitted.

**Initial Application**

Initial application should be as of the beginning of an enterprise’s year.

**Restatement Elected — Earliest Year Not Presented**

If restatement is elected and the earliest year restated is prior to the years presented in the financial statements, then the cumulative adjustment should be to the opening balance of the retained earnings of the earliest year presented.

**Restatement Elected — Earliest Year Presented or No Restatement**

In all other cases, the cumulative effect should be included in determining net income of the earliest year restated or in the year first applied if no prior year is restated. Pro-forma effects of retroactive application are not required if statements of earnings presented for prior years are not restated.
Effects of Adoption Disclosed

The financial statements for the year SFAS 96 is first adopted should disclose the effects of adopting the statement of income from continuing operations, income before extraordinary items, net income, and related per-share amounts. Also, there should be similar disclosure for the effect of any restatements.

Remeasurement of Purchase Combinations

If restatement is elected, the company must remeasure in accordance with SFAS 96 all purchase business combinations occurring in the first year restated and in all subsequent years.

Remeasurement Not Permitted

For purchase combinations consummated before the beginning of the earliest year restated or if restatement is not elected, the enterprise may not remeasure any such prior purchase business combinations. Remaining balances will be left unchanged. Except for leveraged leases, any differences between those remaining balances and their tax bases are temporary differences, and a deferred tax liability or asset should be recognized as of the beginning of the year SFAS 96 is first adopted. This will in most cases increase the cumulative effect.

Special provisions apply to regulated enterprises, which are not discussed here.

Effects of Remeasurement

The following illustrates the financial statement effects of the remeasuring versus the nonremeasurement of purchase combinations.

Assume that MN Corporation acquires Company S’s assets in a 19X1 purchase business combination. The assets had an initial fair value of $200 and a tax basis of zero. The tax rate at the date of acquisition was 40 percent, and the net-of-tax value was recorded at $120. The assets have not been amortized to date.

If MN restates its 19X1 financial statements, it must remeasure purchase business combinations consummated during the period of restatement as follows:

The assets initially recorded net-of-tax \( \text{\$120} \)
Deferred tax gross up \( \text{\$80} \)
Revised book value 200
Tax basis 0
Temporary difference 200
Tax rate 40%
Deferred tax liability $ 80

Note: No cumulative effect adjustment because the net asset under the liability method and the result under the old rule are identical.

If the company does not restate 19X1, it does not remeasure prior business combination, and the analysis is as follows:

The recorded book value is $120
Tax basis 0
Temporary difference 120
Tax rate 40%
Deferred tax liability $ 48

Note: A cumulative effect of $48 would be recorded in this case.

Under the restatement and remeasurement approach, income in future periods would be reduced by $120, resulting from the amortization of the $200 asset and the reversal of the $80 deferred tax liability.

Under no restatement and remeasurement, the amortization of the asset of $120 would be offset by the reversal of the $48 tax liability, reducing net income by $72.

The transition approach can affect future reported earnings.

Transition—Implementation Issues

If an enterprise elects to apply SFAS 96 by restating prior years, it may choose the earliest year that is restated. The enterprise need not restate all prior years' financial statements presented.

SFAS 96 further notes the following situations where a transition adjustment, or a part thereof, is excluded from net income:

• Paragraph 33—Initial recognition of the tax benefits related to a quasi reorganization
• Paragraph 23—Tax benefit of an acquired operating loss or tax credit carryforward
Accounting for Income Taxes

- Paragraph 75—Tax benefits of deductions related to employee stock options credited to capital
- Paragraph 70—Tax benefits attributable to the increase in tax bases of assets acquired in a taxable business combination accounted for as a pooling

ILLUSTRATIONS OF IMPLEMENTATION OF SFAS 96

The 1988 edition of AICPA's Accounting Trends and Techniques indicates that 37 companies have adopted SFAS 96, of which 27 did not restate prior years and 10 companies did. The 1988 edition includes companies with fiscal years ending January 31, 1988.

The following illustrations drawn from practice (Accounting Trends and Techniques, 1988 ed.) reveal how companies that have adopted SFAS 96 meet the accounting and disclosure requirements.

Recognition of Deferred Tax Liability

Prior Years Not Restated—
Aydin Corporation, December 31, 1987

CURRENT LIABILITIES

Deferred income taxes
Total Current Liabilities
LONG-TERM DEBT, less current maturities
DEFERRED INCOME TAXES

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>INCOME BEFORE CUMULATIVE EFFECT OF ADOPTING NEW ACCOUNTING PRINCIPLE</td>
<td>8,803</td>
<td>6,952</td>
<td>3,799</td>
</tr>
<tr>
<td>Cumulative effect on prior years (to December 31, 1986) of adopting new method of accounting for income taxes (note H)</td>
<td>6,003</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Note A—Summary of Significant Accounting Policies

**Income Taxes.** See note H concerning adoption in 1987 of the liability method of accounting for income taxes. Investment tax credits are accounted for using the flow-through method, which reduces the provision for income taxes, to the extent allowable, in the year such credits arise.

Note H—Taxes on Income

As required by generally accepted accounting principles, the Company provides for the deferred income tax effects of transactions that are reported in different periods for financial reporting and income tax return purposes. Through December 31, 1986, deferred tax effects were computed based on the tax rates in effect during the period such differences arose.

In December 1987, the Financial Accounting Standards Board issued Statement 96, “Accounting for Income Taxes,” which the Company has adopted as of January 1, 1987. Statement 96 requires that the balance sheet amounts for deferred income taxes be computed at rates to be in effect when the underlying differences will be reported in the Company’s income tax returns. The deferred income tax provision for the period is then the difference in the liabilities as of the beginning and end of the period.

The effect of adopting Statement 96 is to increase net income for 1987 by $7,033,000 ($1.86 per share), of which $6,003,000 is reported as a cumulative effect of a change in accounting principle, and $1,030,000 ($.27 per share) is reported as a reduction in the 1987 tax provision. The primary reason for these benefits is the reduction in corporate federal income tax rates of the Tax Reform Act of 1986.
The provision for taxes on income consists of the following:

<table>
<thead>
<tr>
<th>Year</th>
<th>Federal</th>
<th>State</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>$6,409,000</td>
<td>$1,823,000</td>
<td>$8,232,000</td>
</tr>
<tr>
<td>Deferred (credit)</td>
<td>(3,580,000)</td>
<td>(1,065,000)</td>
<td>(4,645,000)</td>
</tr>
<tr>
<td>Charge equivalent to tax benefit related to shares acquired by employees under stock options</td>
<td>152,000</td>
<td>30,000</td>
<td>182,000</td>
</tr>
<tr>
<td></td>
<td>$2,981,000</td>
<td>$788,000</td>
<td>$3,769,000</td>
</tr>
<tr>
<td>1986:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>$328,000</td>
<td>$189,000</td>
<td>$517,000</td>
</tr>
<tr>
<td>Deferred</td>
<td>4,263,000</td>
<td>418,000</td>
<td>4,681,000</td>
</tr>
<tr>
<td>Charge equivalent to tax benefit related to shares acquired by employees under stock options</td>
<td>13,000</td>
<td>1,000</td>
<td>14,000</td>
</tr>
<tr>
<td></td>
<td>$4,604,000</td>
<td>$608,000</td>
<td>$5,212,000</td>
</tr>
<tr>
<td>1985:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current (credit)</td>
<td>($336,000)</td>
<td>($336,000)</td>
<td></td>
</tr>
<tr>
<td>Deferred</td>
<td>1,212,000</td>
<td>159,000</td>
<td>1,371,000</td>
</tr>
<tr>
<td>Charge equivalent to tax benefit related to shares acquired by employees under stock options</td>
<td>37,000</td>
<td>6,000</td>
<td>43,000</td>
</tr>
<tr>
<td></td>
<td>$913,000</td>
<td>$165,000</td>
<td>$1,078,000</td>
</tr>
</tbody>
</table>

The components of deferred income taxes are as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Completed contract method of reporting revenue for tax purposes</td>
<td>($8,103,000)</td>
<td>$2,452,000</td>
<td>$3,316,000</td>
</tr>
<tr>
<td>Inventory valuation</td>
<td>1,201,000</td>
<td>(200,000)</td>
<td>(207,000)</td>
</tr>
<tr>
<td>Excess tax over book depreciation</td>
<td>380,000</td>
<td>404,000</td>
<td>850,000</td>
</tr>
<tr>
<td>Benefit of tax net operating loss</td>
<td>1,953,000</td>
<td>2,105,000</td>
<td>(2,272,000)</td>
</tr>
<tr>
<td>Other, net</td>
<td>(76,000)</td>
<td>(80,000)</td>
<td>(316,000)</td>
</tr>
<tr>
<td></td>
<td>($4,645,000)</td>
<td>$4,681,000</td>
<td>$1,371,000</td>
</tr>
</tbody>
</table>
A reconciliation between the federal statutory rate and the effective income tax rate (computed by dividing the provision for taxes on income by income before taxes on income) is as follows:

<table>
<thead>
<tr>
<th></th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal statutory rate</td>
<td>40.0%</td>
<td>46.0%</td>
<td>46.0%</td>
</tr>
<tr>
<td>State income taxes net of federal tax benefit</td>
<td>3.8</td>
<td>2.7</td>
<td>1.8</td>
</tr>
<tr>
<td>Benefit from nontaxable FSC income</td>
<td>(1.9)</td>
<td>(4.5)</td>
<td>(10.3)</td>
</tr>
<tr>
<td>Investment credits</td>
<td>(.2)</td>
<td>(8.0)</td>
<td></td>
</tr>
<tr>
<td>Research and development credit</td>
<td>(3.4)</td>
<td></td>
<td>(6.2)</td>
</tr>
<tr>
<td>Effect on deferred provision due to rate change</td>
<td>(7.9)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other, net</td>
<td>(.6)</td>
<td>(1.2)</td>
<td>(1.2)</td>
</tr>
<tr>
<td>Effective income tax rate</td>
<td>30.0%</td>
<td>42.8%</td>
<td>22.1%</td>
</tr>
</tbody>
</table>

Deferred income tax liabilities primarily relate to contract accounting, inventories, and depreciation.

Investment credits amounted to $26,000 and $393,000 in 1986 and 1985, respectively.

Quarterly Financial Data

(a) The income tax provision and net income for each of the first three quarters of 1987 has been restated to reflect the effect of the new method of accounting for income taxes. The first quarter of 1987 has also been restated to include the cumulative effect of this accounting change (see note H). Earnings per share (before the cumulative effect of new accounting principle) for each of the first three quarters as previously reported were: $.50 (1st quarter); $.62 (2nd quarter); and $.50 (3rd quarter).

(b) Fourth quarter 1986 net income has been reduced by $164,000 ($.04 per share) for the reversal of an investment tax credit that was included in income of the first three quarters of 1986 but repealed in the fourth quarter by the Tax Reform Act of 1986.
Prior Years Restated—
Allegheny Ludlum Corporation, January 3, 1988

LIABILITIES AND SHAREHOLDERS’ EQUITY

Current Liabilities

Deferred income taxes 25,124 28,972
Income taxes 6,666 1,076

Total Current Liabilities 183,662 219,422

Long-Term Obligations

Deferred income taxes 50,709 48,223

Note 1—Summary of Significant Accounting Policies

Taxes on Income. Provisions for income taxes include deferred taxes resulting from differences between the value of assets and liabilities for financial and tax purposes, using the liability method required by Statement of Financial Accounting Standards No. 96, “Accounting for Income Taxes” (see note 11). Provisions for taxes on income include investment tax credits (repealed by the Tax Reform Act of 1986 subject to certain transitional rules) using the flow-through method.

Note 2—Substantial Change of Ownership and Basis of Accounting

On December 28, 1986, the Company repurchased and retired all of the common stock and preference stock owned by a privately held company (approximately 86% of the outstanding common stock and 100% of the preference stock) for $177,960,000, consisting of $127,960,000 in cash and $50,000,000 of Senior Subordinated Notes. The substantial change in ownership resulted in the Com-
pany becoming a new reporting entity for financial reporting purposes.

The purchase method of accounting was used to account for this transaction, whereby assets and liabilities were stated at fair value in accordance with Accounting Principles Board Opinion 16, "Business Combinations." The consolidated balance sheet as of December 28, 1986 reflects the allocation of the acquisition cost to net assets based on the estimated fair values of acquired assets and assumed liabilities at December 28, 1986, as restated for Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes." A summary of the purchase allocation adjustments is as follows:

Note 11—Taxes on Income

On December 30, 1987, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes." The Company has elected early adoption of Statement 96 by restating its accounting for the substantial change in ownership as set forth in note 2. The effect of this change was to record net deferred tax liabilities of approximately $77,195,000 as of December 28, 1986, resulting from temporary differences between the fair values of net assets acquired and their income tax bases. Of this amount, $28,972,000, classified as current, related primarily to LIFO inventories and $48,223,000, classified as long-term, related primarily to pension obligations and properties, plants and equipment. Further, assets acquired and liabilities assumed (previously recorded net of tax) were restored to their full fair values.

There was no effect on shareholders' equity at December 28, 1986, and the effect on net income for 1987 was an increase of approximately $.07 per share. Predecessor information is not restated.
Income taxes (credits) consist of the following:

(in thousands of dollars) 1987 1986 1985 (Predecessor)

Current:
Federal—before investment tax credit $27,272 $12,461 $ 8,427
State 5,117  934 2,105
Investment tax credit (27) (954) (2,170)
32,362 12,441  8,362

Deferred:
Federal (1,826) 6,564 1,845
State 464 1,060 401
(1,362) 7,624 2,246
$31,000 $20,065 $10,608
$26,157 $11,902 $12,670

Income Taxes Paid. The following is a reconciliation of the statutory federal income tax rate to the actual effective income tax rate:

<table>
<thead>
<tr>
<th>Percent of Pretax Income</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
<th>(Predecessor)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal tax rate</td>
<td>40.0%</td>
<td>46.0%</td>
<td>46.0%</td>
<td></td>
</tr>
<tr>
<td>Increase (decrease) in taxes resulting from:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Permanent difference arising from purchase accounting adjustments, including depreciation, pensions, and other items</td>
<td>(7.4)</td>
<td>(10.5)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment tax credits</td>
<td>(1.9)</td>
<td>(6.3)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net change attributable to temporary differences classified as current which reversed during the year</td>
<td>(4.4)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Research credit</td>
<td>(.6)</td>
<td>(2.7)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>State and local income taxes, net of federal tax benefit</td>
<td>4.3</td>
<td>2.1</td>
<td>3.9</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>.2</td>
<td>1.8</td>
<td>.2</td>
<td></td>
</tr>
<tr>
<td></td>
<td>40.1%</td>
<td>40.0%</td>
<td>30.6%</td>
<td></td>
</tr>
</tbody>
</table>

Deferred taxes result from temporary differences in the recognition of income and expenses for financial and income tax reporting purposes and differences between the fair value of assets acquired in business combinations accounted for as purchases and their tax bases. The income tax effects of items comprising the deferred income tax expense are as follows:
Accounting for Income Taxes

<table>
<thead>
<tr>
<th>(in thousands of dollars)</th>
<th>1987</th>
<th>1986 (Predecessor)</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation</td>
<td>$871</td>
<td>$5,140</td>
<td>$5,554</td>
</tr>
<tr>
<td>Workers' compensation</td>
<td>132</td>
<td>358</td>
<td>(1,261)</td>
</tr>
<tr>
<td>Inventory valuation—net</td>
<td>(3,502)</td>
<td>989</td>
<td>(1,869)</td>
</tr>
<tr>
<td>Deferred compensation and other benefit plans</td>
<td>(790)</td>
<td>1,168</td>
<td>(811)</td>
</tr>
<tr>
<td>Other items</td>
<td>1,927</td>
<td>(31)</td>
<td>633</td>
</tr>
<tr>
<td></td>
<td>$(1,362)</td>
<td>$7,624</td>
<td>$2,246</td>
</tr>
</tbody>
</table>

Through December 28, 1986, the Predecessor was a member of a consolidated group for federal income tax purposes and was a party to an agreement which generally provided that the Company will pay the separate tax liability of the Company and its subsidiaries as if it had filed a separate tax return. Commencing in 1987, the Company and its subsidiaries formed their own consolidated group.

Note 16—Quarterly Data (Unaudited) (in thousands of dollars except per share amounts)

The first three quarters of 1987 have been restated for Statement No. 96 (see note 11). The effect of the restatement was to increase (decrease) operating income by $(53,000), $27,000 and $1,105,000. Net income and net income per share increased by $345,000, $367,000 and $304,000 and $.02, $.02 and $.02, respectively.

Recognition of a Deferred Tax Asset and a Deferred Tax Liability

Prior Years Not Restated—
Kerr Glass Manufacturing Corporation,
December 31, 1987

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
</tr>
<tr>
<td>(in thousands)</td>
</tr>
</tbody>
</table>

Assets
Current assets

Deferred income taxes | 520 | 1,137 |
Total current assets | 81,568 | 72,627 |

(continued)
### Accounting for Income Taxes

(continued)

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>(in thousands)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Accrued pension liability: 8,551, 8,180
- Deferred income taxes: 8,312, 7,850
- Other long-term liabilities: 1,048

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>(in thousands, except per share data)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Earnings (loss) before cumulative effect of accounting change: 1,831, 3,772, (2,441)
- Cumulative effect of change in accounting for income taxes: 1,271

Note 4. Income Taxes

Provision (benefit) for income taxes is made up of the following components:

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>(in thousands)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Current
  - Federal: $14, $35, $(700)
  - State: 59, 103, $(50)
  - Total: 73, 138, $(750)

- Deferred
  - Federal: 1,090, 2,473, (2,814)
  - State: 225, 369
  - Total: 1,315, 2,842, (2,814)

Effective January 1, 1987, the Company prospectively adopted FASB Statement No. 96, *Accounting for Income Taxes*. FASB Statement No. 96 requires, among other things, current recognition of the effect of changes in statutory tax rates on previously provided deferred income taxes. The cumulative effect of this change in accounting on the Company's financial position through December 31, 1986, is $1,271,000 or $.35 per common share. The effect of adopting FASB Statement No. 96 on 1987 operating results, exclud-
ing the cumulative effect discussed above, was to decrease net earnings and net earnings per common share $42,000 and $.01, respectively.

Deferred income taxes (benefits) result primarily from timing differences in the recognition of various expenses for tax and financial statement purposes. The sources and tax effects of these differences are as follows:

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provision for plant closings and consolidations deferred for tax</td>
<td>$1,012</td>
<td>$2,070</td>
<td>$(3,404)</td>
</tr>
<tr>
<td>Excess of tax over book depreciation, including assets retired or sold</td>
<td>522</td>
<td>477</td>
<td>1,719</td>
</tr>
<tr>
<td>Reinstatement (reduction) of deferred income taxes attributable to recognition of tax credit and net operating loss carryforwards</td>
<td>286</td>
<td>(25)</td>
<td>(1,154)</td>
</tr>
<tr>
<td>Additional costs inventoried for tax purposes pursuant to the Tax Reform Act of 1986</td>
<td>(446)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other, net</td>
<td>(59)</td>
<td>320</td>
<td>25</td>
</tr>
<tr>
<td>Total</td>
<td>$1,315</td>
<td>$2,842</td>
<td>$(2,814)</td>
</tr>
</tbody>
</table>

Total provision (benefit) for income taxes differed from the amounts computed by applying the U.S. Federal income tax rates of 40% in 1987 and 46% in 1986 and 1985 to earnings (loss) before income taxes. The reasons for these differences are as follows:

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computed “expected” tax expense (benefit)</td>
<td>$1,288</td>
<td>$3,106</td>
<td>$(2,762)</td>
</tr>
<tr>
<td>Increase (reduction) in taxes resulting from:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State income taxes (benefits), net of</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal income tax benefit</td>
<td>146</td>
<td>255</td>
<td>(27)</td>
</tr>
<tr>
<td>Net investment tax credits</td>
<td>14</td>
<td>(366)</td>
<td>(680)</td>
</tr>
<tr>
<td>Other, net</td>
<td>(60)</td>
<td>(15)</td>
<td>(95)</td>
</tr>
<tr>
<td>Actual tax expense (benefit)</td>
<td>$1,388</td>
<td>$2,980</td>
<td>$(3,564)</td>
</tr>
</tbody>
</table>

As of December 31, 1987, the Company had a net operating loss carryforward for tax purposes of $1,284,000 expiring in the year 2000, and a tax credit carryforward (primarily investment tax credits) of $543,000 expiring in the year 1999.
The Internal Revenue Service has completed audits of Kerr’s Federal income tax returns through 1981 and is currently examining the income tax returns for 1982 through 1985. The Internal Revenue Service has proposed certain adjustments with which Kerr disagrees. However, if the Internal Revenue Service should prevail, such adjustments will not materially affect the financial condition of the Company.

Note 13. Condensed Quarterly Data for 1987 and 1986 (Unaudited)

<table>
<thead>
<tr>
<th>Three Months Ended</th>
<th>March 31</th>
<th>June 30</th>
<th>Sept. 30</th>
<th>Dec. 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987 Earnings (loss) before cumulative effect of change in accounting for income taxes</td>
<td>404</td>
<td>1,959</td>
<td>1,313</td>
<td>(1,845)</td>
</tr>
<tr>
<td>Cumulative effect of change in accounting for income taxes (b)</td>
<td>1,271</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net earnings (loss)</td>
<td>1,675</td>
<td>1,959</td>
<td>1,313</td>
<td>(1,845)</td>
</tr>
</tbody>
</table>

(b) The change in accounting results from the effect of the adoption of FASB Statement No. 96, Accounting for Income Taxes, as of January 1, 1987. Net earnings for the first quarter of 1987 have been restated to reflect the cumulative effect of the accounting change resulting in an increase in net earnings of $1,271,000 or $.35 per common share for primary earnings per common share and $.33 per common share for fully diluted earnings per common share, over the previously reported amounts.

(c) Provision for income taxes in the three months ended December 31, 1986, was increased by a reversal of investment tax credits in the amount of $396,000 ($ .11 per common share) primarily due to the passage of the Tax Reform Act of 1986.
### Prior Years Restated—Fruehauf Corporation, December 31, 1987

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>December 31, 1987</th>
<th>December 31, 1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current portion of deferred income taxes</td>
<td>20,790</td>
<td></td>
</tr>
<tr>
<td>Total current assets</td>
<td>$692,314</td>
<td>$1,310,677</td>
</tr>
<tr>
<td>Current liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income taxes payable (note 6)</td>
<td>65,418</td>
<td>33,779</td>
</tr>
<tr>
<td>Current portion of deferred income taxes</td>
<td></td>
<td>49,172</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>$394,530</td>
<td>$908,109</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>152,495</td>
<td>184,642</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>183,920</td>
<td>164,846</td>
</tr>
</tbody>
</table>

#### Note 1. Organization and Summary of Accounting Principles

*Taxes on Income*. The financial statements include appropriate provision for taxes on income for all items included in operations irrespective of the period when such taxes are payable. No provision has been made for future United States taxes on the undistributed portion of the Corporation’s equity in earnings of foreign subsidiaries and affiliates since it is anticipated that the unremitted earnings will be permanently reinvested for growth and expansion.

#### Note 6. Income Taxes

The balance sheet at December 31, 1986 has been restated to reflect the implementation of Statement of Financial Accounting Standards No. 96. The provision for income taxes has been computed in accordance with the principles contained in that pronouncement.
The components of earnings before taxes are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Period Ended December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1987</td>
</tr>
<tr>
<td>United States</td>
<td>$(64,339,107)</td>
</tr>
<tr>
<td>Foreign</td>
<td>(11,341,134)</td>
</tr>
<tr>
<td>Loss before taxes on income</td>
<td>$(75,680,241)</td>
</tr>
</tbody>
</table>

The provision for taxes on income is summarized as follows:

<table>
<thead>
<tr>
<th></th>
<th>Period Ended December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1987</td>
</tr>
<tr>
<td>Current:</td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td></td>
</tr>
<tr>
<td>Federal</td>
<td>$12,007,000</td>
</tr>
<tr>
<td>State and local</td>
<td>86,000</td>
</tr>
<tr>
<td>Foreign</td>
<td>4,595,000</td>
</tr>
<tr>
<td></td>
<td>$16,688,000</td>
</tr>
<tr>
<td>Deferred:</td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>$(51,279,000)</td>
</tr>
<tr>
<td>Foreign</td>
<td>391,000</td>
</tr>
<tr>
<td></td>
<td>$(50,888,000)</td>
</tr>
<tr>
<td>Total income tax benefit included in Consolidated Statements of Operations</td>
<td>$(34,200,000)</td>
</tr>
</tbody>
</table>

Excluded from the provision for taxes on income (current U.S. Federal taxes) is a benefit of $9,300,000 relating to assets held for sale and interest expense not included in the Statement of Operations (note 12).

Income taxes payable at December 31, 1987 include approximately $26 million due on the sale of the Canadian and European subsidiaries and approximately $25 million due on the pension plan terminations.
A reconciliation of the provision for taxes on income (benefit) to federal income tax computed at the statutory rate follows:

<table>
<thead>
<tr>
<th>Period Ended December 31</th>
<th>1987</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net loss</td>
<td>$(41,480,241)</td>
<td>$(20,305,505)</td>
</tr>
<tr>
<td>Income tax benefit</td>
<td>(34,200,000)</td>
<td>(13,600,000)</td>
</tr>
<tr>
<td>Loss before taxes on income</td>
<td>$(75,680,241)</td>
<td>$(33,905,505)</td>
</tr>
<tr>
<td>Statutory federal income tax rate</td>
<td>40%</td>
<td>46%</td>
</tr>
<tr>
<td>Federal income tax (benefit) computed at statutory rate</td>
<td>$(30,272,000)</td>
<td>$(15,597,000)</td>
</tr>
<tr>
<td>Increase (decrease) resulting from:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity in earnings of unconsolidated foreign affiliates</td>
<td>(1,282,000)</td>
<td></td>
</tr>
<tr>
<td>Consolidated foreign subsidiaries’ non-deductible net operating losses</td>
<td>5,454,000</td>
<td></td>
</tr>
<tr>
<td>Nontaxable foreign exchange (gain) loss</td>
<td>(2,942,000)</td>
<td></td>
</tr>
<tr>
<td>Dividends received from foreign subsidiaries</td>
<td>998,000</td>
<td></td>
</tr>
<tr>
<td>Tax benefit from foreign sales corporation</td>
<td>(454,000)</td>
<td></td>
</tr>
<tr>
<td>Effective tax rate differential on earnings of consolidated foreign affiliates</td>
<td>1,298,000</td>
<td></td>
</tr>
<tr>
<td>Investment tax credit recapture</td>
<td>974,000</td>
<td></td>
</tr>
<tr>
<td>Tax rate differential for deferred taxes</td>
<td>(8,958,000)</td>
<td></td>
</tr>
<tr>
<td>All other items</td>
<td>984,000</td>
<td>(1,997,000)</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>$(34,200,000)</td>
<td>$(13,600,000)</td>
</tr>
<tr>
<td>Effective tax rate</td>
<td>45.2%</td>
<td>40.1%</td>
</tr>
</tbody>
</table>

Deferred taxes on income result from differences in the timing of the recognition of certain revenues and expenses for tax and financial statement purposes. The income tax effect of the major items follows on the next page.
### Revenue:
- **Installment sales contracts**: $(25,140,000)
- **Sales-type leases**: $(22,871,000)
- **Long-term contracts**: 117,000
- **Royalties**: $(231,000)

### Expenses:
- **Deferred compensation**: 13,679,000
- **Amortization**: (1,400,000)
- **Depreciation**: (32,176,000)
- **Adjustments to nondeductible reserves**: 17,789,000
- **Inventory**: (4,812,000)
- **Investment tax credit carryforward**: 2,257,000
- **Net operating loss carryforward**: 932,000
- **Pensions**: 122,000
- **Interest on defeased debt**: 1,276,000
- **All other items**: (430,000)
- **Total**: $(50,888,000)

Deferred tax assets (liabilities) result from differences in the basis of assets and liabilities for tax and financial statement purposes. The cumulative tax effect of the major items follows:

### Period Ended December 31

<table>
<thead>
<tr>
<th></th>
<th>1987</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fixed assets</strong></td>
<td>$(173,357,000)</td>
<td>$(205,533,000)</td>
</tr>
<tr>
<td><strong>Nondeductible reserves</strong></td>
<td>58,994,000</td>
<td>76,783,000</td>
</tr>
<tr>
<td><strong>Intangibles</strong></td>
<td>(42,039,000)</td>
<td>(43,439,000)</td>
</tr>
<tr>
<td><strong>Inventory</strong></td>
<td>(27,273,000)</td>
<td>(32,085,000)</td>
</tr>
<tr>
<td><strong>Net operating loss carryforward</strong></td>
<td>11,044,000</td>
<td>11,976,000</td>
</tr>
<tr>
<td><strong>Deferred compensation</strong></td>
<td>4,838,000</td>
<td>18,517,000</td>
</tr>
<tr>
<td><strong>Unremitted royalties</strong></td>
<td>(590,000)</td>
<td>(821,000)</td>
</tr>
<tr>
<td><strong>Installment sales contracts</strong></td>
<td>(482,000)</td>
<td>(25,622,000)</td>
</tr>
<tr>
<td><strong>Sales-type leases</strong></td>
<td>(296,000)</td>
<td>(179,000)</td>
</tr>
<tr>
<td><strong>Long-term contracts</strong></td>
<td></td>
<td>(179,000)</td>
</tr>
<tr>
<td><strong>Investment tax credit carryforward</strong></td>
<td>2,257,000</td>
<td></td>
</tr>
<tr>
<td><strong>Pensions</strong></td>
<td>2,305,000</td>
<td>2,427,000</td>
</tr>
<tr>
<td><strong>Interest</strong></td>
<td>1,213,000</td>
<td>2,489,000</td>
</tr>
<tr>
<td><strong>All other items</strong></td>
<td>2,513,000</td>
<td>2,083,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$(163,130,000)</td>
<td>$(214,018,000)</td>
</tr>
</tbody>
</table>
Deferred taxes for installment sales contracts and sales-type leases, which had been sold to Fruehauf Finance Company, became currently payable when the Corporation sold Fruehauf Finance Company.

At December 31, 1987, the Corporation had a net tax operating loss carryforward of $32,481,000, which will expire at December 31, 2000.

Quarterly Financial Information (Unaudited)

The results of operations for the first three quarters of 1987 have been adjusted for the following items: . . . . (iv) the implementation of Statements of Financial Standards No. 96, Accounting for Income Taxes, and No. 87, Employers' Accounting for Pensions.

Recognition of a Deferred Tax Asset Only

Prior Years Not Restated—
General Electric Company
December 31, 1987

Extraordinary item—GE Capital Corporation loss on early extinguishment of certain long-term debt (note 15)  (62)
Cumulative effect to January 1, 1987 of initial application of Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes" (note 1)
GE and consolidated affiliates  59
GE Financial Services, Inc.  518

1. Summary of Significant Accounting Policies

Income Taxes. Statement of Financial Accounting Standards (SFAS) No. 96, "Accounting for Income Taxes," was issued by the Financial Accounting Standards Board in December 1987. A requirement of SFAS 96 is that deferred tax liabilities or assets at the end of each period will be determined using the tax rate expected to be in effect when taxes are actually paid or recovered. Accordingly, under the new rules, income tax expense provisions will increase or decrease in the same period in which a change in tax rates is enacted. Previous rules required providing deferred taxes using rates in effect when the tax asset or liability was first recorded, without subsequent adjustment solely for tax-rate changes.
In conformity with SFAS 96 transition rules, GE has elected to adopt the new income tax accounting in 1987. The cumulative effect to January 1, 1987 ($59 million for GE and consolidated affiliates and $518 million for GE Financial Services, Inc.) of the change is shown separately in the 1987 column of the Statement of Earnings. Also, as required, quarterly earnings reported for 1987 have been restated for the effect of this change on interim quarters in 1987 as if it had occurred at January 1. Restated quarterly amounts can be found in note 27.

Investment tax credit (ITC). The ITC was repealed, with some transitional exceptions, effective January 1, 1986. However, for financial reporting purposes, GE has deferred recognition of the ITC each year and continues to amortize ITC as a reduction of the provision for income taxes over the lives of the facilities to which the credit applies.

8. Provision for Income Taxes (Excluding Extraordinary Item and Cumulative Effect of Changes in Accounting Principles)

Significant components of the normal provision for income taxes by taxing jurisdiction are shown below.

<table>
<thead>
<tr>
<th>Provision for income taxes</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>(in millions)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. federal income taxes:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated amount payable</td>
<td>956</td>
<td>1,062</td>
<td>842</td>
</tr>
<tr>
<td>Deferred tax expense (benefit)</td>
<td>(65)</td>
<td>(95)</td>
<td>90</td>
</tr>
<tr>
<td>Investment credit deferred (amortized)—net</td>
<td>(87)</td>
<td>(38)</td>
<td>35</td>
</tr>
<tr>
<td></td>
<td>804</td>
<td>929</td>
<td>967</td>
</tr>
<tr>
<td>Foreign income taxes:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated amount payable</td>
<td>197</td>
<td>198</td>
<td>135</td>
</tr>
<tr>
<td>Deferred tax expense (benefit)</td>
<td>8</td>
<td>(24)</td>
<td>(4)</td>
</tr>
<tr>
<td></td>
<td>205</td>
<td>174</td>
<td>131</td>
</tr>
<tr>
<td>Other (principally state and local income taxes)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>79</td>
<td>97</td>
<td>45</td>
</tr>
<tr>
<td></td>
<td>1,088</td>
<td>1,200</td>
<td>1,143</td>
</tr>
</tbody>
</table>

Deferred income taxes for 1987 reflect the impact of "temporary differences" between the amount of assets and liabilities for financial
reporting purposes and such amounts as measured by tax laws and regulations. These "temporary differences" are determined in accordance with Statement of Financial Accounting Standards No. 96 (see note 1) and are more inclusive in nature than "timing differences" as determined under previously applicable generally accepted accounting principles. Deferred income taxes for 1986 and 1985 have not been restated. Principal items making up the deferred U.S. federal income tax provisions follow.

Deferred U.S. federal income taxes
Increase (decrease) in provision for income taxes .

(in millions) 1987 1986 1985
Tax over book depreciation $18 $87 $124
Margin on installment sales (16) (33) 48
 Provision for warranties 9 (27) 23
 Provision for pensions 10 (52) (171)
Other—net (86) (70) 66
$65 $(95) $ 90

Other—net includes a number of temporary differences such as those related to various portions of transactions involving business dispositions and restructuring expense provisions.

The U.S. investment tax credit (ITC) was repealed, with some transitional exceptions, effective January 1, 1986. ITC in 1986 and 1985 had aggregated $49 million and $111 million, respectively, and the amounts added to net earnings because of GE's deferral from prior years were $87 million in 1986 and $76 million in 1985. As a result of the accounting change in 1987, unamortized ITC is treated as a temporary difference for deferred tax accounting. Accordingly, $52 million was added to 1987 earnings before extraordinary item and cumulative effect of changes in accounting principles. The remaining unamortized ITC balance of $191 million (net of deferred tax) at year-end 1987 will be added to income in future years.

The U.S. federal statutory tax rate on corporations was 40% in 1987, down from 46% in each of the two previous years. GE's normal effective tax rate (provision for income taxes as a percentage of earnings before income taxes, extraordinary item and cumulative effect of changes in accounting principles) was 33.9% in 1987 compared with 32.5% in 1986 and 33.3% in 1985. A summary of reasons for differences between the statutory rate and GE's effective rate follows.
Differences between U.S. deferral statutory and GE effective tax rates

<table>
<thead>
<tr>
<th></th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. federal statutory rate</td>
<td>40.0%</td>
<td>46.0%</td>
<td>46.0%</td>
</tr>
<tr>
<td>Reductions in taxes resulting from:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inclusion of GEFS earnings (before extraordinary item and cumulative effect of accounting change) in consolidated before-tax income on an after-tax basis</td>
<td>(6.9)</td>
<td>(6.3)</td>
<td>(5.5)</td>
</tr>
<tr>
<td>Varying tax rates of consolidated affiliates (principally foreign)</td>
<td>(3.7)</td>
<td>(2.2)</td>
<td>(3.6)</td>
</tr>
<tr>
<td>Investment tax credit</td>
<td>(2.7)</td>
<td>(2.3)</td>
<td>(2.2)</td>
</tr>
<tr>
<td>Income tax at capital gains rate</td>
<td>(0.6)</td>
<td>(1.4)</td>
<td>(0.2)</td>
</tr>
<tr>
<td>Varying rates on unusual items</td>
<td>0.8</td>
<td>0.4</td>
<td>0.6</td>
</tr>
<tr>
<td>Current-year effect of income tax accounting change</td>
<td>4.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>All other—net</td>
<td>2.9</td>
<td>(0.9)</td>
<td>(0.6)</td>
</tr>
<tr>
<td>GE effective tax rate</td>
<td>33.9%</td>
<td>32.5%</td>
<td>33.3%</td>
</tr>
</tbody>
</table>

Provision has been made for U.S. federal income taxes to be paid on that portion of the undistributed earnings of affiliates and associated companies expected to be remitted to the parent company. Undistributed earnings intended to be reinvested indefinitely in affiliates and associated companies totaled $1,318 million, $1,063 million and $964 million at the end of 1987, 1986 and 1985, respectively. It is estimated that foreign tax credits would approximately offset the U.S. taxes payable if these earnings were to be distributed.

Based on the location (not taxing jurisdiction) of the GE business providing goods or services, domestic income before taxes, extraordinary item and cumulative effect of changes in accounting principles was $2,690 million in 1987 ($3,081 million in 1986 and $3,232 million in 1985). The corresponding amounts for foreign-based operations were $517 million, $611 million and $188 million in each of the last three years, respectively.

General Electric Financial Services, Inc. (GEFS) is a nonconsolidated affiliate for financial reporting but is included in GE's consolidated U.S. federal income tax return. Taxes payable by the consolidated companies shown in this note exclude the effect of significant tax credits and deductions of GEFS, which arise primarily from leasing activities. GE and GEFS together had net taxes payable for 1987, 1986 and 1985. Existing leases of GEFS will generate taxable income
in future years, which is provided for in the deferred income taxes of GEFS (see note 15). At December 31, 1987, 1986 and 1985, tax credit carryforwards totaling $168 million, $275 million and $358 million, respectively, were recorded by GEFS as a partial offset to deferred taxes. For financial reporting purposes, GEFS investment tax credit carryforward amounts are amortized to earned income over lease periods (as are investment tax credits currently usable). For tax purposes, they will be offset against taxes payable in the future.

17. Other Assets

<table>
<thead>
<tr>
<th>December 31 (in millions)</th>
<th>1987</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recoverable engineering costs on government contracts</td>
<td>$791</td>
<td>$405</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>620</td>
<td>180</td>
</tr>
</tbody>
</table>

Deferred income taxes at December 31, 1987 included net current deferred tax assets of about $366 million.

27. Quarterly Information (Unaudited)

Net earnings and related per-share amounts for the first three quarters of 1987 have been restated as required by SFAS 96, "Accounting for Income Taxes."

ALTERNATIVE MINIMUM TAX

Comprehensive Tax System

*Alternative Tax System.* The alternative minimum tax (AMT) is viewed as a comprehensive tax system that is an alternative to the "regular tax" systems with the higher outcome of the calculation determining the actual tax liability. The alternative system should be used to measure an enterprise’s deferred tax asset or liability in a manner consistent with the tax law.

*Applied to Interperiod Tax Allocation.* After giving consideration to any interaction between the two systems, such as the alternative
minimum tax credit, the deferred tax asset or liability is recognized based on the results of the two calculations for each future year.

**Impacts on Temporary Differences.** Existing temporary differences may be recognized or measured differently under each of the two tax systems, or a temporary difference may exist for only one system because of different recognition or measurement provisions.

**AMT Tax Credit.** The tax law allows the excess of the tentative minimum tax (TMT) over the regular tax, with some adjustment, as a tax credit to be carried forward indefinitely and used to reduce a regular tax liability but not an AMT liability. The minimum tax credit consists of that portion of the AMT attributable to deferral items, as opposed to such portion of the AMT attributable to exclusion items as preferences.

The following illustrates the computation of the minimum tax credit.

<table>
<thead>
<tr>
<th>Minimum Tax Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regular taxable income</td>
</tr>
<tr>
<td>Deferral items</td>
</tr>
<tr>
<td>Preference items</td>
</tr>
<tr>
<td>AMTI</td>
</tr>
<tr>
<td>TMT</td>
</tr>
<tr>
<td>Rate 20 percent AMTI</td>
</tr>
<tr>
<td>Regular Tax ($820,000 \times 34 percent)</td>
</tr>
<tr>
<td>AMT</td>
</tr>
<tr>
<td>AMT Credit</td>
</tr>
<tr>
<td>Regular taxable income</td>
</tr>
<tr>
<td>Preference items</td>
</tr>
<tr>
<td>TMT</td>
</tr>
<tr>
<td>(Rate 20 percent \times 838,000)</td>
</tr>
<tr>
<td>Regular tax</td>
</tr>
<tr>
<td>AMT without deferral preferences</td>
</tr>
<tr>
<td>Minimum tax credit carryforward against future year’s regular tax liability</td>
</tr>
</tbody>
</table>

**AMT Tax Credit Reduces Deferred Tax Liability.** The AMT tax credit, which has an indefinite life, can be used to reduce only a cer-
tain portion of regular tax owed in future years and can be used with the limitations set forth in SFAS 96 as an offset to originating and existing deferred tax credits. However, any remaining AMT tax credit may not be recognized as a deferred tax asset.

*Deferred Tax Liability Based on Higher Computation.* The amount of a deferred tax liability to be recognized under SFAS 96 should be based on the higher of the deferred tax liability computed for the regular tax and for the AMT.

*AMT—NOL.* AMT NOL deduction may not exceed 90 percent of Alternative Minimum Taxable Income (AMTI) before the deduction. The AMT NOL is the same as the regular tax NOL reduced by preference items included in the loss and modified for any adjustments.

**Determination of AMT Amount**

It is beyond the scope of this chapter to discuss the details of the AMT. Certain basic principles need to be understood, however, to follow the case illustrating the interaction between the regular tax, AMT, and deferred income taxes. The computation is as follows:

**Calculating AMT**

Beginning with regular taxable income (add back NOL deduction), follow these steps:

- *Add:* AMT preference items, that is, amounts related to the preference component of percentage depletion, intangible drilling costs, charitable contributions of appreciated property, private-activity tax-exempt interest, and accelerated depreciation on certain property placed in service before January 1, 1987.

- *Add or deduct:* Adjustments for items treated differently for AMT represent effects of depreciation on post 1986 assets, and alternative accounting for circulation expenditures; mining exploration and development; long-term contracts; installment sales; passive activity losses, and certain other items.
Accounting for Income Taxes

**Tentative AMT Income**

- **Add**: Book income adjustment (50 percent of adjusted financial reporting income—tentative AMT income).*

- **Deduct**: AMT NOL deduction not to exceed 90 percent of AMTI before the deduction. (AMT NOL must be reduced for preference items.)

AMT income × AMT rate (20 percent**) yields

\[ TMT \] (Less foreign tax credits, 90-percent limit, and investment tax credit carryover 25-percent limit). Overall: 90-percent limit.

- **Deduct**: Regular Tax

The foregoing calculations yield the AMT.

**ACE Adjustment Replaces Book Income Adjustment.** Beginning with taxable years after December 31, 1989, the financial reporting

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*Adjusted financial reporting income is based on income reported in the enterprise’s financial statements with a priority ordering for the use of different financial statements, i.e., SEC filings, certified statements, and the like, and includes adjustments. Book income must take into account all items of income, expense, gain and loss for the year including extraordinary items, cumulative adjustments resulting from accounting changes, and prior-period adjustment to retained earnings.

Adjust book income by such items as—

- **Income taxes**—Eliminate federal and foreign taxes, except foreign taxes pre-deducted for income tax purposes. Any item reflected in financial statement net-of-tax should be grossed up.

- **Disclosures**—Book income must be increased by amounts disclosed in footnotes, or other supplementary information, if disclosure results in a greater amount of book income. (This excludes disclosures if authorized by GAAP or reflecting “historic practice.”)

- **Cumulative effect**—Exclude amounts attributable to years before 1987.

- **Related corporations**—Adjust to conform financial statements to reflect applicable members.

  - Eliminate book income and add dividends received from parties consolidated for book, but not tax, purposes.
  - Eliminate excess of equity method income over dividends received (as measured for tax purposes) from parties not consolidated for book or tax purposes.
  - Eliminate all income and the excess of equity method income over dividends received for parties excluded from the consolidated tax return.

** The rate is 20 percent on AMTI in excess of $40,000, if AMT is higher than regular tax. The $40,000 exemption is reduced by 25 percent of AMTI over $150,000 and entirely phased out when AMTI reaches $310,000.

---

300
income adjustment will be replaced by an “Adjusted Current Earnings” computation (ACE), which is essentially Subchapter C Earnings and Profits with certain adjustments. Under the U.S. Tax Code, the ACE adjustment is 75 percent of the amount by which ACE exceeds AMTI, exclusive of the ACE adjustment and any AMT NOL deduction and can result in taxable or deductible amounts. There are limits, however, to the deduction for ACE.

Case 11 illustrates the interaction of the regular tax, AMT, and deferred income taxes.

Case 11. Determination of deferred tax liability and provision for income tax—application of AMT

The enterprise is a U.S. enterprise whose tax liability is determined based on the Tax Reform Act of 1986. A 35 percent tax rate of regular taxable income is assumed for all years. Additional assumptions are as follows:

- The current year, Year 1, is the enterprise's first year of operations.
- The enterprise has tax-exempt income of $2,600 from municipal bonds (nonpreference) in the current year.
- U.S. tax law provides that the book income adjustment, a feature of the AMT system, will be replaced by an adjustment for ACE; that change is assumed to occur in Year 5.
- Depreciable assets that cost $2,000 were acquired in the middle of the current year and will be depreciated as follows:

<table>
<thead>
<tr>
<th>Financial Reporting</th>
<th>Regular Tax Depreciation 40 percent</th>
<th>Depreciation AMT 30 percent</th>
<th>ACE 85 percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$200</td>
<td>$400</td>
<td>$300</td>
</tr>
<tr>
<td>Year 2</td>
<td>400</td>
<td>640</td>
<td>510</td>
</tr>
<tr>
<td>Year 3</td>
<td>400</td>
<td>384</td>
<td>356</td>
</tr>
<tr>
<td>Year 4</td>
<td>400</td>
<td>230</td>
<td>334</td>
</tr>
<tr>
<td>Year 5</td>
<td>400</td>
<td>230</td>
<td>334</td>
</tr>
<tr>
<td>Year 6</td>
<td>200</td>
<td>116</td>
<td>166</td>
</tr>
<tr>
<td></td>
<td><strong>$2,000</strong></td>
<td><strong>$2,000</strong></td>
<td><strong>$2,000</strong></td>
</tr>
<tr>
<td></td>
<td><strong>$2,000</strong></td>
<td><strong>$2,000</strong></td>
<td><strong>$250</strong></td>
</tr>
<tr>
<td></td>
<td><strong>$2,000</strong></td>
<td><strong>$116</strong></td>
<td><strong>250</strong></td>
</tr>
<tr>
<td></td>
<td><strong>$500</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Financial income and income taxes currently payable for the current year are as follows:
Regular tax calculation:
- Pretax financial income: $4,000
- Municipal bond income: (2,600)
- Depreciation difference: (200)
- Regular taxable income: $1,200

Regular tax (35 percent): $420

AMT calculation:
- Regular taxable income: $1,200
- Depreciation adjustment [Difference between regular tax and AMT depreciation ($400-300)]: 100
- Tentative AMTI: 1,300

Book income adjustment:
- [50 percent of ($4,000-1,300)]: 1,350

AMTI: $2,650

TMT (20 percent): $530

Income taxes currently payable: $530
(The AMT is $530 – $420 = $110)

*The book income adjustment is equal to one-half of the amount by which pretax financial income exceeds tentative AMTI. No book income adjustment is made in years in which tentative AMTI exceeds pretax financial income.

The enterprise's current tax liability will be $530 (regular tax $420 plus AMT $110). Within certain limitations, in this example, the tax law permits the excess of the TMT over the regular tax ($110) to be carried forward and used as a credit against the regular tax in future years. However, the AMT credit can only be carried forward and cannot be used to reduce a future year's regular tax below the TMT for that future year.

At the end of the current year (Year 1), a liability for the deferred tax consequences of depreciation differences is calculated as shown in Exhibit 11 (amounts are rounded to the nearest dollar).

Temporary differences between financial reporting depreciation and regular tax depreciation appear in Exhibit 11, line 1. The ($240) deductible amount is carried back to Year 1. Deferred tax on a regular tax basis appears on line 4. The ($84) item in Year 1 is the benefit of the loss carryback at the 35 percent rate.
The computation of deferred taxes on an AMT basis appears on lines 5 through 13. The tentative AMTI is the difference between the regular taxable temporary depreciation differences, line 5, and the AMT depreciation adjustment on line 6. In essence, line 7 represents the temporary depreciation differences arising from the excess of financial reporting depreciation over AMT depreciation.

The book income adjustment, line 8, applies only if book income is higher than tax income. The book income adjustment does not apply in Year 1 because of the loss carryback. In Year 2, the book income adjustment is $55 because the zero book income (SFAS 96 assumes a break-even in future years) is greater than the TAMTI loss of $(110). The ACE adjustment for Years 5 and 6 is 75 percent of the amount by which ACE exceeds AMTI, exclusive of ACE adjustment and any AMT NOL deductions. See Exhibit 11(a). The ACE adjustment appears on line 9.

AMT NOL deduction may not exceed 90 percent of the AMTI before the deduction. There is no limit here because AMTI in Year 1 is $2,650, whereas the NOL is $(55). The AMT NOL ($55) is the same as the regular tax NOL ($240) reduced by preference items included in the loss and modified for any adjustments. The loss carryback to Year 1 results in—

- An $84 reduction in regular tax (Line 4).
- An $11 reduction in TMT (Line 13).
- A $73 increase in AMT carryforward ($84-$11) (Line 18).
- The carryforward at the end of Year 1 is $183 (Line 19) and consists of the $110 carryforward arising in Year 1 (TMT $530- Regular tax $420) and the $73 resulting from the loss carryback from Year 2.
- The AMT credit carryforward of $183 does not change in Year 2 but is carried forward to Year 3.

The higher of the regular tax or AMT appears on line 14. The AMT credit carryforward is used in Year 3 to reduce the regular tax of $6 to $3, which is both the AMT and the deferred tax liability (lines 15 and 16). As a result, the carryforward is reduced to $180 at the end of Year 3. The AMT carryforward continues to reduce the deferred tax liability but not below the AMT.

Based on the scheduling in Exhibit 11, the deferred tax liability in Year 1 is $31 (line 16) and consists of a current deferred tax asset of $11 and a noncurrent deferred tax liability of $42.
### Calculation of Deferred Income Tax Under Regular Tax and Alternative Minimum Tax

<table>
<thead>
<tr>
<th>Year</th>
<th>Regular Tax Calculation</th>
<th>AMT Calculation</th>
<th>Loss Carryback</th>
<th>AMTI Before Loss Carryback</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year 2</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Year 3</td>
<td>$(240)</td>
<td>$16</td>
<td>0</td>
<td>$16</td>
</tr>
<tr>
<td>Year 4</td>
<td>$16</td>
<td>$0</td>
<td>$16</td>
<td>$16</td>
</tr>
<tr>
<td>Year 5</td>
<td>$0</td>
<td>$170</td>
<td>0</td>
<td>$170</td>
</tr>
<tr>
<td>Year 6</td>
<td>$0</td>
<td>$170</td>
<td>0</td>
<td>$170</td>
</tr>
</tbody>
</table>

1. Taxable (deductible) amounts
2. Loss carryback
3. Regular taxable amounts
4. Regular tax (35 percent)
5. Regular taxable amounts before loss carryback and carryforward
6. AMT depreciation adjustment
7. Tentative AMTI before loss carryback
8. Book income adjustment
9. ACE adjustment
10. AMTI before loss carryback
11. Loss carryback
12. AMTI
13. TMT (20 percent) $ (11)  $ 0  $ 3  $ 13  $ 26  $ 0
14. Higher of regular
tax or TMT $ (11)  $ 0  $ 6  $ 60  $ 60  $30
15. AMT credit carryforward
applied 0 0 3 47 34 30
16. Deferred tax
liability of $31 $ (11)  $ 0  $ 3  $ 13  $ 26  $ 0

*Financial income in future years under SFAS 96 is zero; therefore, the book income adjustment is $55
because the zero book income is greater than the TAMTI of $(110).

**The ACE adjustment is equal to 75 percent of the difference between TAMTI and ACE. Unlike the book
income adjustment, the ACE adjustment, subject to certain limitations, can result in deductible or taxable
amounts. For purposes of this example, it is assumed that depreciation is the only reason for differences
between pretax financial income, regular taxable income, TAMTI, and ACE.
Exhibit 11(a)  
*Calculation of ACE Adjustment*

The ACE adjustments for Years 5 and 6 are calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Year 5</th>
<th>Year 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>TAMTI</td>
<td>$ 66</td>
<td>$ 34</td>
</tr>
<tr>
<td>ACE depreciation adjustment*</td>
<td>84</td>
<td>(84)</td>
</tr>
<tr>
<td>ACE</td>
<td>150</td>
<td>(50)</td>
</tr>
<tr>
<td>TAMTI</td>
<td>66</td>
<td>34</td>
</tr>
<tr>
<td>ACE less TAMTI</td>
<td>$ 84</td>
<td>$(84)</td>
</tr>
<tr>
<td>75 percent of difference</td>
<td>$ 63</td>
<td>$(63)</td>
</tr>
</tbody>
</table>

*The depreciation adjustment is computed as the difference between AMT depreciation and ACE depreciation.

**Note:** Adjustments for ACE include such items as the following:

- Depreciation is based on the “slower” of financial reporting depreciation or ACE depreciation. ACE depreciation depends on when the property was acquired. For example, for property placed in service after December 31, 1989, the alternative depreciation system under ACRS is used (straight line over asset depreciation range class life).

- Intangible drilling costs and mine exploration costs are capitalized and amortized over the slower of the financial reporting method or a 60 month (intangible) or 120 month (mining) amortization period beginning at the start of the production.

- Exclusion items such as tax exempt interest are included for ACE.

- Depletion for property placed in service after December 31, 1989, is cost depletion or financial reporting depletion, whichever produces the smaller present value of the deduction.

- Other adjustments relate to LIFO inventories, and dividends received exclusion.
**Deferred tax asset.** The amount of deferred tax consequences attributable to temporary differences that will result in net tax deductions in future years that could be recovered (based on loss carryback provisions in the tax law) by refund of taxes paid in the current year or a prior year. Recognition and measurement of a deferred tax asset does not anticipate the tax consequences of income that might be earned in future years.

**Deferred tax consequences.** The future effects on income taxes (as measured by the provisions of enacted tax laws) resulting from temporary differences at the end of the current year without regard to the effects of events not yet recognized or inherently assumed in the financial statements.

**Deferred tax expense (benefit).** The net change during the year in an enterprise’s deferred tax liability or asset.

**Deferred tax liability.** The amount of deferred tax consequences attributable to temporary differences that will result in net taxable amounts in future years. The liability is the amount of taxes payable on those net taxable amounts in future years, based on tax law provisions. Recognition and measurement of a deferred tax liability does not anticipate the tax consequences of losses or expenses that might be incurred in future years.

**Gains and losses included in comprehensive income but excluded from net income.** Under present practice, this category includes certain changes in market values of investments in marketable equity securities classified as noncurrent assets, certain changes in market values of investments in industries having specialized accounting practices for marketable securities, adjustments from

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recognizing certain additional pension liabilities, and foreign currency translation adjustments. Future changes to GAAP may change what is included in this category.

**Income tax expense (benefit).** The sum of current tax expense (benefit) and deferred tax expense (benefit).

**Operating loss carryback or carryforward for tax purposes.** An excess of tax deductions over gross income during a year that may be carried back or forward to reduce taxable income in other years. Different tax jurisdictions have different rules about whether an operating loss may be carried back or forward as well as about the length of the carryback or carryforward period. The discussion and examples in SFAS 96 assume that the tax law requires that an operating loss be first carried back for up to three years and then forward up to 15 years. As used in this Statement, this term is intended also to include carrybacks or carryforwards for individual deductions that exceed statutory limitations.

**Operating loss carryforward for financial reporting purposes.** The amount of an operating loss carryforward for tax purposes is (a) reduced by the amount that offsets temporary differences that will result in net taxable amounts during the carryforward and (b) increased by the amount of temporary differences that will result in net tax deductions for which a tax benefit has not been recognized in the financial statements.

**Statutory limitations.** Provisions in the tax law that limit the amount by which certain deductions or tax credits are applied to reduce taxable income or income taxes payable.

**Tax credit carryback or carryforward for tax purposes.** Tax credits that exceed statutory limitations that may be carried back or forward to reduce taxes payable in other years. Different tax jurisdictions have different rules regarding whether a tax credit may be carried back or forward and regarding the length of the carryback or carryforward period.

**Tax credit carryforward for financial reporting.** The amount of a tax credit carryforward for tax purposes reduced by the amount recognized as a reduction of a deferred tax liability for temporary differences that will result in net taxable amounts during the tax credit carryforward period.
**Tax-planning strategy.** A transaction or series of transactions that meet certain criteria and that, if implemented, would affect the particular future years in which temporary differences result in taxable or deductible amounts. A tax-planning strategy, including elections for tax purposes that are required or permitted by the tax law, either reduces the amount of a deferred tax liability or increases the amount of a deferred tax asset that would otherwise be recognized.

**Temporary difference.** A difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years, when the reported amount of the asset or liability is recovered or settled, respectively. Some temporary differences cannot be identified with a particular asset or liability for financial reporting, but those temporary differences (a) result from events that have been recognized in the financial statements and (b) will result in taxable or deductible amounts in future years based on provisions in the tax law. Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation, and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.
APPENDIX B

Advanced Topics in Accounting for Income Taxes

CHANGES IN TAX RATES OR TAX STATUS OF ENTITY

Recognition of Change in Rates. The effect of a change in tax rates on existing deferred tax liabilities or assets is recognized when the law is enacted or the entity’s status changes.

Change in Tax Status. Upon a change in tax status from non-taxable to taxable or the reverse, a deferred tax liability or asset must be recognized or eliminated.

Allocation of Effects of Change. The effects are allocated entirely to income from continuing operations.

Comparison to APB 11. Note that under APB 11, recognized changes in tax rates or tax laws that affected components of equity, such as translation adjustments, were allocated to that component.

Illustration of Treatment of Change in Tax Rates

To see the effect of this change in treatment on the relationship between a deferred tax liability and the equity account, consider the following example.

Case B-1. Treatment of change in tax rates

An enterprise’s only temporary difference at the end of Years 1 and 2 is the foreign currency translation adjustment of $1,000, which arose in Year 0.

The tax rate changes from 40 percent to 34 percent at the beginning of Year 2.

<table>
<thead>
<tr>
<th>Income Statement (selected accounts):</th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax income from continuing operations</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Income tax expense (benefit):</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>800</td>
<td>680</td>
</tr>
<tr>
<td>Deferred</td>
<td>(60)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$1,200</td>
<td>$1,380</td>
</tr>
<tr>
<td>Effective tax rate</td>
<td>40%</td>
<td>31%*</td>
</tr>
</tbody>
</table>
**Accounting for Income Taxes**

(continued)

<table>
<thead>
<tr>
<th>Balance Sheet (selected accounts):</th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred income taxes payable</td>
<td>$400</td>
<td>$340</td>
</tr>
<tr>
<td>Equity:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cumulative translation adjustment</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Deferred taxes thereon</td>
<td>400</td>
<td>400</td>
</tr>
<tr>
<td>Net balance</td>
<td>$600</td>
<td>$600</td>
</tr>
</tbody>
</table>

*The effective tax rate is lower than the statutory rate of 34 percent because of the effect of the change in tax rate on the temporary difference.

It is evident that after the tax rate change, the balance in the cumulative translation adjustment account does not reflect the current tax rate.

**Practice Prior to SFAS 96**

Under previous practice, deferred tax accounts are not adjusted for the effects of a change in tax rates until the temporary difference reverses. When adjusted, the effects are allocated to income or to components of equity such as translation adjustments, if relevant.

**Case B-2. Change in tax rates**

At December 31, 19X0, HI Corporation had charged $10,000 more depreciation for tax than book. This depreciation difference will reverse as follows: 19X1, $2,000; 19X2, $3,000; and 19X3, $5,000.

At December 31, 19X0, Company E had recorded a $4,600 deferred tax credit related to this depreciation difference. The company used the net change method. Tax rates are: 19X0-X1, 46 percent; 19X2, 40 percent; and 19X3, 34 percent.

**Case Objectives**

Assuming HI Corporation adopted SFAS 96 in 19X1, this case shows how to compute the amortization of the deferred tax liability under the liability approach in SFAS 96 and under the deferred approach in APB 11.
Accounting for Income Taxes

Note: Under SFAS 96, the effect of an enacted change in tax rates impacts the deferred tax liability and expense in the year of change. Tax expense would be reduced by an additional $780 in the enactment year. Whereas, under APB 11, the reversals would continue based on original scheduling without giving immediate effect to the change in tax rates.

Exhibit B-2

HI Corporation
Amortization of Deferred Tax Credits

<table>
<thead>
<tr>
<th>Year</th>
<th>Percent</th>
<th>Liability Method</th>
<th>Deferred Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>19X1</td>
<td>46%</td>
<td>$1,700</td>
<td>$ 920</td>
</tr>
<tr>
<td>19X2</td>
<td>40%</td>
<td>1,200</td>
<td>1,200</td>
</tr>
<tr>
<td>19X3</td>
<td>34%</td>
<td>1,700</td>
<td>2,480</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$4,600</td>
<td>$4,600</td>
</tr>
</tbody>
</table>

Note: The tax rate change effect is as follows:

Reversal

19X2 \(3,000 \times (46\% - 40\%) = \) $ 180
19X3 \(5,000 \times (46\% - 34\%) = \) $ 600

Rate reduction benefit reduces liability in 19X1 \$ 780
19X1 Reversal \$2,000 \times 46\% = \$ 920
Total reduction of liability in 19X1 \$1,700

Clearly scheduling is important here.

Under APB 11, the effect of the rate reduction would appear in 19X3.

Case B-3. Change in tax rates and computation of effect of tax rate change

The following case illustrates the computation of the effect of a change in tax rates.

Assume that the deferred tax liability at December 31, 19X1, is $1,067, computed as follows:
## Accounting for Income Taxes

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Prior</th>
<th>19X2</th>
<th>19X3</th>
<th>19X4</th>
<th>19X5</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Originating) or</td>
<td>$2,320</td>
<td></td>
<td>$(680)</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>reversing amount</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carryback to 19X0</td>
<td></td>
<td>$(680)</td>
<td>680</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Loss) or taxable</td>
<td>2,320</td>
<td>(680)</td>
<td>0</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>amount</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax rate</td>
<td></td>
<td>.46</td>
<td></td>
<td>.46</td>
<td>.46</td>
<td>.46</td>
</tr>
<tr>
<td>Deferred tax</td>
<td>$1,067</td>
<td>$(313)</td>
<td>$0</td>
<td>$460</td>
<td>$460</td>
<td>$460</td>
</tr>
<tr>
<td>liability or (asset)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

During 19X2, the tax rates change as follows: 19X3, 40 percent; 19X4 and 19X5, 34 percent. Continuing with the above example, the deferred tax for December 31, 19X2, would be $1,080.

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>19X3</th>
<th>19X4</th>
<th>19X5</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Originating) or</td>
<td>$3,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>reversing amount</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Loss) or taxable</td>
<td>3,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>amount</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax rate</td>
<td></td>
<td>.40</td>
<td>.34</td>
<td>.34</td>
</tr>
<tr>
<td>Deferred tax</td>
<td>$1,080</td>
<td>$400</td>
<td>$340</td>
<td>$340</td>
</tr>
<tr>
<td>liability</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Assume that in 19X2 the company had reported $10,000 pretax income. The amount of income tax expense for the year would be $4,300.

| Pretax income            | $10,000 |
| Additional asset cost    |         |
| recovery                | (680)   |
| Taxable income          | 9,320   |
| Tax rate                | .46     |
| Taxes currently payable | $4,287  |
| Deferred tax liability January 1 | 1,067 |
| Deferred tax liability December 31 | 1,080 |
| Deferred tax expense    | 13      |
| Income tax expense      | $4,300  |
The effect of the tax rate change alone is determined using with and without procedures to compute the change in the deferred tax liability or asset.

The amount of the deferred tax liability at the end of 19X2 if tax rates had not changed would be $1,380.

<table>
<thead>
<tr>
<th>(Originating) or reversing amount</th>
<th>Total</th>
<th>19X3</th>
<th>19X4</th>
<th>19X5</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$3,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>(Loss) or taxable amount</td>
<td>3,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Tax rate</td>
<td>.46</td>
<td>.46</td>
<td>.46</td>
<td>.46</td>
</tr>
<tr>
<td>Tax payable</td>
<td>$1,380</td>
<td>$ 460</td>
<td>$ 460</td>
<td>$ 460</td>
</tr>
</tbody>
</table>

With tax rate change:

Increase in deferred tax liability (from above) $ 13

Without tax rate change:

Deferred tax liability January 1 $1,067
Deferred tax liability December 31 1,380
Increase in deferred tax liability 313
Benefit of tax rate change $300

The deferred tax expense would have been $300 higher if tax rates had not changed. Therefore, the benefit of the tax rate change is $300. This amount must be disclosed separately on the income statement or in notes to financial statements.

**Tax Status**

**Change in Status Filed.** An enterprise that files an election to change its tax status should recognize the effect of that voluntary change on the date that the change is approved by the taxing authority or on the date of filing the election if approval is not necessary. The effect of a change in tax status is a discrete event and should be recognized in the period it occurs.

**Election of S Corporation.** If an enterprise elects S Corporation status after December 31, 1986, it is subject to a corporate-level
tax on any unrecognized "built-in gain" realized during the 10-year period after the conversion to S Corporation status. The gain is taxable on the subsequent disposition of any asset and is determined by applying the maximum corporate rate applicable to the particular type of income to the lesser of (a) the amount of the built-in gain realized for that year or (b) the amount that would be taxable income for that year if the enterprise were not an S Corporation.

Built-in gains may result in temporary differences which at the date of conversion is the excess, if any, of (a) the lower of either the appraised value or the reported amounts of the company's assets over (b) the tax bases of those assets. Note: A temporary difference for inventory is considered to result in a taxable amount in the following year. However, there would be no taxable amount for depreciable assets if recovery of those assets will be by use in operations.

BUSINESS COMBINATIONS

Pooling — Purchase
For financial reporting, a business combination can be either of the following:

- A pooling of interests in which assets and liabilities are maintained at book values
- A purchase in which assets and liabilities of the acquired company are revalued to reflect at least a portion of the difference between book and market value, based on the percentage of ownership, and goodwill is recognized

Taxable — Nontaxable
For tax purposes, a combination can be viewed as —

- Taxable in which the acquired corporation revalues its assets and liabilities to reflect acquisition values.
- Nontaxable in which original tax bases are maintained.

Revaluation — Nonrevaluation
There are four possible combinations of financial reporting and tax treatment, as shown by the following chart.
Pooling

<table>
<thead>
<tr>
<th>Taxable</th>
<th>Revalue for tax purposes only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nontaxable</td>
<td>No revaluation</td>
</tr>
</tbody>
</table>

Purchase

<table>
<thead>
<tr>
<th>Taxable</th>
<th>Revalue for tax and for financial reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nontaxable</td>
<td>Revalue for financial reporting only</td>
</tr>
</tbody>
</table>

**Combination Types**

*Nontaxable Purchase.* In practice, the most common type of business combination is a nontaxable purchase.

*Nontaxable Pooling.* The second most common type is a nontaxable pooling. This second type causes no temporary differences other than those that already exist unless net operating loss or similar carryforwards are possible.

*Taxable Pooling.* A taxable pooling is possible, but it doesn’t occur frequently. A pooling-of-interests combination may be a taxable combination. The increase in the tax basis of the net assets acquired results in temporary differences requiring a deferred tax liability or asset. As of the combination date, recognizable tax benefits attributable to the increase in tax basis are allocated to contributed capital. Tax benefits attributable to the increase in tax basis that become recognizable after the combination date are reported as a reduction of income tax expense.

*Taxable Purchase.* Taxable purchase combinations were frequent before the Tax Reform Act of 1986. They are of interest here only if SFAS 96 is applied retroactively to years before 1986. Such combinations would produce temporary differences only if the revaluation for tax purposes differed from the revaluation for financial reporting purposes. Such a situation is rare.

**Differences in Tax and Financial Reporting Bases**

1. In purchase business combinations, one of the major issues for both tax and financial reporting purposes is the computation of goodwill.
2. Amortization of goodwill is not allowed for tax purposes, and financial statement amortization is often spread over as many as 40 years.

3. Therefore, corporations frequently are motivated to assign the minimum justifiable amount to goodwill. SFAS 96 amended prior pronouncements to specify goodwill computation procedures.

4. Under SFAS 96, assets and liabilities of an acquired company are valued without considering income tax consequences. A deferred tax liability or asset is determined for the resulting temporary differences of the acquired company at the date of acquisition.

5. Under SFAS 96, a temporary difference cannot be associated with goodwill, unallocated negative goodwill, nor leveraged leases that are present in the financial records of the acquired company.

6. If the purchase price exceeds the aggregate of the revalued assets and liabilities and deferred tax liability or asset, the result is goodwill.

7. If the aggregate amount exceeds the purchase price, noncurrent assets (except marketable securities) are first reduced to zero, and any excess is negative goodwill. This latter provision is the same as under previous pronouncements.

*Purchase Business Combinations.* Differences between the assigned values and the tax bases of assets and liabilities (except goodwill or unallocated negative goodwill and leveraged leases) of an enterprise acquired in a purchase business combination require the recognition of a deferred tax liability or asset.

1. The SFAS 96 changes current practice, which utilizes a net-of-tax approach and a discounted valuation. Both of these applications would be proscribed under the new Statement.

2. The following situation illustrates the application of SFAS 96 to a nontaxable purchase combination.
**Purchase Business Combination — Nontaxable, Differences Between Assigned Values and Tax Basis of Assets**

- Purchase price: $40,000
- Tax basis of net assets acquired: 10,000
- Assigned value of net assets, other than goodwill: 24,000
- Future recovery of assets and settlements of liabilities will result in taxable and deductible amounts that can be offset against each other.
- Tax rate is 40 percent

The application of SFAS 96 requires that goodwill of $21,600 and a deferred tax liability of $5,600 be recognized as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets</td>
<td>$24,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>21,600</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>$ 5,600</td>
</tr>
<tr>
<td>Cash</td>
<td>40,000</td>
</tr>
</tbody>
</table>

The deferred tax liability is:

\[(24,000 - 10,000) \times 40 \text{ percent} = 5,600\]

The difference between assigned net asset value and the tax basis is a temporary difference.

*Note: (1)* Under APB 16 and APB 11, the entry would be as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets</td>
<td>$24,000-$5,600 $18,400</td>
</tr>
<tr>
<td>Goodwill</td>
<td>21,600</td>
</tr>
<tr>
<td>Cash</td>
<td>40,000</td>
</tr>
</tbody>
</table>

Other things being equal, the future net income under the two approaches would be the same.

*Note: (2)* In computing the deferred income tax expense or benefit for a year in which a business combination has occurred, the addition to or deduction from a net deferred income tax liability or asset resulting from the combination is treated as an adjustment to the opening balance of a net deferred tax liability or asset.
Accounting for Income Taxes

**Purchase Business Combination — Taxable, Values Assigned to Goodwill for Tax and Accounting Purposes Differ**

- **Purchase price**: $40,000
- **Tax basis of net assets acquired, other than goodwill**: 40,000
- **Accounting basis of net assets acquired, other than goodwill**: 24,000

The acquiring enterprise has a deferred tax liability of $60,000 that will result in net taxable amounts in future years, and the acquired $16,000 of temporary differences will result in deductible amounts in the same future years.

**Tax rate is 40 percent.**

SFAS 96 allows the use of the future taxable amounts of the acquiring company in determining the amount of future deductible amounts of the acquired company that can be recognized at the date of acquisition. Therefore, the deferred tax liability debit is an offset to the deferred tax credit of the acquiring company.

The amount is based on 40 percent of the temporary difference ($40,000 − $24,000).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets, other than goodwill</td>
<td>$24,000</td>
</tr>
<tr>
<td>Deferred tax liability (acquiring enterprise)</td>
<td>6,400</td>
</tr>
<tr>
<td>Goodwill</td>
<td>9,600</td>
</tr>
<tr>
<td>Cash</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

If the tax basis and accounting basis of net assets are identical, there are no temporary differences.

**Operating Loss and Tax Credit Carryforward — Purchase Method.** Accounting for a business combination should reflect any provisions in tax law that permit or restrict the use of either company’s operating loss carryforwards to reduce taxable income or taxes payable attributable to the other company subsequent to the combination.

If permitted by tax law or by tax election (consolidated tax return), an operating loss or tax credit carryforward for financial
reporting purposes of either combining enterprise may be recognized as a reduction of a deferred tax liability of the other, as of the acquisition date. This results in either reducing goodwill or noncurrent assets (except long-term investments in marketable securities) of the acquired enterprise or creating or increasing negative goodwill.

The Tax Reform Act of 1986 changed rules regarding utilization of carryforwards of other companies. Therefore, recognition of an acquired company's NOL as an offset to an acquirer's deferred tax liability may be an exception rather than the rule.

To contrast the new rules, note that according to APB 11 —

- Net-of-tax values were required to be assigned to acquired assets and liabilities.
- Subsequent recognition of purchased NOL carryforwards could result in retroactive restatement of purchase-price allocation.
- Carryforwards subsequently recognized were recorded by reducing goodwill to zero.
- Noncurrent assets were reduced and any remaining amounts were recorded as a negative goodwill.
- No consideration could be given to an acquirer's NOL or tax credit carryforwards at the acquisition date.

To illustrate the application of SFAS 96 to a purchase combination in which a loss carryover exists, consider the following facts:

Loss Carryforward — Nontaxable Purchase Business Combination

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price</td>
<td>$40,000</td>
</tr>
<tr>
<td>Net assets — assigned value</td>
<td>24,000</td>
</tr>
<tr>
<td>Tax basis</td>
<td>10,000</td>
</tr>
<tr>
<td>Acquired enterprise — operating loss carryforward</td>
<td>32,000</td>
</tr>
<tr>
<td>Temporary differences of acquiring and acquired company will result in taxable amounts before the end of the loss carryforward period.</td>
<td></td>
</tr>
<tr>
<td>Acquiring company has a deferred tax liability that stems from temporary differences that will result in net taxable amounts in future years.</td>
<td></td>
</tr>
<tr>
<td>Tax rate is 40 percent</td>
<td></td>
</tr>
</tbody>
</table>
In this situation, the $32,000 operating loss carryforward offsets the net taxable amount of $14,000. This is the difference between tax basis and accounting basis of net assets, and it will result in future taxable amounts.

The remaining $18,000 operating loss carryforward will be offset against the acquiring company’s deferred tax liability. This step results in reducing the acquiring company’s deferred tax liability amount of $7,200 ($18,000 x 40 percent) and it reduces the amount that would otherwise be assigned to goodwill.

Journal Entry:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets</td>
<td>$24,000</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>7,200</td>
</tr>
<tr>
<td>Goodwill</td>
<td>8,800</td>
</tr>
<tr>
<td>Cash</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

Carryforward—Pooling-of-Interests. For restatement of periods prior to the combination, an operating loss carryforward of an acquired enterprise does not offset the acquiring company’s taxable income because consolidated tax returns cannot be filed for those periods.

However, if consolidated tax returns are expected to be filed subsequent to the combination, one combining company’s operating loss carryforward in a prior period reduces the other enterprise’s deferred tax liability in the loss and subsequent periods to the extent that—

- The temporary differences will result in taxable amounts subsequent to the combination date.
- The loss carryforward can reduce those taxable amounts based on provisions of the tax law.
- The tax benefit is recognized as part of the adjustment to restate financial statements on a combined basis for prior periods.
- The same requirements apply to tax credit carryforwards and to temporary differences that will result in net deductible amounts in future years.

Subsequent Recognition of Carryforward Benefits. If not recognized at the acquisition date, the tax benefits of an acquired enterprise’s operating loss or tax credit carryforward for financial reporting purposes that are recognized in financial statements after the
acquisition date should first be used to reduce to zero any goodwill and other noncurrent intangible assets related to the acquisition and then be recognized as a reduction of income tax expense.

Additional amounts of carryforwards for financial reporting purposes arising after the acquisition date and before recognition of the tax benefits of amounts existing at the acquisition date are recognized as a reduction of income tax expense.

If both types of carryforwards exist, the attribution of the tax benefit is determined by the provisions of the tax law that identify the sequence in which the amounts are utilized for tax purposes. If not determinable by provisions in the tax law, the tax benefit recognized is prorated between a reduction of goodwill and other noncurrent intangibles and income tax expense.

The following case illustrates the recognition of tax benefits subsequent to a business combination:

**Case B-4. Recognition of tax benefits subsequent to a business combination**

JK Corporation acquires S Company in a nontaxable purchase business combination occurring January 1, 19X1.

<table>
<thead>
<tr>
<th>Assigned Values</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets acquired $10,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Goodwill (no other intangibles) 3,000</td>
<td></td>
</tr>
<tr>
<td>Purchase price $13,000</td>
<td></td>
</tr>
</tbody>
</table>

- The excess of tax basis over the assigned value of identified net assets does not meet the criteria for recognition of a deferred tax asset.
- There are no other temporary differences.
- Disregard goodwill amortization.
- Pretax loss from operations for 19X1 is $6,000. Pretax income from operations for 19X2 is $5,000.
- In 19X1 the net assets acquired for $10,000 are sold at book value, giving rise to a $2,000 tax loss.
- Tax rate in 19X1 and 19X2 is 40 percent.

**Case Objective**

This case shows how to allocate tax benefit of loss carryforward.
The determination of taxable income and net income for 19X1 and 19X2 and the application of SFAS 96 to the determination of income tax expense appears in Exhibit B-4.

The realization in 19X2 of the tax benefit of the tax loss carryforward of $2,000 ($5,000 x 40 percent) is apportioned between the tax loss in the sale of assets and the operating loss.

The $8,000 loss carryforward at the end of 19X1 has two components.

- $2,000 (25 percent) is attributable to the excess of tax basis over the assigned value of the identified net assets acquired at the date of the business combination.
- $6,000 (75 percent) is attributable to losses occurring after the business combination.

Provisions in the tax law do not distinguish between those two components, and the component that is utilized for tax purposes is indeterminable.

Therefore, in 19X2 the $2,000 tax benefit (40 percent of $5,000) is prorated so that goodwill is reduced $500 (25 percent of $2,000) and tax expense is reduced $1,500 (75 percent of $2,000). Because $500 of the tax benefit reduces goodwill, $500 of tax expense is reported in 19X2.

**Exhibit B-4 Allocation of Tax Benefit of Tax Loss Carryforward After a Purchase Combination**

<table>
<thead>
<tr>
<th>Tax Determination</th>
<th>JK Corporation</th>
<th>Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Financial Income</td>
<td>Income</td>
</tr>
<tr>
<td><strong>Tax Determination</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19X1—Pretax operating loss</td>
<td>$(6,000)</td>
<td>$(6,000)</td>
</tr>
<tr>
<td>Loss on sale of assets</td>
<td></td>
<td>(2,000)</td>
</tr>
<tr>
<td>Tax loss carryforward</td>
<td></td>
<td>$(8,000)</td>
</tr>
<tr>
<td>(no taxes paid in prior years)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>19X2—Pretax income from operations</td>
<td>$ 5,000</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Tax loss carryforward</td>
<td></td>
<td>(8,000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td></td>
<td>$0</td>
</tr>
</tbody>
</table>

(continued)
Exhibit B-4 (continued)

<table>
<thead>
<tr>
<th></th>
<th>JK Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>19X1</td>
</tr>
<tr>
<td>Pretax income (loss)</td>
<td>$(6,000)</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>500</td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>$(6,000)</td>
</tr>
</tbody>
</table>

Apportionment of Tax Benefit of Loss

- **Tax loss on asset sales**: $2,000 = 25% × $2,000 = $500 allocated to goodwill reduction
- **Operating loss**: $6,000 = 75% × $2,000 = $1,500 allocated to tax expense reduction

Journal Entry:

- Income tax expense 500
- Goodwill 500

Financial and taxable income for 19X3 is as follows:

<table>
<thead>
<tr>
<th></th>
<th>JK Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Financial Income</td>
</tr>
<tr>
<td>Income from operations</td>
<td>$3,000</td>
</tr>
<tr>
<td>Loss carryforward</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$0</td>
</tr>
</tbody>
</table>

The consolidated statement of earnings would be as follows:

- Pretax income $3,000
- Income tax expense 300
- Net income $2,700

The $1,200 benefit of the operating loss carryforward (40 percent of $3,000) is prorated so that goodwill is reduced $300 (25 percent of $1,200). Because $300 of the tax benefit reduces goodwill, $300 of tax expense is reported in 19X3.

**Business Combinations — Implementation Issues**

*Acquired NOL.* The recognition of an acquired NOL or tax credit carryforward should be *first* applied to reduce goodwill to zero.
Next, other noncurrent intangible assets related to the acquisition are reduced to zero. Then, any additional recognized benefit reduces income tax expense.

**Subsequent Recognition of Acquiring Company’s NOL.** If a tax benefit for some or all of an acquiring company’s operating loss carryforward for financial reporting cannot be recognized at the acquisition date as a reduction of the acquired company’s deferred tax liability because the criteria for recognition are not met, the tax benefit should be reported as a reduction of income tax expense when recognized in the financial statements for subsequent years.

**Other Intangibles.** Deferred taxes should be provided for temporary differences related to intangible assets other than goodwill. Goodwill is a residual and is one of the four exceptions to comprehensive tax allocation.

**Potential Reallocation for Tax Purposes.** If a reallocation of the purchase price for tax purposes is probable, recognition and measurement of a deferred tax liability or asset at the date of the purchase business combination should be based on the expected final tax allocation, not the initial allocation. For reporting periods prior to finalization of the purchase price allocation, the enterprise should recognize a deferred tax liability for those excess tax deductions and determine deferred taxes based on the expected final purchase price allocation. At the date that the purchase price allocation is finalized, the enterprise should adjust its deferred tax liability or asset to reflect the revised tax basis of the purchased assets and liabilities and the amount of any settlement with the IRS for prior-year income taxes. The effect of that adjustment should be applied to increase or decrease the remaining balance of goodwill.

**Tax Basis of Stock of an Acquired Enterprise.** If the tax basis in the stock of an acquired company exceeds the tax basis of the net assets of the acquired company, the excess will result in deductible amounts if the stock is sold or the business is liquidated.

Prior to sale or liquidation, the potential tax benefit does not meet the recognition requirements of SFAS 96 whenever a deferred tax liability is not recognized for that acquired enterprise’s APB 23 differences or deposits by U.S. steamship enterprises. The potential
tax benefit is included in the computation of the unrecognized deferred tax liability that is disclosed for those items. Otherwise, the recognition requirements would be met to the extent that the deductible amount reduces a deferred tax liability for temporary differences that do not result in taxable amounts until the acquired enterprise is sold or liquidated.

For example, it would reduce the enterprise's deferred tax liability for the temporary difference related to a gain as a result of the acquired enterprise's sale of stock at a price that exceeds the per-share carrying amount.
# APPENDIX C
Comparison of Provisions of SFAS 96, Accounting for Income Taxes, and Present Standards (APBs 11, 23, and 24)

<table>
<thead>
<tr>
<th>Provision</th>
<th>SFAS 96</th>
<th>Present Rules/ APB 11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Concept of accounting for income taxes</td>
<td>Comprehensive recognition of deferred taxes.</td>
<td>Same.</td>
</tr>
<tr>
<td>Exceptions</td>
<td>Continues same exceptions to income tax allocation.</td>
<td>Exceptions for deposits in statutory reserve funds by U.S. steamship companies and APB 23 items.</td>
</tr>
<tr>
<td>Focus</td>
<td>Accruing asset or liability for future tax return consequences of temporary differences.</td>
<td>Income statement matching of initial tax effects of timing differences and related pretax amounts.</td>
</tr>
<tr>
<td>Method</td>
<td>Liability method — Tax rates applied to cumulative temporary differences based on expected impact of differences on future tax returns.</td>
<td>Deferred method — Tax rates of year in which timing differences originate are used to estimate tax effects.</td>
</tr>
<tr>
<td>Effect of change in tax rates</td>
<td>Deferred tax balance is adjusted for a change in tax rates, and effect is allocated to income from continued operations.</td>
<td>No effect given to change in tax rate.</td>
</tr>
<tr>
<td>Measurement and recognition</td>
<td>Deferred taxes computed as if a tax return were prepared for the net amount of temporary differences that will result in taxable or deductible amounts in each future year.</td>
<td>Tax effects measured by the differential between income taxes computed with and without inclusion of the transaction creating the timing difference. Gross or net change method.</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>Recognize a deferred tax asset for net deductible amounts that could be realized by loss carryback from future years to reduce taxes in the current or prior year or reduce current deferred tax liability. No asset is recognized for additional net deductible amounts in future years.</td>
<td>Recognized based on the results of the deferred tax calculations, subject only to a reasonable-likelihood-of-realization test.</td>
</tr>
</tbody>
</table>
### Benefit of Operating Loss Carryforwards

**Provision**: Can deduct operating loss carryforward for tax purposes from net taxable amounts scheduled to occur in future years included in the loss carryforward period (that is, to reduce a deferred tax liability). Unrecognized amounts of carryforwards are treated as a reduction of income tax expense when realized and are reported in the same manner as the source of income that permits the use of the carryforward.

**SFAS 96**: Recognized as an asset if realization is assured beyond a reasonable doubt in the year of the loss. Otherwise, the benefit can offset deferred tax credits. Previously unrecognized carryforward is treated as an extraordinary item when realized.

**Present Rules/ APB 11**: Proscribed by APB 10 (but is applied in purchase business combinations).

### Discounting

**Provision**: No discounting.

**SFAS 96**: Proscribed by APB 10 (but is applied in purchase business combinations).

**Present Rules/ APB 11**: Applicable only to indefinite reversal items.

### Tax-planning Strategies

**Provision**: Must be considered in determining the timing of the reversal of temporary differences.

**SFAS 96**: In purchase combinations, net-of-tax values are assigned to the assets and liabilities of the acquired enterprise.

**Present Rules/ APB 11**: If recognized when realized subsequent to the purchase, then restate the purchase transaction. Reduce positive goodwill to zero; then noncurrent assets are reduced; and any additional amounts are negative goodwill.

### Business Combinations

**Provision**: A tax liability or asset is recognized for differences between the tax basis and assigned values of the net assets of the acquired enterprise.

**SFAS 96**: Realization of operating loss carryforward is accounted for by first reducing to zero positive goodwill and other noncurrent acquired intangible assets (other than marketable equity securities) and then reducing income tax expense.

**Present Rules/ APB 11**: Same.

### Intercompany Tax Allocation

**Provision**: No prescribed principles.

**SFAS 96**: Same.

**Present Rules/ APB 11**: Same.

### Intraperiod Allocation

**Provision**: Allocate to income from continuing operations, extraordinary items, discontinued operations, cumulative effect of accounting change, and equity accounts.

**SFAS 96**: Classified the same way as related assets and liabilities.

**Present Rules/ APB 11**: Same.

### Balance Sheet Classification of Deferred Tax

**Provision**: Classification depends on when the temporary differences reverse.

**SFAS 96**: Classified the same way as related assets and liabilities.

**Present Rules/ APB 11**: Same.
# APPENDIX D

## Financial Statements and Notes Checklist for Income Taxes

Following are selected questions pertinent to Statement of Financial Accounting Standards No. 96. These items are extracted from the *AICPA Auditing and Accounting Manual*, Section 8400, “Disclosure Checklists for Corporations.” These items are not all-inclusive and are not intended to present minimum requirements.

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. If significant, has the amount of net operating loss or tax credit carryforwards for which any tax benefits will be applied to reduce goodwill and other noncurrent assets (of an acquired enterprise) been disclosed separately?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[SFAS 96, par. 29 (AC I25.128)]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. If financial statements for prior years are restated, have all purchase business combinations that were consummated in those prior years been remeasured in accordance with the requirements of SFAS 96 (AC section I25)?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[SFAS 96, par. 25]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Are income tax effects for unrealized gains or losses on marketable securities recognized in conformity with SFAS 96?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[SFAS 96 (AC I25)]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Have deferred tax assets been recognized for the net tax benefit of net deductible amounts that could be realized by loss carryback from future years:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>a. To reduce a current deferred tax liability?</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>b. To reduce taxes paid in the current or a prior year?</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[SFAS 96, par. 17e (AC I25.116e)]</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
5. Have deferred tax assets been adjusted for the effect of a change in tax law or rates with the effect included in income from continuing operations for the period that includes the enactment date?  
[SFAS 96, par. 20 (AC I25.119)]

6. Have deferred tax assets attributable to different tax jurisdictions been presented separately and not offset?  
[SFAS 96, par. 24 (AC I25.123)]

7. Have the types of temporary differences that give rise to significant portions of a deferred tax asset been disclosed?  
[SFAS 96, par. 24 (AC I25.123)]

8. Have deferred tax assets been classified in two categories — the current amount and the noncurrent amount — in a classified statement of financial position?  
[SFAS 96, par. 24 (AC I25.123)]

9. Is the current amount of a deferred tax asset the net deferred tax consequence of:
   a. Temporary differences that will result in net taxable or deductible amounts during the next year?  
   [SFAS 96, par. 12 (AC I25.111)]

   b. Temporary differences related to an asset or liability that is classified for financial reporting as current because of an operating cycle that is longer than one year?  
   [SFAS 96, par. 24 (AC I25.123)]

   c. Temporary differences for which there is no related identifiable asset or liability for financial reporting whenever other related assets and liabilities are classified as current because of an operating cycle that is longer than one year?  
   [SFAS 96, par. 24 (AC I25.123)]
10. Have deferred tax liabilities been recognized for temporary differences that will result in net taxable amounts in future years?

[SFAS 96, par. 17 f-h (AC I25.116f-h)]

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

11. Has a deferred tax liability been adjusted for the effect of a change in tax law or rates with the effect included in income from continuing operations for the period that includes the enactment date?

[SFAS 96, par. 20 (AC I25.119)]

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

12. Have deferred tax liabilities attributable to different tax jurisdictions been presented separately and not offset?

[SFAS 96, par. 24 (AC I25.123)]

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

13. Have the types of temporary differences that give rise to significant portions of a deferred tax liability been disclosed?

[SFAS 96, par. 24 (AC I25.123)]

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

14. Have deferred tax liabilities been classified in two categories — the current amount and the noncurrent amount — in a classified statement of financial position?

[SFAS 96, par. 24 (AC I25.123)]

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

15. Is the current amount of a deferred tax liability the net deferred tax consequence of:

   a. Temporary differences that will result in net taxable or deductible amounts during the next year?

   b. Temporary differences related to an asset or liability that is classified for financial reporting as current because of an operating cycle that is longer than one year?

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
c. Temporary differences for which there is no related identifiable asset or liability for financial reporting (SFAS 96, par. 12 [AC I25.111]) whenever other related assets and liabilities are classified as current because of an operating cycle that is longer than one year?  

[SFAS 96, par. 24 (AC I25.123)]

16. Has the following information been disclosed whenever a deferred tax liability is not recognized for any of the areas addressed by APB 23 [AC I25 & I42] or for deposits in statutory reserve funds by U. S. steamship enterprises:

a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable?

b. The cumulative amount of each type of temporary difference?

c. The amount of the unrecognized deferred tax liability for any unremitted earnings if determination of that liability is practicable or a statement that determination is not practicable and the amount of withholding taxes that would be payable upon remittance of those earnings?

d. The amount of the unrecognized deferred tax liability for temporary differences other than unremitted earnings (that is, the bad debt reserve of a stock or mutual savings and loan association or a mutual savings bank, the policy holders surplus of a life insurance enterprise, and the statutory reserve funds of a U. S. steamship enterprise)?

[SFAS 96, par. 25 (AC I25.124)]

17. Has the fact that the entity is a public enterprise that is not subject to income taxes because its income is taxed directly to its owners and the net
difference between the tax bases and the reported amounts of the enterprise's assets and liabilities been disclosed?

[SFAS 96, par. 24 (AC I25.123)]

18. Has the amount of income tax expense or benefit been allocated to:
   a. Continuing operations?
   b. Discontinued operations?
   c. Extraordinary items?
   d. The cumulative effect of accounting changes?
   e. Prior period adjustments?
   f. Gains and losses included in comprehensive income but excluded from net income?
   g. Capital transactions?

[SFAS 96, par. 26 (AC I25.125)]

19. Have the following significant components of income tax expense attributable to continuing operations for each year presented been disclosed in the financial statements or notes thereto:
   a. Current tax expense or benefit?
   b. Deferred tax expense or benefit exclusive of (f) below?
   c. Investment tax credits?
   d. Government grants (to the extent recognized as a reduction of income tax expense)?
   e. The benefits of operating loss carryforwards?
   f. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the enterprise?

[SFAS 96, par. 27 (AC I25.126)]

20. Has the nature of significant reconciling items been disclosed?

[SFAS 96, par. 28 (AC I25.127)]
21. Have the amounts and expiration dates (or a reasonable aggregation of expiration dates) of operating loss and tax credit carryforwards for financial reporting (that is, amounts not already recognized as reductions of a deferred tax liability) and for tax purposes (that is, amounts available to reduce taxes payable on tax returns in future years) been disclosed?

[SFAS 96, par. 29 (AC I25.128)]

22. If the enterprise is part of a group that files a consolidated tax return, have the following items been disclosed in its separately issued financial statements:

a. The amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented?

b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the disclosures in (a) above are presented?

[SFAS 96, par. 30 (AC I25.129)]

23. For the earliest year restated or for the year SFAS 96 [AC I25] is first adopted if no prior year is restated, has the effect of applying SFAS 96 on the amount of deferred tax charges or credits at the beginning of the fiscal year been reported as the effect of a change in accounting principle in a manner similar to the cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, except for any effects of the type required by SFAS 96 to be excluded from net income?

[SFAS 96, par. 33]
24. When initially presented, have the financial statements for the year SFAS 96 [AC I25] was first adopted disclosed the following:

   a. The effect of adopting SFAS 96 [AC I25] on income from continuing operations, income before extraordinary items, and on net income for the year of adoption if restated financial statements for the prior year are not presented?

   b. The effect of any restatement on income from continuing operations, income before extraordinary items, and on net income for each year presented?

   [SFAS 96, par. 34]
# CHAPTER 7

## Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans

(FASB Statement No. 88)

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CHAPTER 7

Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans
(FASB Statement No. 88)

This chapter is intended to provide guidance for the implementation of the provisions of FASB Statement No. (SFAS) 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Plans and for Termination Benefits and the Special Report: A Guide to Implementation of Statement No. 88—Questions and Answers. It will cover the following areas:

- Accounting for Settlements
- Accounting for Curtailments
- Accounting for Termination Benefits
- Accounting for Disposal of a Segment
- Required Disclosures
- Accounting for Asset Reversion Transactions

INTRODUCTION

The pronouncement and its accompanying implementation guide establish standards and guidance for practice for an employer's accounting for a settlement or a curtailment of its defined benefit plan and for termination benefits. The accounting requirements are applied within the general framework of SFAS 87, Employers' Accounting for Pensions. Settlements, curtailments, and terminations occurring prior to the adoption of SFAS 87 are not subject to SFAS 88, but rather are accounted for under earlier authoritative pronouncements.
DEFINITION AND EXAMPLES OF "SETTLEMENT"

A settlement is defined as a transaction that is an irrevocable action that relieves the employer (or the plan) of primary responsibility for a pension benefit obligation and eliminates significant risks related to the obligation and the assets used to effect the settlement.

Examples of settlements include (a) lump sum cash payments to plan participants in exchange for their rights to specified pension benefits, and (b) purchase of nonparticipating annuity contracts for the vested benefits portion.

DEFINITION OF "ANNUITY CONTRACT"

An annuity contract is a contract where an insurance company undertakes a legal obligation to provide benefits to individuals in return for fixed consideration or a premium. An annuity contract is irrevocable and transfers risk from the pension plan or company to the insurance company.

*Participating annuity contracts* are contracts giving the plan or employer a share of the experience of the insurance company. If the participation feature is such that the employer or plan continues to be subject to risk and rewards associated with the benefit obligation or the assets transferred to the insurance company, a settlement has not occurred.

ASCERTAINING WHETHER SETTLEMENT HAS OCCURRED

**Purchase of Participating Annuities**

The key concern in ascertaining whether a settlement has occurred if a participating annuity is purchased is whether the employer’s exposure to gains or losses with regard to the pension benefit obligation or the plan assets is the same before and after the transaction (for exam-
ple, a company cannot avoid having a settlement by simply adding a *de minimis* participation right for a small premium).

**Purchase of Nonparticipating Annuities**

The timing of payment may be a factor in determining whether the employer is irrevocably relieved of responsibility for the pension benefit obligation. If a premium has not been paid, the annuity may be revocable. Also, if plan assets have not been transferred, they may be at risk. No settlement gain or loss can be recognized if plan assets or pension benefit obligations remain at risk. Issuance of individual annuity contracts may be relevant in assessing whether the employer is irrevocably relieved, but nonissuance in itself is not the critical factor.

**Limited-Term Annuities**

An insurance contract paying only a portion of a participant’s pension benefits (for example, the next six years of the retiree’s payments) is a limited-term annuity and does not result in a settlement. Limited-term annuities do not eliminate the significant risks associated with the pension benefit obligation.

**Employer Maintains Risks and Rewards**

If the insurance company is controlled by the employer or if there is reasonable doubt that the insurance company will meet its obligations, a settlement has not occurred. Essentially, the employer remains subject to all or most of the risks and rewards associated with the covered pension obligation or the assets transferred to the insurance company.

Settlement gains and losses can be recognized for purchases of nonparticipating annuities from a less-than-majority-owned investee that is not controlled by the employer. This intercompany transaction constitutes an exception to usual accounting under the equity method.
ACCOUNTING FOR SETTLEMENTS

Determining Maximum Settlement Gain or Loss

When a pension obligation is settled, the maximum gain or loss subject to recognition in earnings is the unrecognized net (gains) and losses plus remaining unrecognized net assets existing as a transition amount on the adoption of SFAS 87.

Measurement Date

Unrecognized net (gains) and losses are measured at the settlement date and include any additional gain or loss first measured at the time of settlement.

Net (gains) and losses are the previously unrecognized changes in the amount of either the projected benefit obligation (PBO) or plan assets from experience different from the assumed and from changes in assumptions.

Mechanics of Measurement

Plan assets and the projected benefit obligation are measured as of the date of settlement to determine maximum gain and percentage reduction in the PBO. Thus, the effects of intervening events occurring after a prior measurement date are incorporated in the determination of settlement gains and losses.

Selection of Interest Rate. Interest rates implicit in the determination of the purchase price of nonparticipating annuity contracts used to effect the settlement could differ from assumed discount rates that were being used in determining net periodic pension cost. Any changes in the estimated value of the PBO and plan assets that become evident at the time the PBO is settled are included in the maximum gain subject to pro rata recognition. These implicit interest rates in the purchase price of the annuity might also have to be considered in measuring the unsettled portion of the PBO if they are the best estimate of the rate at which this portion could be settled (for example, demographics and the period when payments are made are similar for unsettled portion).
Partial Settlements
If only part of the PBO is settled, a pro rata portion of the maximum amount is recognized equal to the percentage reduction in the PBO.

Use of Participating Annuities
If a settlement involves the use of a participating annuity contract, the maximum gain (not maximum loss) is reduced by the cost of the participation.

Situations in Which Gain or Loss Need Not Be Recognized
A gain or loss on settlements is not required—but is permitted—to be recognized if the cost of all settlements is less than or equal to the sum of service and interest costs of that year’s net periodic pension cost for the benefit plan.

Computing Cost of Settlement in Making Calculation
• Cost of settlement is the cash paid to employees for those settlements involving cash settlements.
• Cost of settlements using nonparticipating annuities is the contract cost.
• Cost of settlements using participating annuities is the contract cost less the portion attributed to the participation rights.

Reason for Exception. The above exception reduces the cost of implementation of SFAS 88 for companies that frequently acquire annuities for funding purposes.

Accounting Policy Must Be Consistently Applied. The accounting policy adopted for recognition of gains and losses from settlements should be applied consistently from year to year.

Impact on Interim Periods. A company has a policy of not recognizing gains and losses if the cost of settlements does not exceed the sum of service cost and interest cost. Accordingly, in the first quarter consider a company that didn’t recognize settlement gains and losses because of the expectation that the threshold would not be exceeded. If in the following interim period the company determines that the threshold amount will be exceeded, then the settlement gain or loss will be recognized in the second quarter as a change in estimate.
CONCEPT BEHIND GAIN AND LOSS RECOGNITION

Because settlement extinguishes the PBO and transfers a corresponding amount of plan assets, there is no longer a reason to delay recognition of the net (gains) and losses. Such previously unrecognized gains and losses will not reverse in the future, because an irrevocable action has occurred eliminating significant risks involving either pension benefit obligations or plan assets. Gains and losses occurring in one period will no longer be offset by subsequent gains and losses.

Unrecognized prior service costs are unaffected by a settlement because affected employees are expected to continue to render services in future periods.

Unrecognized transition assets are included with net (gains) and losses and are subject to immediate recognition. Unrecognized transition obligations are considered to have resulted from past plan amendments rather than plan losses and accordingly are treated in the same way as prior service costs arising after the adoption of SFAS 87. Unrecognized net assets at the time of transition are considered to result in a similar manner to net gains occurring after the adoption of SFAS 87 and are accounted for similarly in a settlement.

Because rates at which pension benefit obligations are being settled can differ from assumed discount rates used to estimate PBO, additional net (gains) and losses emerging from the settlement adjust the previously unrecognized net (gain) or loss. Accordingly, this affects the maximum gain or loss. This adjustment for settlement gains and losses is made regardless of whether a portion or the entire pension benefit obligation is settled.

Case 1. Conditions for settlement occurrence and accounting period

Situation A. An employer decides to terminate a defined benefit pension plan and establish a successor plan. Has a settlement occurred if the company commits itself to acquire a nonparticipating annuity? Has a settlement occurred if the employer purchases in 19X8 a nonparticipating annuity contract for the vested portion of all plan participants’ benefits, which can be rescinded if regulatory approvals for the termination are not received? Has a settlement occurred if approvals are considered probable in 19X8 but are not
obtained until January 15, 19X9, preceding issuance of 19X8 financial statements?

Situation B. Pension plan participants agree to a lump sum payment in exchange for their pension benefits. The amount is fixed but not yet paid. May a settlement gain or loss be recognized?

Case Objectives and Solutions
This case examines necessary conditions for occurrence of a settlement and considerations in determining the accounting period in which settlements of gains and losses are recognized. The case also considers whether a settlement gain or loss is to be recognized when a company makes a commitment to enter into individual nonparticipating annuity contracts.

Situation A. In the first situation, a commitment is made to acquire an individual nonparticipating annuity. For a settlement gain or loss to be recognized, the insurance company must have unconditionally undertaken a legal obligation to provide the specified pension benefits. A commitment to purchase does not relieve the company of its obligations. Settlement gains and losses are not to be recognized if significant risks related to pension benefit obligations and plan assets to be used in the settlement have not been eliminated.

In the second variation within the case, the nonparticipating annuity is actually purchased in 19X8. However, remaining approvals are applied for in 19X8 and received in 19X9. Recognition of settlement gains and losses is again prohibited, since all three criteria for a settlement have not been satisfied. An irrevocable action relieving the employer or plan of primary responsibility for the pension benefit obligation has not yet occurred. Probability of completion is not relevant in such a determination. Since approvals are obtained in 19X9, gains and losses from settlements will be recognized in 19X9 financial statements. Adjustment of the 19X8 financial statements is inappropriate, although disclosure may be necessary.

Situation B. The agreement to make a fixed lump sum payment is still insufficient for recognition of a settlement gain or loss. The plan assets to be transferred are still at risk, and the agreement may still be revocable to the extent cash has not been transferred.

Case 2. Determination of settlement gain or loss
Lockin Corporation has a final-pay noncontributory defined benefit plan. On December 31, 19X9, the plan settles the vested benefits
($2,600,000) portion of the PBO by purchasing a nonparticipating annuity contract in the amount of those vested benefits.

Situations Before Settlement

<table>
<thead>
<tr>
<th>Assets and obligations</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vested benefits</td>
<td>$(2,600,000)</td>
<td>$(2,600,000)</td>
</tr>
<tr>
<td>Nonvested benefits</td>
<td>(400,000)</td>
<td>(400,000)</td>
</tr>
<tr>
<td>Accumulated benefits</td>
<td>$(3,000,000)</td>
<td>$(3,000,000)</td>
</tr>
<tr>
<td>Future salary increases</td>
<td>(1,000,000)</td>
<td>(1,000,000)</td>
</tr>
<tr>
<td>PBO</td>
<td>(4,000,000)</td>
<td>(4,000,000)</td>
</tr>
</tbody>
</table>

| Fair value of plan assets         | 3,100,000          | 4,200,000          |
| Funded status                     | (900,000)          | 200,000            |
| Unrecognized net (assets)/        |                    |                    |
| obligation at transition         | 850,000            | (200,000)          |
| Unrecognized prior service cost   | 250,000            | 0                  |
| Unrecognized net (gain) or loss   | (300,000)          | (300,000)          |
| (Accrued) or prepaid pension cost | (100,000)          | (300,000)          |
| before additional minimum liability |                 |                    |

Case Objectives and Solutions

The case uses the information for alternative situations A and then B to determine the settlement gain or loss that would be recognized.

**Situation A.** As can be seen in Exhibit 1, following, the maximum gain is $300,000, consisting of the unrecognized net (gain) after the adoption of SFAS 87. The transition amount is an unrecognized obligation, which is excluded in the determination. There is a reduction in PBOs of 65 percent ($2,600,000/$4,000,000), which is the pro rata portion that is considered settled. Accordingly, 65 percent of the maximum gain ($195,000) is recognized.

Exhibit 1

<table>
<thead>
<tr>
<th>Assets and obligations</th>
<th>Before Settlement</th>
<th>Effect of Settlement</th>
<th>After Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vested benefits</td>
<td>$(2,600)</td>
<td>$2,600</td>
<td>$0</td>
</tr>
<tr>
<td>Nonvested benefits</td>
<td>(400)</td>
<td>(400)</td>
<td>(400)</td>
</tr>
<tr>
<td>Accumulated benefits</td>
<td>(3,000)</td>
<td>2,600</td>
<td>(400)</td>
</tr>
<tr>
<td>Future salary increases</td>
<td>(1,000)</td>
<td>(1,000)</td>
<td>(1,000)</td>
</tr>
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### Exhibit 1 (continued)

<table>
<thead>
<tr>
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<th>Before Settlement</th>
<th>Effect of Settlement</th>
<th>After Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PBO</strong></td>
<td>(4,000)</td>
<td>(1,400)</td>
<td></td>
</tr>
<tr>
<td>Fair value of plan assets</td>
<td>3,100</td>
<td>(2,600)</td>
<td>500</td>
</tr>
<tr>
<td>Funded status</td>
<td>(900)</td>
<td>(900)</td>
<td></td>
</tr>
<tr>
<td>Unrecognized net (assets)/obligation at transition</td>
<td>850</td>
<td>850</td>
<td></td>
</tr>
<tr>
<td>Unrecognized prior service cost</td>
<td>250</td>
<td>250</td>
<td></td>
</tr>
<tr>
<td>Unrecognized net (gain) or loss</td>
<td>(300)</td>
<td>195</td>
<td>(105)</td>
</tr>
<tr>
<td>(Accrued) or prepaid pension cost before additional minimum liability</td>
<td>$ (100)</td>
<td>$ 195</td>
<td>$ 95</td>
</tr>
</tbody>
</table>

The journal entry is as follows:

Accrued pension liability 195
Gain from settlement 195

**Situation B.** As can be seen in Exhibit 2, the maximum gain is $500,000, consisting of unrecognized transition assets and unrecognized net gains. Plan assets of $2,600,000 were used to acquire a non-participating annuity and accordingly settle an equivalent amount of vested benefits. Again, the pro rata amount of the PBO that is settled is 65 percent, and the amount of gain recognized is $325,000 (65 percent of $500,000).

### Exhibit 2

#### Situation B

<table>
<thead>
<tr>
<th>Assets and obligations</th>
<th>Before Settlement</th>
<th>Effect of Settlement</th>
<th>After Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vested benefits</td>
<td>$(2,600)</td>
<td>$2,600</td>
<td>$ 0</td>
</tr>
<tr>
<td>Nonvested benefits</td>
<td>(400)</td>
<td></td>
<td>(400)</td>
</tr>
<tr>
<td>Accumulated benefits</td>
<td>(3,000)</td>
<td>2,600</td>
<td>(400)</td>
</tr>
<tr>
<td>Future salary increases</td>
<td>(1,000)</td>
<td></td>
<td>(1,000)</td>
</tr>
<tr>
<td>PBO</td>
<td>(4,000)</td>
<td></td>
<td>(1,400)</td>
</tr>
<tr>
<td>Fair value of plan assets</td>
<td>4,200</td>
<td>(2,600)</td>
<td>1,600</td>
</tr>
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</table>

(continued)
Exhibit 2 (continued)

<table>
<thead>
<tr>
<th></th>
<th>Before Settlement</th>
<th>Effect of Settlement</th>
<th>After Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funded status</td>
<td>200</td>
<td></td>
<td>200</td>
</tr>
<tr>
<td>Unrecognized net (assets)/obligation at transition</td>
<td>(200)</td>
<td>130</td>
<td>(70)</td>
</tr>
<tr>
<td>Recognized prior service cost</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrecognized net (gain) or loss</td>
<td>(300)</td>
<td>195</td>
<td>(105)</td>
</tr>
<tr>
<td>(Accrued) or prepaid pension cost before additional minimum liability</td>
<td>$(300)</td>
<td>$325</td>
<td>$ 25</td>
</tr>
</tbody>
</table>

The journal entry is as follows:

Accrued pension liability 325,000
Gain on settlement 325,000

SFAS 88 does not address the allocation of the $325,000 between unamortized transition amounts and unamortized gains. Since the allocation can affect the determination of income in future periods, the implementation guide recommends allocation on a pro rata basis as being an unbiased approach, which results in 40 percent of the $325,000 being allocated against the unrecognized net assets and 60 percent of the $325,000 against unrecognized net gains. The remaining amount of unamortized transition amounts will continue to be amortized on a straight-line basis over the remainder of the amortization period determined at transition.

**Case 3. Accounting for asset reversion transactions**

Greedy Corporation withdraws $75,000 in excess plan assets from a pension plan but is not required to settle any pension benefit obligation as part of this asset reversion.

**Case Objective and Solution**

This case addresses the appropriate accounting for this asset reversion transaction. A settlement has not occurred, and none of the previously unrecognized net gains and losses are now recognized. The withdrawal is a negative contribution and is a credit to accrued or prepaid pension cost.
CURTAILMENTS

Definition

A curtailment is an event that significantly reduces the expected future year of service of present employees or eliminates for a significant number of employees the accrual of defined benefits for some or all of their future services. Settlements and curtailments can occur separately or together.

There is no threshold for determining significance. Judgment should be applied for each pension plan based on facts and circumstances.

Examples and Accounting Impacts

Curtailments include termination of employees’ services earlier than expected, with or without the closing of a facility or discontinuing a segment and termination of a plan so that no additional defined benefits are earned for future services. A curtailment can also occur if an employer temporarily suspends accrual of pension plan benefits for covered employees or temporarily lays off a significant number of employees.

Frequently, curtailments are accompanied by reductions in PBOs (resulting in gains). However, obligations can also be increased, especially if employees agree to leave early.

Accounting for Curtailments

Loss From Unrecognized Prior Service Costs

Unrecognized prior service costs related to years of service no longer expected to be rendered as a result of a curtailment is a loss.

Loss Includes Unrecognized Remaining Net Obligations at Transition. Remaining unrecognized net obligations existing at the SFAS 87 transition date and the cost of retroactive plan amendments, as defined under SFAS 87, are included with unamortized prior service costs in applying this provision.
Determination of Curtailment Loss Associated With Prior Service Costs. For example, consider a company that has $20,000 of unrecognized prior service costs associated with a plan amendment. The employer amortizes prior service costs by assigning an equal amount to each service period of each employee who is active and expected to receive benefits under the plan. If the reduction in years of service is 100 years and the amortization per year of service is $25, a curtailment loss of $2,500 is recognized. If an employer amortizes prior service costs under an alternatively acceptable method, such as straight-line amortization over average service period, determination of unrecognized prior service with years of service no longer expected to be received is difficult to calculate, and calculation of curtailment cost on percentage reduction years of service is permissible. Thus, a curtailment loss of $667 would result from the elimination of two-thirds of estimated future years of service of those employed and expected to receive benefits under the amended plan, having $1,000 unamortized prior service costs.

Amortization of Remaining Unrecognized Net Obligation. If an unrecognized net obligation is reduced as part of accounting for a curtailment, the balance is amortized on a straight-line basis over the remainder of the amortization period determined at transition.

Gain or Loss From Changes in PBOs
A second component of curtailment (gains) or losses arises from (decreases) or increases in the PBO.

Calculation of Maximum Gain From Changes in PBOs. In determining the maximum curtailment gain from decreases in PBOs, the sum of net (gains) and losses and unrecognized net transition assets is calculated. If that sum results in an unrecognized loss, the curtailment gain is limited to the amount that the reduction in PBO exceeds the unrecognized loss. If the sum results in an unrecognized gain, the entire reduction in the PBO is recognized as a curtailment gain.

Calculation of Maximum Loss From Changes in PBOs. Similarly, a curtailment loss is recognized in full when the sum of the net (gains) and losses and unrecognized net transition assets results in an unrecognized loss. To the extent that the above sum results in an unrecognized gain, the maximum curtailment loss is limited to the excess above the unrecognized gain.
Timing of Recognition

If the curtailment related activities (that is, the sum of the effects identified with unrecognized prior service costs associated with years of service no longer expected to be rendered plus [decreases] or increases in PBOs) result in a net loss, it is recognized in earnings when it is probable that a curtailment will occur and the effects are reasonably estimable. If the sum of the effects is a net gain, it is recognized in earnings when the related employees terminate or the plan suspension or amendment is adopted.

The effects of settlements and curtailments resulting from a pension plan termination may be recognized in different accounting periods.

Curtailments or Settlements Occurring After Pension Plan’s Measurement Date But Before Fiscal Year-End

Ordinarily, gains and losses on curtailments or settlements occurring after the pension plan’s measurement date but before the company’s fiscal year-end will be recognized in the financial statements for the subsequent fiscal year. However, exceptions to this rule requiring recognition in the current year include gains and losses resulting from an employer’s termination of the plan without instituting a successor plan and gains and losses attributable to disposal of segments. If gains and losses are not recognized in the current year but would have had an impact on results of operation and financial position, disclosure should be made in the current year’s financial statements.

Proper Sequence in Measuring Curtailments and Settlements

If both a curtailment and settlement occur on a pension-related event, the sequence selected can affect the determination of aggregate gain or loss recognized. Since the order of recognition is clearly arbitrary, the employer can use any order as long as the approach is consistently followed in determining the effects of settlements and curtailments that are to be recognized at the same time.

Concept Behind Gain and Loss Recognition

A curtailment increases or decreases PBOs and directly results in losses and gains. Similarly, under a curtailment, prior service costs
are no longer deferred and amortized over time, because the benefits from such amendments to plans cannot be attributable to future periods. Prior service costs are not delayed, because the curtailment reduces future economic benefits derived from loyalty, morale, productivity, and the like.

**Case 4. Determination of settlement, curtailment, or combination**

*Situation A*
Concurrent with dismissal of one-half of the work force, future benefits are reduced but the plan remains in existence and continues to pay benefits, invest assets, and receive contributions.

*Situation B*
A plan is terminated and is not replaced by a successor plan.

*Situation C*
An employer purchases nonparticipating annuity contract for vested benefits and establishes a successor plan to provide defined benefits for future services.

*Situation D*
A pension plan is terminated, the pension benefit obligation is settled, excess assets are withdrawn, and a successor plan having the same pension benefit formula is established.

*Situation E*
Identical to situation D, but the new plan provides additional but reduced pension benefits for all years of employees' future services.

**Case Solutions**

*Situation A* clearly meets the definition of a curtailment, which is defined as the elimination of future years of service for a significant number of employees or the elimination for a significant number of employees of the accrual of defined benefits for their future services.

*Situation B* is a combination of both settlement and curtailment. The key for curtailment is that there is no longer the accrual of
defined pension benefits in an amended plan or a new plan for previously covered employees, or a new or amended plan includes only an insignificant number of employees previously covered under an old plan. The termination of a plan involves settling the obligation, which constitutes a recognition requirement for a settlement.

**Situation C** is a settlement regardless of whether the old plan remains in effect or a new plan is established.

**Situation D** is a settlement but not a curtailment. The original plan has been settled. However, the establishment of a new plan with identical benefits means, from an accounting viewpoint, the original defined benefits plan has in substance not been terminated. This transaction is accounted for as a settlement and withdrawal of excess plan assets. However, a curtailment would have occurred had the successor plan covered only an insignificant number of employees previously covered by the old plan.

**Situation E** is a settlement and a reduction in plan benefits. By creating a new plan, the substance of the transaction is to maintain a pension plan having reduced pension benefits. For this to qualify as a curtailment, there would have to be an elimination for a significant number of employees of the accrual of pension benefits for some or all of their future services. The reduction in pension benefits is a negative pension plan amendment (that is, accounted for in the same way as prior service costs, but accordingly this transaction reduces future pension provisions).

**Case 5. Conditions for curtailment**

The following case reviews circumstances under which a settlement has occurred.

Revise Corp. experiences a number of unrelated, individually insignificant reductions of expected future service of employees covered over time that accumulate in the year into a significant reduction. What if the individually insignificant reductions of expected future years of service were caused by a single event (for example, a strike or single plan of reorganization) and result in reductions that accumulate during more than one fiscal year to a significant reduction? What if Revise Corporation maintains a pension plan covering employees in several divisions and one division is eliminated? What if the reduction is significant to that division but is not significant in
relation to expected years of future service of all employees covered by the plan.

**Case Solution**

In the first situation, each reduction is not related to a single event. Accordingly, the effects are gains and losses attributable under SFAS 87 to changes in PBOs or plan assets resulting from experience different from that assumed and from changes in assumptions. These net (gains) and losses are amortized using the corridor method (or other permissible systematic amortizations).

In the case of the strike or reorganization, there is a single event leading to a significant reduction in expected years of service for employees covered by a particular pension plan. This is considered a curtailment, and the fact that reductions occur over a period of time does not matter.

In the last situation, an elimination of a division is not a curtailment because the event is an insignificant reduction of expected future years of service. SFAS 88 is applied on an overall basis for each individual pension plan. The impact from elimination of the division will again be included in net (gains) and losses, as defined under SFAS 87.

**Case 6. Determining curtailment gains and losses**

Unhapemployee Corp. decides on June 1 to dismiss a significant number of employees, in reaction to decreased demand for certain goods it produces. The actual termination occurs on June 30. Using the information below for two alternative situations, determine the accounting impact of curtailment. Costs are estimable on June 1.

<table>
<thead>
<tr>
<th>Situation A</th>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>June 30</strong></td>
<td><strong>Before Curtailment</strong></td>
</tr>
<tr>
<td>Assets and obligations</td>
<td></td>
</tr>
<tr>
<td>Vested benefits</td>
<td>$(3,100)</td>
</tr>
<tr>
<td>Nonvested benefits</td>
<td>(500)</td>
</tr>
</tbody>
</table>
## Accounting for Settlements and Curtailments

(continued)

<table>
<thead>
<tr>
<th></th>
<th>June 30</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Before Curtailment</td>
</tr>
<tr>
<td>Accumulated benefits</td>
<td>(3,600)</td>
</tr>
<tr>
<td>Future salary increases</td>
<td>(600)</td>
</tr>
<tr>
<td>PBO</td>
<td>(4,200)</td>
</tr>
<tr>
<td>Fair value of plan assets</td>
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<tr>
<td>Funded status</td>
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<tr>
<td>Unrecognized net (assets)/obligation at transition</td>
<td></td>
</tr>
<tr>
<td>Unrecognized net (gain) or loss</td>
<td></td>
</tr>
<tr>
<td>(Accrued) or prepaid pension cost before additional minimum liability</td>
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### Situation B

<table>
<thead>
<tr>
<th></th>
<th>June 1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Before Curtailment</td>
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<tr>
<td>Assets and obligations</td>
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</tr>
<tr>
<td>Vested benefits</td>
<td>$(3,100)</td>
</tr>
<tr>
<td>Nonvested benefits</td>
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<td>PBO</td>
<td>(4,200)</td>
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<tr>
<td>Fair value of plan assets</td>
<td></td>
</tr>
<tr>
<td>Funded status</td>
<td></td>
</tr>
<tr>
<td>Unrecognized net (assets)/obligation at transition</td>
<td></td>
</tr>
<tr>
<td>Unrecognized net (gain) or loss</td>
<td></td>
</tr>
<tr>
<td>(Accrued) or prepaid pension cost before additional minimum liability</td>
<td></td>
</tr>
</tbody>
</table>

### Case Objectives and Solutions

The case reviews accounting for curtailments under two circumstances. Situation A is a curtailment occurring when unrecognized net asset at transition is less than unrecognized net loss subsequent to transition. Situation B is a curtailment occurring when remaining unrecognized net asset at transition exceeds unrecognized net loss subsequent to transition.
### Situation A

<table>
<thead>
<tr>
<th></th>
<th>June 30</th>
<th></th>
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</tr>
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<tbody>
<tr>
<td></td>
<td>Before</td>
<td>Effect of</td>
<td>After</td>
</tr>
<tr>
<td></td>
<td>Curtailment</td>
<td>Curtailment</td>
<td>Curtailment</td>
</tr>
<tr>
<td>Assets and obligations</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vested benefits</td>
<td>$(3,100)</td>
<td></td>
<td>$(3,100)</td>
</tr>
<tr>
<td>Nonvested benefits</td>
<td>(500)</td>
<td>20</td>
<td>(480)</td>
</tr>
<tr>
<td>Accumulated benefits</td>
<td>(3,600)</td>
<td>20</td>
<td>(3,580)</td>
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<tr>
<td>Future salary increases</td>
<td>(600)</td>
<td>90</td>
<td>(510)</td>
</tr>
<tr>
<td>PBO</td>
<td>(4,200)</td>
<td>110</td>
<td>(4,090)</td>
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<tr>
<td>Fair value of plan assets</td>
<td>4,100</td>
<td></td>
<td>4,100</td>
</tr>
<tr>
<td>Funded status</td>
<td>(100)</td>
<td></td>
<td>10</td>
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<tr>
<td>Unrecognized net (assets)/obligation at transition</td>
<td>(200)</td>
<td>(200)</td>
<td></td>
</tr>
<tr>
<td>Unrecognized net (gain) or loss (Accrued) or prepaid pension cost before additional minimum liability</td>
<td>400</td>
<td>(110)</td>
<td>290</td>
</tr>
<tr>
<td></td>
<td>100</td>
<td></td>
<td>100</td>
</tr>
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</table>

The decrease in PBO is $110. Under SFAS 88 the curtailment gain from changes in PBO (which does not include any amounts attributable to prior services costs) is limited to the excess above unrecognized losses or the entire gain, if there is an unrecognized gain. The sum of the unrecognized transition losses and net (gains) and losses totals to a $200 loss. Accordingly, the entire curtailment gain of $110 is offset against the $200. The decrease in PBO that is not recognized as a curtailment gain must first be applied against the unrecognized net (gains) or losses (obviously in this instance a loss).

Because the sum of the effects from the curtailment is a net curtailment gain of $110, that gain is recognized on June 30 when the related employees actually terminate, and measurement of PBO and plan assets is as of that date.

### Situation B

<table>
<thead>
<tr>
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<tr>
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<td>Curtailment</td>
<td>Curtailment</td>
<td>Curtailment</td>
</tr>
<tr>
<td>Assets and obligations</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vested benefits</td>
<td>$(3,100)</td>
<td></td>
<td>$(3,320)</td>
</tr>
<tr>
<td>Nonvested benefits</td>
<td>(500)</td>
<td>20</td>
<td>(480)</td>
</tr>
</tbody>
</table>

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An increase in PBO results in a loss. The sum of the unrecognized net (gains) or loss and the unrecognized transition asset is ($100), a gain. The maximum curtailment loss is the excess of the curtailment loss above the amount of unrecognized gains totaling ($100). The portion considered a curtailment loss is $10 ($110-100). The increase in PBO that is not recognized as a curtailment loss must first be applied against the unrecognized net asset at transition. Had there existed both an unrecognized net asset and unrecognized net gain (subsequent to transition), the curtailment loss from increases in PBOs may be applied against either of the two amounts or on a pro rata basis as long as the policy is consistently applied. The journal entry is as follows:

Loss from curtailment 10
Accrued pension cost 10

Since the sum of effects from curtailment is a loss, that loss is recognized when it is probable a curtailment will occur and the effects are reasonably estimable.

Case 7. Terminations consisting of settlements and curtailments

Employdepriv Inc. terminated on December 10, 19X8, its defined benefit plan. The accumulated benefit obligation of $750,000 was
settled by purchasing nonparticipating annuities. Excess assets revert to the company. No new pension arrangement is substituted for the old plan and $400 reverts to the company.

The termination gain is to be calculated using the following information.

<table>
<thead>
<tr>
<th>December 10</th>
<th>Before Termination</th>
<th>Effect of Termination</th>
<th>After Termination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets and obligations</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vested benefits</td>
<td>$ (700)</td>
<td>$ 700</td>
<td>0</td>
</tr>
<tr>
<td>Nonvested benefits</td>
<td>(50)</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>Accumulated benefits</td>
<td>(750)</td>
<td>750</td>
<td>0</td>
</tr>
<tr>
<td>Future salary increases</td>
<td>(200)</td>
<td>200</td>
<td>0</td>
</tr>
<tr>
<td>PBO</td>
<td>(950)</td>
<td>950</td>
<td>0</td>
</tr>
<tr>
<td>Fair value of plan assets</td>
<td>1,150</td>
<td>(1,150)</td>
<td>0</td>
</tr>
<tr>
<td>Funded status</td>
<td>200</td>
<td>(200)</td>
<td>0</td>
</tr>
<tr>
<td>Unrecognized net (assets)/obligation at transition</td>
<td>(100)</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Unrecognized net (gain) or loss</td>
<td>(150)</td>
<td>150</td>
<td>0</td>
</tr>
<tr>
<td>(Accrued) or prepaid pension cost before additional minimum liability</td>
<td>(50)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Case Objectives and Solution

Case 7 examines the accounting for a plan termination that includes both a settlement and curtailment.

The curtailment gain is $200, which is attributable to the decrease in PBOs on the employer’s release from future salary increases. As required under SFAS 88, the sum of net (gains) and losses and unrecognized transition assets is calculated to determine the maximum gain recognizable. If the sum results in a gain, the entire amount is recognized. In this example, the previously unrecognized amount is a gain of $250 ($100 unrecognized net (assets) at transition and $150 unrecognized net (gains) and losses), and accordingly the entire curtailment amount is recognized as a curtailment gain.

Since the curtailment reduced the PBO by $200, the journal entry for this part of the transaction is as follows:
Accounting for Settlements and Curtailments

(accumulated/prepaid pension cost) 200
Gain on termination
(attributable to curtailment) 200

$950 in plan assets is used to settle the accumulated benefits including the portion that was nonvested. $400 in cash reverts to the employer. The journal entry is as follows:

Cash 400
(accumulated/prepaid pension cost) 400

Upon the full settlement of the remaining PBO, the maximum gain or loss is limited to the unrecognized net (gains) and losses plus the remaining unrecognized net assets existing as a transition amount. This totals $250 and the required journal entry is as follows:

(accumulated/prepaid pension cost) 250
Gain on termination
(attributable to settlement) 250

In summary, the gain on termination without a replacement of the defined benefit plan is composed of a gain from curtailment of $200 and a gain from settlement of $250. One can also see that gain differs from the amount of cash reverted to the employer.

TERMINATION BENEFITS

Definition

Termination benefits are benefits offered to employees in connection with their termination of employment. They include —

- Special termination benefits offered for a short period of time to induce early retirement.
- Contractually required payments required by the plan on a specified event that causes employees' services to be terminated involuntarily, such as a plant closing.

They may consist of special and contractual payments in the form of lump sum payments, future payments, or both.
Recognition of Termination Benefits

Special Termination Benefits
Special termination benefits are recognized as a liability and loss when the employee accepts the offer and the amount is reasonably estimable. If the special termination offer also results in a curtailment, the recognition of the curtailment may be in a different period, because the net loss from curtailment is recognized only when it is probable a curtailment may occur and effects are reasonably estimable.

Contractual Liability Payments
Contractual liability payments are recognized as liability and loss when it is probable that employees will be entitled to benefits and they are reasonably estimated.

Supplemental Early Retirement Benefits Are Not Accounted for as Contractual Termination Benefits. Supplemental early retirement benefits are accounted for as part of net periodic pension cost, under guidance in SFAS 87.

Termination Indemnities (Severance Indemnities). Indemnities paid for involuntary termination due to a specific event qualify as contractual termination benefits. However, if benefits are paid for virtually all terminations, the plan providing for termination indemnities is accounted for under SFAS 87.

Components of Cost
The cost of termination benefits recognized as liability and loss includes lump sum payments and present value of expected future payments. A curtailment may also accompany the termination.

Determination of Liability Related to Special Termination Benefits
The liability and loss from the acceptance of special termination benefits is the computed difference, as of the date of employee acceptance of the offer, between actuarial present value of employees’ accu-
mulated pension benefits with and without the special termination benefits. The change in PBO due to the related curtailment is the difference between the PBO before the acceptance of the offer and the projected benefit after acceptance, using the normal pension plan formula and assuming no future service because of termination.

**Case 8. Accounting for special terminations**

Declining Corporation offers on June 1, 1989, special termination benefits to certain of its employees. Acceptances had to be received by July 31. The special benefits involve increased pension benefits payable directly out of plan assets and an additional immediate lump sum payment.

Thirty percent of the eligible employees accept the offer by July 31. The actuaries determine that special termination benefits increase the actuarial present value of accumulated pension benefits by $200. The early retirements decrease by $80,000 the PBOs associated with the effects of future compensation levels. The additional lump sum payment was $100.

The portion of the unrecognized obligation at transition assigned to the years of service no longer expected from employees who have chosen to retire early is $210,000.

### July 31

<table>
<thead>
<tr>
<th></th>
<th>Before Termination</th>
<th>Effect of Termination</th>
<th>After Termination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets and obligations</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vested benefits</td>
<td>$(3,300)</td>
<td>$(200)</td>
<td>$(3,500)</td>
</tr>
<tr>
<td>Nonvested benefits</td>
<td>(300)</td>
<td></td>
<td>(300)</td>
</tr>
<tr>
<td>Accumulated benefits</td>
<td>(3,600)</td>
<td>(200)</td>
<td>(3,800)</td>
</tr>
<tr>
<td>Future salary increases</td>
<td>(600)</td>
<td>80</td>
<td>(520)</td>
</tr>
<tr>
<td>PBO</td>
<td>(4,200)</td>
<td>(120)</td>
<td>(4,320)</td>
</tr>
<tr>
<td>Fair value of plan assets</td>
<td>2,800</td>
<td></td>
<td>2,800</td>
</tr>
<tr>
<td>Funded status</td>
<td>(1,400)</td>
<td></td>
<td>(1,520)</td>
</tr>
<tr>
<td>Unrecognized net (assets)/obligation at transition</td>
<td>1,000</td>
<td>(100)</td>
<td>900</td>
</tr>
<tr>
<td>Unrecognized net (gain) or loss (Accrued) or prepaid pension cost before additional minimum liability</td>
<td>(200)</td>
<td>(200)</td>
<td>(200)</td>
</tr>
<tr>
<td></td>
<td>$ (200)</td>
<td>$ (220)</td>
<td>$ (420)</td>
</tr>
</tbody>
</table>
Case Objective and Solution

This case examines the accounting for a special termination. The increase in vested benefits for terminated employees of $200 and the lump sum payment of $100 is a special termination loss, which totals $300. The decrease in PBO attributable to changes in future salary increases of $80 is curtailment related. Since the maximum curtailment gain is recognized in full when the sum of unrecognized transition assets and net (gains) and losses results in an unrecognized gain (0 + $200), an $80 curtailment gain is recognized.

A second component of curtailment gains and losses is the reduction in prior service costs related to reductions in expected years of service of terminated employees. The loss from unrecognized prior service costs includes remaining unrecognized net obligations existing at the SFAS 87 transition date, which in this instance totaled $1,000. Plan modifications result in a curtailment-related loss of $100 for the reduction in previously expected years of service.

The total loss on employee termination is $320, consisting of special termination losses of $300, $80 curtailment gain related to reductions in future salaries, and $100 loss related to expensing off of unrecognized net obligations at transition associated with reduction in expected future years of service. The journal entry is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss on special termination</td>
<td>320</td>
</tr>
<tr>
<td>Accrued pension cost</td>
<td>220</td>
</tr>
<tr>
<td>Liability for termination benefits</td>
<td>100</td>
</tr>
</tbody>
</table>

The effects of curtailments are measured at July 31, which is when curtailment-related events are probable to occur and measurable.

DISPOSAL OF A SEGMENT

Accounting for Settlements, Curtailments, and Termination of Benefits Accompanying Disposal of Segment

Settlement gains and losses, curtailment gains and losses, and costs of termination benefits related to a disposal of a segment of a business
are included with the gain and loss associated with the disposal of the segment and are recognized under APB Opinion No. (APB) 30, Reporting Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.

Measurement of settlement gains and losses, curtailment gains and losses and costs of termination benefits directly related to disposals follows SFAS 88 guidance.

Recognition Date

The recognition date, as specified under APB 30, prevails for events directly related to a disposal of a segment of a business, and the net results of those events are included in determining gain or loss associated with the disposal. This could lead to different dates than ordinarily prevail under SFAS 88.

Settlements on Disposal of Part of a Line of Business

Under Interpretation 1 of APB 30, when an employer sells a portion of a line of business, gains and losses on such a disposal reflect all costs and expenses directly traced to the decision to dispose. If an employer simply chooses to settle a pension benefit obligation at the time of a sale of a portion of a line of business, the resulting coincidence of events is not, in and of itself, an indication of cause and effect relationship. Therefore, recognition rules (including dates) as specified under SFAS 88 would still apply. However, if settlement is a necessary condition of the sale, the settlement gain or loss is recognized under APB 30.

Transfers of Pension Benefit Obligation on Disposal of Segment

A settlement occurs if there is an irrevocable action relieving the employer of the pension benefit obligation and risks and rewards associated with plan assets. If the company remains contingently liable, a settlement has not occurred. If the expected future years of service of employees covered by the plan is significantly reduced, a curtailment has also occurred.
Reductions in Work Force Not Considered Curtailments

Even if a curtailment has not occurred, reductions in the work force may still lead to gains and losses related to the disposal. Measuring the effects of this reduction in work force can be performed in the same manner as if it were a curtailment.

REQUIRED DISCLOSURES UNDER SFAS 88

Disclosures include description of events and the amount of gain and loss recognized. These disclosures are required even if the event is directly associated with the disposal of a segment.

The determination of whether a gain or loss from a settlement or curtailment or the cost of termination benefits is to be classified as extraordinary requires judgment and must meet requirements specified under APB 30 (for example, unusual in nature and infrequent in occurrence).

Classification Rules and Accompanying Disclosures

A company that terminates an old plan, withdraws excess plan assets, and establishes a new defined contribution plan may not combine net gains and losses from settlements and curtailments on the old plan with period pension cost on contributions to the newly established defined contribution plan and thereby report on a net basis. These are two separate events requiring separate recognition.

EFFECTIVE DATE

SFAS 88 supersedes SFAS 74, Accounting for Special Termination Benefits Paid to Employees. The statement is effective for events occurring in fiscal years following the adoption of SFAS 87, Employers’ Accounting for Pensions.
Transition

Prior Period Not Restated
SFAS 88 is effective for fiscal years beginning when SFAS 87 is first applied. Restatement of previously issued annual financial statements is not permitted. If SFAS 88 is adopted in an interim period other than in the first quarter, earlier interim periods are restated.

Asset Reversion Transactions

Definition. Asset reversion transactions are transactions in which an employer settles a significant portion of pension obligations as part of transactions in which plan assets in excess of obligations revert to the employer.

Prior Accounting. Under prior standards (APB 8), gains on these transactions were deferred on the balance sheet if the employer continued to offer defined benefits. They were then amortized as a reduction of pension cost of subsequent periods.

Accounting Asset Reversions Under SFAS 88. Under SFAS 88, these previously deferred gains are recognized at the time of adoption of SFAS 87 as a cumulative effect of a change in accounting principle. This accounting applies only to situations in which a prior asset reversion was accompanied by a settlement. The amount of gain is the lesser of unamortized amount related to asset reversion or any unrecognized net asset for the plan (or successor plan) existing at the time of transition to SFAS 88. If a credit balance results from the above limitation on amounts recognized, remaining amounts of credits from prior reversions are combined with the accrued or prepaid pension cost and are not amortized to income. This credit balance is reduced in the future when contributions exceed pension cost. Similarly, if an unrecognized liability exists at transition, none of the deferred gain from asset reversion is recognized.
CHAPTER 8
Accounting for Cash Flows
(FASB Statement No. 95 as Amended by FASB Statement No. 102)

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<td>Transition</td>
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<td>Financing Activities</td>
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CHAPTER 8

Accounting for Cash Flows
(FASB Statement No. 95 as Amended by FASB Statement No. 102)

INTRODUCTION

Statement of Financial Accounting Standards (SFAS) No. 95, *Statement of Cash Flows*, November 1987, establishes standards for presenting a statement of cash flows as part of general purpose financial statements. The new pronouncement supersedes Accounting Principles Board (APB) Opinion No. 19, *Reporting Changes in Financial Position*, and requires business enterprises to substitute a statement of cash flows for the statement of changes in financial position. In addition, companies must separately present information about non-cash investment and financing transactions. In preparing a complete set of financial statements, the statement of cash flows is required for each period for which the results of operations are provided.

Under prior practice, there was considerable diversity in the definition of funds, for example, cash, cash and short-term investments, short-term investments, as well as quick assets and working capital. SFAS 95 reduces this diversity by requiring the statement of cash flows to focus on cash and cash equivalents and by requiring disclosure of the cash components.

While not-for-profit organizations are excluded from the scope of this Statement, financial institutions and certain investment companies are subject to SFAS 95 requirements.

CASH EQUIVALENTS

Definition of Cash Equivalents

Cash equivalents are short-term, highly liquid investments that are both readily convertible to cash and so near maturity that fluctu-
tions in interest rates generally result in insignificant risk of changes in investment values. In contrast, cash includes currency and other accounts that have characteristics of demand deposits. Cash equivalents result from funds temporarily invested to earn interest and not to take advantage of interest rate changes or other factors. Items typically considered to be cash equivalents include treasury bills, commercial paper, money market funds, and federal funds sold (for an enterprise with banking operations).

Only investments with original maturities to the reporting entity of three months or less qualify as cash equivalents. Thus, the acquisition of a treasury note with a remaining life of three months would also qualify under the definition. However, an existing investment in a three-year old treasury note with a remaining life of three months does not qualify. Nor are investments in equity securities considered to be cash equivalents.

**Disclosure and Presentation of Cash Equivalents**

A company must disclose policies used to determine which investments are cash equivalents. Note that changing the definition of cash equivalents is considered to be a change in accounting principle, requiring the retroactive restatement of previous years' financial statements presented with the current year's statements for comparative purposes.

The total amount of beginning- and end-of-the-period cash and cash equivalents shown in the statement of cash flows must correspond to a similarly titled item or subtotal in the statement of financial position.

**CLASSIFICATION OF CASH FLOWS**

Cash receipts and cash payments are to be classified into investing, financing, or operating activities. SFAS 95 provides specific definitions for investing and financing activities. Activities not considered to be investing or financing are then categorized as operating activities. This format enables users to assess significant relationships
within each activity group as well as among the three kinds of activities. The source-and-use format is no longer appropriate.

*Investing activities* include—
- Lending money and collecting on loans.
- Acquiring and selling (disposing of) property, plant and equipment, and other productive assets.
- Acquiring or selling debt or equity instruments.

*Financing activities* include—
- Obtaining resources from owners and providing a return on, and a return of, the investment of such resources.
- Borrowing money and repaying (settling) the obligations.
- Obtaining and paying for other resources acquired on long-term credit.

*Operating activities* include—
- All transactions and other events that are not investing and financing activities.
- Delivery or production of goods for sale and services provided.
- Generally, cash effects of transactions entering into income.

**Components of Cash Flows From Operating Activities**

Cash flows from operating activities are the cash effects of transactions and other events that bear upon income determination. Interest received on loans, and dividends received on equity securities, are included in cash flows from operating activities, although they are investment-related. Interest paid on loans is included as a cash flow from an operating activity, although the expenditure itself is finance-related. However, capitalized interest is part of the cost of the non-monetary asset and is treated as investment-related.

All income taxes paid are treated as operating cash flows. Allocation of income taxes among activities is considered to be arbitrary and, therefore, is not required.
Additional Classification Guidance

If a cash inflow or outflow relates to more than one activity category, the classification will be determined according to the predominant source of cash flow for that item. For instance, the acquisition, production, and sale of equipment used or rented by a firm is generally investment-related. This presumption is overcome, however, if such equipment is used or rented for a short period and then sold. Under such circumstances, the acquisition or production of such an asset as well as the subsequent sale, is classified as part of operating activities.

All cash collected from customers or paid to suppliers, including cash arising from installment sales, is classified as an operating cash flow. This is a change from the exposure draft, which treated only those cash flows occurring soon after a sale or purchase as an operating activity.

Each cash flow is classified according to its nature, even if it is intended as a hedge. For example, the purchase or sale of a futures contract is an investing activity, regardless of whether that contract is intended to hedge a firm commitment or purchase inventory.

Gains and losses resulting from the redemption of a firm’s own debt are financing-related and are categorized as cash flows related to the retirement of outstanding debt.

Gains and losses resulting from asset disposals are investment-related. Receipts from the disposal of property, plant, or equipment include the proceeds of an insurance settlement.

Advance payments on the purchase of productive assets are considered to be investing cash flows. Any debt to the seller of the productive asset is a financing transaction.

All principal payments on mortgages, including those on seller-financed or debt on productive assets, are classified as financing cash flows.

GROSS AND NET CASH FLOWS

Ordinarily, information about the gross amounts of cash receipts and cash payments is presented for each period. For example, the change in property, plant, and equipment during a period is separately reported as cash payments for new equipment and cash proceeds on the disposal of property, plant, and equipment.
Exceptions

Netting cash receipts and disbursements provides sufficient information for certain classes of cash flows and is appropriate when—

- Cash flows are related to the temporary investment of cash in short-term, highly liquid investments (that is, cash equivalents). These temporary investments are cash-management procedures and are not considered to be operating, financing, or investing activities. They are merely shifts between different forms of cash. The terms cash and cash equivalents rather than funds are used to describe such net flows from temporary investments.

- Items other than cash and cash equivalents relating to investments, loans receivable, and debt situations in which turnover is quick, the amounts are large, and the maturities are short. To qualify for netting, investments, loans, and debt must have an original maturity of three months or less. For a commercial entity, examples of when netting might be appropriate include revolving credit arrangements and commercial paper obligations. Were it not for this netting exception, an enterprise that issues seven-day commercial paper and rolls it over every week would report financing cash inflows and outflows four times greater than those of an enterprise issuing a one-month paper. In addition, demand deposits of a bank, customer accounts payable of a broker-dealer, and credit card operations of a financial services business may also be netted.

GUIDANCE ON STATEMENT PRESENTATION

The statement of cash flows for a period reports separately the net cash provided for or used by operating, investing, and financing activities. The cash flows reconcile beginning and ending amounts of cash and cash equivalents. Separate disclosure of cash flows pertaining to extraordinary or discontinued items is no longer required.

The new Statement permits the use of either the direct or indirect method of presenting cash flows from operating activities. However, companies are encouraged to present cash flows from operating activities using the direct method.
Direct Method

This method involves showing the major classes of operating cash receipts (cash collected from customers or earned on investments) and cash payments (cash paid to suppliers or to creditors for interest). The net cash flow from operating activities is the difference between cash received from operations and cash payments for operations.

Items Separately Reported Under Direct Method

Companies reporting under the direct method are required to report separately the following classes of operating cash receipts and payments:

- Cash collected from customers, including lessees and licensees
- Interest and dividends received
- Other operating cash receipts, if any
- Cash paid to employees and other suppliers of goods and services
- Interest paid
- Income taxes paid
- Other operating payments, if any

Companies also are encouraged to provide additional breakdowns beyond the minimum items required under the direct method. For instance, a manufacturer can separate purchases of inventory from selling, general, and administrative expenditures.

Exhibit 1 illustrates the direct approach using the presentation from the 1988 annual report of Russ Togs, Inc.

Exhibit 1  
Russ Togs, Inc.  
Consolidated Statement of Cash Flows

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from customers</td>
<td>$272,026</td>
<td>$275,474</td>
<td>$283,613</td>
</tr>
<tr>
<td>Cash paid to suppliers and employees</td>
<td>(265,383)</td>
<td>(258,440)</td>
<td>(265,771)</td>
</tr>
<tr>
<td>Interest and other income received</td>
<td>2,327</td>
<td>2,977</td>
<td>3,195</td>
</tr>
<tr>
<td>Interest paid</td>
<td>(1,535)</td>
<td>(1,209)</td>
<td>(1,448)</td>
</tr>
<tr>
<td>Income taxes paid</td>
<td>(8,444)</td>
<td>(14,512)</td>
<td>(8,446)</td>
</tr>
<tr>
<td>Net cash provided by (used in) operating activities</td>
<td>(1,009)</td>
<td>4,290</td>
<td>11,143</td>
</tr>
</tbody>
</table>
### Exhibit 1 (continued)

**Cash Flows From Investing Activities:**

<table>
<thead>
<tr>
<th>Description</th>
<th>1988</th>
<th>1987</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds from sale of property and equipment</td>
<td>$ 116</td>
<td>$ 430</td>
<td></td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>$(1,701)</td>
<td>$(2,190)</td>
<td>$(1,503)</td>
</tr>
<tr>
<td>Reduction in investment in direct financing lease</td>
<td></td>
<td></td>
<td>675</td>
</tr>
<tr>
<td>Net cash used in investing activities</td>
<td>(1,701)</td>
<td>(2,074)</td>
<td>(398)</td>
</tr>
</tbody>
</table>

**Cash Flows From Financing Activities:**

<table>
<thead>
<tr>
<th>Description</th>
<th>1988</th>
<th>1987</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net borrowings (repayments) under line of credit agreement</td>
<td>3,810</td>
<td>2,480</td>
<td>(907)</td>
</tr>
<tr>
<td>Principal payments on long-term debt</td>
<td>(63)</td>
<td>(783)</td>
<td>(1,009)</td>
</tr>
<tr>
<td>Cost of shares of common stock acquired for treasury</td>
<td>(4,134)</td>
<td>(1,512)</td>
<td>(2,914)</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>(4,585)</td>
<td>(4,152)</td>
<td>(4,290)</td>
</tr>
<tr>
<td>Proceeds from exercise of stock options</td>
<td>141</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash paid in lieu of fractional shares on three-for-two stock split</td>
<td>(11)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net cash used in financing activities</td>
<td>(4,842)</td>
<td>(3,967)</td>
<td>(9,120)</td>
</tr>
<tr>
<td>Net increase (decrease) in cash and cash equivalents</td>
<td>(7,552)</td>
<td>(1,751)</td>
<td>1,625</td>
</tr>
<tr>
<td>Cash and cash equivalents—beginning of year</td>
<td>16,547</td>
<td>18,298</td>
<td>16,673</td>
</tr>
<tr>
<td>Cash and cash equivalents—end of year</td>
<td>8,995</td>
<td>16,547</td>
<td>18,298</td>
</tr>
<tr>
<td>Reconciliation of net earnings to net cash provided by operating activities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net earnings</td>
<td>$ 9,290</td>
<td>$13,819</td>
<td>$10,986</td>
</tr>
</tbody>
</table>

(continued)
### Exhibit 1 (continued)

Adjustments to reconcile net earnings to net cash provided by operating activities:

<table>
<thead>
<tr>
<th>Description</th>
<th>1988</th>
<th>1987</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation and amortization</td>
<td>$1,985</td>
<td>$1,870</td>
<td>$1,938</td>
</tr>
<tr>
<td>(Gain) loss on sale of property and equipment</td>
<td>19</td>
<td>(21)</td>
<td>78</td>
</tr>
<tr>
<td>Decrease (increase) in:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>1,506</td>
<td>1,142</td>
<td>6,798</td>
</tr>
<tr>
<td>Inventories</td>
<td>(10,227)</td>
<td>(6,303)</td>
<td>(7,446)</td>
</tr>
<tr>
<td>Income tax refunds receivable</td>
<td>(286)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid expenses and other current assets</td>
<td></td>
<td>(4,029)</td>
<td>(93)</td>
</tr>
<tr>
<td>Other assets</td>
<td>253</td>
<td>(84)</td>
<td>1,166</td>
</tr>
<tr>
<td>Increase (decrease) in:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>6,420</td>
<td>(1,860)</td>
<td>(5,358)</td>
</tr>
<tr>
<td>Accrued expenses and taxes</td>
<td>(4,948)</td>
<td>166</td>
<td>1,071</td>
</tr>
<tr>
<td>Income taxes</td>
<td>(3,187)</td>
<td>(468)</td>
<td>2,599</td>
</tr>
<tr>
<td>Deferred compensation</td>
<td>(393)</td>
<td>70</td>
<td>61</td>
</tr>
<tr>
<td>Deferred taxes</td>
<td>176</td>
<td>(12)</td>
<td>(657)</td>
</tr>
<tr>
<td>Total</td>
<td>(10,299)</td>
<td>(9,529)</td>
<td>157</td>
</tr>
<tr>
<td>Net cash provided by (used in) operating activities</td>
<td>(1,009)</td>
<td>4,290</td>
<td>$11,143</td>
</tr>
</tbody>
</table>

**Notes to Financial Statements**

Note A (in part): Summary of Significant Accounting Policies:

7. In 1988, the Company adopted SFAS 95, and, accordingly, has presented a statement of cash flows. Prior financial statements have been restated to present a comparative format.

The Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents for purposes of the consolidated statement of cash flows.

**Indirect Method**

Companies choosing not to use the direct method then must indirectly calculate net cash from operating activities by removing from net income the effects of these major classes of reconciling items:
• Deferrals of past cash receipts and cash payments (inventory, deferred income, prepaid expenses, and deferred expenses)

• Accruals of expected future cash receipts and payments (accounts receivable and notes receivable from sales transactions; interest receivable; accounts payable and notes payable from transactions with suppliers; interest payable; taxes payable; excess of income under the equity method over dividends; and other accruals)

• Investing or financing-related items and noncash expenses (depreciation; amortization; provision for bad debts; goodwill; gains and losses on the extinguishment of debt; gains and losses on the disposal of property, plant, and equipment; and gains and losses on the disposal of discontinued operations)

This technique is referred to as the indirect or reconciliation method.

Reconciliation of Net Cash Flows From Operating Activities to Net Income

A reconciliation of net cash flows from operating activities to net income must be provided, regardless of whether the direct or indirect method is used. The reconciliation separately reports major classes of reconciling items. At a minimum, changes in inventory, payables, and receivables which are related to operating items are separately reported; however, enterprises are encouraged to provide further breakdowns of reconciling items. For instance, changes in receivables from the sale of goods might be reported separately from other receivables.

If the direct method is employed, the reconciliation is to be provided in a separate schedule. If the indirect method is used, the reconciliation may be included in a separate schedule or within the statement of cash flows. Additionally, under the indirect method, both income taxes paid and interest paid (net of capitalized amounts), must be separately disclosed. In determining net cash from operating activities, all adjustments to net income are to be clearly identified as reconciling items.

Exhibit 2 illustrates the indirect approach using the presentation contained in the 1988 annual report of Allied Signal, Inc.
### Exhibit 2

**Allied Signal, Inc.**

**Consolidated Statement of Cash Flows**

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1988</th>
<th>1987</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>(dollars in millions)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Cash Flows From Operating Activities:

- **Net income**: $463, $656, $605

- **Adjustments to reconcile net income to net cash flows from operating activities**:
  - Depreciation and amortization (including goodwill): 416, 391, 419
  - Deferred taxes: (87), 276, 59
  - Liabilities extinguished by the use of common stock: 87, 49, 25
  - Increase in accounts and notes receivable: (124), (201), (29)
  - Decrease (increase) in inventories: (126), 30, (267)
  - Decrease (increase) in other current assets: 2, (58), (155)
  - Increase in accounts payable: 116, 92, 144
  - Increase (decrease) in accrued liabilities: (90), (585), 15
  - Gain on Union Texas common stock issuance: —, (108), —
  - Gain on sales of investment/businesses in 1988 and investment/discontinued operations in 1987: (158), (159), —
  - Extraordinary item: —, (59), —
  - Other: 169, 239, 54

- **Net cash flow from operating activities**: 668, 563, 870

#### Cash Flows From Investing Activities:

- **Expenditures for property, plant, and equipment**: (602), (609), (708)
- **Cash paid for acquisitions net of cash acquired**: —, (89), (148)
- **Proceeds from disposals of property, plant, and equipment**: 32, 31, 60
- **Proceeds from sales of investment/businesses in 1988 and investment/discontinued operations in 1987**: 359, 2,291, —
- **Decrease (increase) in investments**: 142, (74), (301)

- **Net cash flow from investing activities**: (69), 1,550, (1,097)
Exhibit 2 (continued)

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
</tr>
<tr>
<td>---</td>
</tr>
</tbody>
</table>

| Cash Flows From Financing Activities: |  |
|--------------------------------------|
| Net increase (decrease) in short-term obligations | $36 | $(397) | $(290) |
| Proceeds from issuance of common stock | 11 | 62 | 138 |
| Proceeds from issuance of long-term debt | 113 | 305 | 343 |
| Repurchases of long-term debt (including current maturities) | $(259) | $(478) | $(290) |
| Repurchases of common and preferred stock | $(183) | $(1,148) | $(807) |
| Cash dividends on common and preferred stock | $(269) | $(301) | $(347) |
| Net cash flow from financing activities | $(551) | $(1,957) | $(705) |
| Net increase (decrease) in cash and cash equivalents | 48 | 156 | (932) |
| Cash and cash equivalents at beginning of year | 349 | 193 | 1,125 |
| Cash and cash equivalents at end of year | $397 | $349 | $193 |

The Notes to Financial Statements are an integral part of this statement.

21. Supplemental Cash Flow Information

In 1988 the Company adopted SFAS 95—Statement of Cash Flows, and amounts for 1987 and 1986 have been reclassified for comparative purposes. Cash payments during the years 1988, 1987, and 1986 included interest of $258 million, $283 million, and $197 million and income taxes of $134 million, $192 million, and $138 million, respectively.

Debt assumed by the purchasers of businesses in 1988 and 1987 was approximately $52 million and $159 million, respectively.

In May 1988 the Company formed a process technology and catalyst joint venture with Union Carbide. The joint venture was formed by each of the companies contributing the assets and the joint venture assuming the liabilities of both companies' business units in exchange for a 50 percent interest. In addition, the Company received consideration which reflects the difference in the value of the Company's business compared to that of Union Carbide. As a result of the transactions, the Company recorded an after-tax gain of $24 million, or $.16 a share, based on the recorded amount of the business contributed. The transactions had the following noncash impact on the Company's balance sheet:

(continued)
### Exhibit 2 (continued)

<table>
<thead>
<tr>
<th>Amount</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ (94)</td>
</tr>
<tr>
<td>Property, plant and equipment-net</td>
<td>(71)</td>
</tr>
<tr>
<td>Investments and long-term receivables</td>
<td>253</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>(129)</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>41</td>
</tr>
</tbody>
</table>

In 1986 in noncash transactions shareholders exchanged convertible preferred stock of $55 million for common shares.

In May 1986 the Company distributed a special noncash dividend of one share of common stock of Henley for each four shares of the Company's publicly held common stock to its shareholders, which resulted in a charge of $2,370 million to additional paid-in capital and a credit in the same amount to the investments and long-term receivables account.

### Noncash Transactions

Noncash transactions—for example, nonmonetary exchanges, the conversion of debt to equity, the acquisition of a machine by incurring a liability—are to be reported in related disclosures. These disclosures may be either narrative or summarized within a schedule. The objective of these disclosures is to clearly relate cash and noncash aspects of transactions involving similar items. If a transaction is part cash and part noncash, only the cash portion is reported in the statement of cash flows.

Exhibit 3 provides a sample of a narrative presentation of noncash activities used by Quantum Chemical Corporation. Tosco Corporation in Exhibit 4 uses a schedule to present its noncash activities.
Accounting for Cash Flows

### Exhibit 3
Quantum Chemical Corporation and Subsidiary Companies
Consolidated Statement of Cash Flows

<table>
<thead>
<tr>
<th></th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>(dollars in millions)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Cash Flow From Operating Activities:**

<table>
<thead>
<tr>
<th>Description</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations</td>
<td>$143.6</td>
<td>$55.1</td>
<td>$58.5</td>
</tr>
<tr>
<td>Adjustments to reconcile income to net cash provided by (used for) continuing operations:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation, depletion, and amortization</td>
<td>155.1</td>
<td>97.4</td>
<td>73.8</td>
</tr>
<tr>
<td>(Earnings)/losses of associated companies, net of dividends</td>
<td>2.1</td>
<td>4.1</td>
<td>.3</td>
</tr>
<tr>
<td>Other</td>
<td>5.2</td>
<td>16.6</td>
<td>9.0</td>
</tr>
<tr>
<td>Change in assets and liabilities, net of effects from companies acquired:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>(45.4)</td>
<td>(55.4)</td>
<td>(51.0)</td>
</tr>
<tr>
<td>Inventory</td>
<td>(2.2)</td>
<td>17.4</td>
<td>38.9</td>
</tr>
<tr>
<td>Prepaid expenses and other assets</td>
<td>(11.5)</td>
<td>4.5</td>
<td>16.8</td>
</tr>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td>120.7</td>
<td>16.9</td>
<td>6.0</td>
</tr>
<tr>
<td>Deferred taxes on income</td>
<td>(1.5)</td>
<td>2.0</td>
<td>17.6</td>
</tr>
<tr>
<td>Cash provided by continuing operations</td>
<td>366.1</td>
<td>158.6</td>
<td>169.9</td>
</tr>
<tr>
<td>Income from discontinued operations</td>
<td>108.0</td>
<td>20.5</td>
<td>18.7</td>
</tr>
<tr>
<td>Adjustments to reconcile income to net cash provided by (used for) discontinued operations:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net gain on sale of spirits and wine segment</td>
<td>(98.9)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in net assets of spirits and wine segment</td>
<td>(9.1)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td></td>
<td>8.2</td>
<td>8.1</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td>4.0</td>
<td>2.7</td>
</tr>
<tr>
<td>Cash provided by operating activities</td>
<td>366.1</td>
<td>191.3</td>
<td>199.4</td>
</tr>
</tbody>
</table>

**Cash Flow From Investing Activities:**

<table>
<thead>
<tr>
<th>Description</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds from sale of spirits and wine segment</td>
<td>684.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenses and income taxes related to sale of spirits and wine segment</td>
<td>(158.9)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds from sale of associated company</td>
<td>28.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of acquisitions, net of cash acquired</td>
<td>(782.4)</td>
<td>(220.1)</td>
<td></td>
</tr>
<tr>
<td>Proceeds from sale of insurance subsidiary</td>
<td></td>
<td>77.4</td>
<td></td>
</tr>
<tr>
<td>Capital expenditures excluding capital leases</td>
<td>(154.2)</td>
<td>(93.2)</td>
<td>(75.3)</td>
</tr>
<tr>
<td>Investment in marketable securities, net</td>
<td>(64.5)</td>
<td>(.2)</td>
<td>(20.0)</td>
</tr>
<tr>
<td>Other</td>
<td>16.5</td>
<td>12.0</td>
<td>50.5</td>
</tr>
<tr>
<td>Cash provided by (used for) investing activities</td>
<td>351.8</td>
<td>(863.8)</td>
<td>(187.5)</td>
</tr>
</tbody>
</table>

(continued)
Exhibit 3 (continued)

<table>
<thead>
<tr>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>(dollars in millions)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Cash Flows From Financing Activities:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changes in notes payable to banks</td>
<td>$(703.3)</td>
<td>$544.2</td>
</tr>
<tr>
<td>Changes in long-term debt and capital lease obligations</td>
<td>148.7</td>
<td>242.7</td>
</tr>
<tr>
<td>Redemption of preferred and preference stocks</td>
<td>(92.3)</td>
<td>(4.7)</td>
</tr>
<tr>
<td>Issuance (repurchase) of common stock, net</td>
<td>(60.7)</td>
<td>5.3</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>(72.7)</td>
<td>(75.0)</td>
</tr>
<tr>
<td>Cash provided by (used for) financing activities</td>
<td>(780.3)</td>
<td>712.5</td>
</tr>
<tr>
<td>Net increase (decrease) in cash and short-term investments</td>
<td>(62.4)</td>
<td>40.0</td>
</tr>
<tr>
<td>Cash and short-term investments at beginning of year</td>
<td>87.3</td>
<td>47.3</td>
</tr>
<tr>
<td>Cash and short-term investments at end of year</td>
<td>$24.9</td>
<td>$87.3</td>
</tr>
</tbody>
</table>

Supplemental disclosures—Cash payments for income taxes were $267.8 million, $79.7 million, and $67.6 million in 1987, 1986, and 1985, respectively; in these periods interest payments were $75.7 million, $59.8 million, and $43.5 million, respectively.

Capital lease obligations of $3.0 million, $8.4 million, and $.9 million were incurred in 1987, 1986, and 1985, respectively.

Capital stock was issued upon conversion of debentures of $.5 million in 1987 and $.4 million in 1986 and 1985.

In conjunction with the purchase of the capital stock of companies acquired, the Company assumed liabilities of $142.7 million and $17.2 million in 1986 and 1985, respectively.

Note 1. Summary of Accounting Policies

**Consolidated Statement of Cash Flows**

The Company has adopted SFAS 95, *Statement of Cash Flows*. Prior years have been reclassified to conform to the 1987 presentation. For purposes of this Statement short-term investments which have a maturity of 90 days or less are considered cash equivalents.
<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>(dollars in thousands)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Cash Flows From Operating Activities:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income (loss) before extraordinary items</td>
<td>$27,822</td>
<td>($56,420)</td>
<td>$8,867</td>
</tr>
<tr>
<td>Adjustments to arrive at net cash provided by operating activities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Extraordinary credit resulting from utilization of net operating loss carryforwards</td>
<td>25,133</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Writedown of assets and related termination costs</td>
<td>40,662</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Depreciation and depletion</td>
<td>22,094</td>
<td>21,834</td>
<td>20,966</td>
</tr>
<tr>
<td>Amortization of deferred items</td>
<td>14,767</td>
<td>16,882</td>
<td>15,556</td>
</tr>
<tr>
<td>Amortization of deferred gains</td>
<td>(2,206)</td>
<td>(24,450)</td>
<td>(16,942)</td>
</tr>
<tr>
<td>Interest earned on notes receivable from issuance of common stock</td>
<td>(379)</td>
<td>(436)</td>
<td>(2,091)</td>
</tr>
<tr>
<td>Loss on equity investments</td>
<td></td>
<td></td>
<td>1,694</td>
</tr>
<tr>
<td>Issuance of common stock in settlement of litigation</td>
<td>5,250</td>
<td>5,500</td>
<td></td>
</tr>
<tr>
<td>Issuance of debt in payment of interest on debt</td>
<td>23,455</td>
<td>35,295</td>
<td></td>
</tr>
<tr>
<td>(Increase) decrease:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>(11,723)</td>
<td>43,184</td>
<td>24,157</td>
</tr>
<tr>
<td>Inventories</td>
<td>1,787</td>
<td>(4,144)</td>
<td>37,520</td>
</tr>
<tr>
<td>Prepaid expenses and other current assets</td>
<td>4,319</td>
<td>4,651</td>
<td>(2,660)</td>
</tr>
<tr>
<td>Increase (decrease):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td>27,868</td>
<td>(33,637)</td>
<td>(17,941)</td>
</tr>
<tr>
<td>Other noncurrent liabilities</td>
<td>(1,185)</td>
<td>(9,331)</td>
<td>(7,650)</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>(534)</td>
<td>(690)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Other</td>
<td>(717)</td>
<td>(1,529)</td>
<td>(264)</td>
</tr>
<tr>
<td>Total adjustments</td>
<td>79,224</td>
<td>81,701</td>
<td>95,130</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>107,046</td>
<td>25,281</td>
<td>103,997</td>
</tr>
</tbody>
</table>

(continued)
### Exhibit 4 (continued)

#### Cash Flows From Investing Activities:

<table>
<thead>
<tr>
<th>Description</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds from sales of property, plant, and equipment</td>
<td>$605</td>
<td>$42,205</td>
<td>$1,963</td>
</tr>
<tr>
<td>Purchase of property, plant, and equipment</td>
<td>(15,587)</td>
<td>(14,121)</td>
<td>(26,723)</td>
</tr>
<tr>
<td>Increase in deferred turnarounds and charges and other assets</td>
<td>(8,200)</td>
<td>(13,849)</td>
<td>(16,784)</td>
</tr>
<tr>
<td>Purchase of short-term investments</td>
<td>(15,839)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net cash provided by (used in) investing activities</td>
<td>(39,021)</td>
<td>14,235</td>
<td>(41,544)</td>
</tr>
</tbody>
</table>

#### Cash Flows From Financing Activities:

<table>
<thead>
<tr>
<th>Description</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuance of Series E Preferred Stock</td>
<td>12,100</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>Issuance of long-term debt</td>
<td></td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Costs of refinancing debt</td>
<td></td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Net borrowings under working capital facilities</td>
<td></td>
<td></td>
<td>35,000</td>
</tr>
<tr>
<td>Principal payments under debt agreements:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Refinancing Agreement</td>
<td>(275,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>(5,440)</td>
<td>(99,697)</td>
<td>(104,148)</td>
</tr>
<tr>
<td>Payments received from employee stock option plan (ESOP)</td>
<td>806</td>
<td>2,507</td>
<td></td>
</tr>
<tr>
<td>Preferred stock dividends</td>
<td>(22,583)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net cash used in financing activities</td>
<td>(15,117)</td>
<td>(47,190)</td>
<td>(69,148)</td>
</tr>
<tr>
<td>Net increase (decrease) in cash and cash equivalents</td>
<td>52,908</td>
<td>(7,674)</td>
<td>(6,695)</td>
</tr>
<tr>
<td>Cash and cash equivalents at beginning of year</td>
<td>15,965</td>
<td>23,639</td>
<td>30,334</td>
</tr>
<tr>
<td>Cash and cash equivalents at end of year</td>
<td>$68,873</td>
<td>$15,965</td>
<td>$23,639</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of this statement.
Exhibit 4 (continued)
Supplemental Schedule of Noncash Investing and Financing Activities

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>(dollars in thousands)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sale of property, plant, and equipment for notes receivable (net of cash received)</td>
<td>$1,676</td>
<td>$5,000</td>
<td>$7,300</td>
</tr>
<tr>
<td>Sale of secured assets held for sale (net of cash received) for assumption of debt</td>
<td></td>
<td></td>
<td>$7,500</td>
</tr>
<tr>
<td>Purchase of property, plant, and equipment (net of cash paid) for notes</td>
<td>$6,356</td>
<td>$2,553</td>
<td></td>
</tr>
<tr>
<td>Issuance of common stock in payment of floating rate subordinated notes</td>
<td>$7,991</td>
<td>$4,382</td>
<td></td>
</tr>
<tr>
<td>Extraordinary gain from refinancing of debt (Note 3)</td>
<td></td>
<td></td>
<td>$74,000</td>
</tr>
<tr>
<td>Surrender of series C preferred stock (Note 3)</td>
<td></td>
<td></td>
<td>$70,845</td>
</tr>
</tbody>
</table>

Supplemental Disclosures of Cash Flow Information

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash paid during year:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>$27,277</td>
<td>$5,868</td>
<td>$10,247</td>
</tr>
<tr>
<td>Income taxes</td>
<td>$ 567</td>
<td>$ 931</td>
<td>$ 3,082</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of this statement.

Note 1. Summary of Significant Accounting Policies

Reclassifications and Restatement. Certain previously reported amounts have been restated to conform to classifications adopted in 1987. In addition, Tosco has adopted in 1987 the recently issued SFAS 95, which requires a statement of cash flows as part of a full set of financial statements in place of a statement of changes in financial position. Accordingly, the consolidated statements of changes in financial position for the years ended December 31, 1986 and 1985 have been replaced with statements of cash flows.

Exchange Rate Effects

Entities with foreign currency transactions or foreign currency operations must prepare a statement of cash flows reporting the foreign currency equivalent of foreign currency cash flows, using exchange rates in effect at the date of the cash flows. Weighted average exchange rates may be used if the results are not materially different from those rates at the cash flows dates.
The effect of the exchange rate changes on cash balances held in foreign currencies is to be separately reported within the reconciliation of the change in cash and cash equivalents.

Cash Flows From Discontinued Operations

Separate disclosure of cash flows from discontinued operations is not required. However, a company may segregate, within the operating section of the statement of cash flows, its cash flows from discontinued operations from cash flows related to continuing operations. If so, this form of presentation should be made for each comparative period included within the statement of cash flows. Income taxes paid need not be allocated between continuing and discontinued operations.

On discontinuing an operation, certain losses and expenses related to disposal are typically identified. These might include anticipated losses on disposal including pension and other post-employment-related events such as termination and severance-related costs. To the extent these anticipated losses and expenses have no immediate cash impacts or are investment-related, these items will be included in the reconciliation of net income to net cash flows from operations under the indirect method.

Cash received on the disposal of the discontinued operations is an investment activity, and the related disposal gains and losses are reconciling items in deriving net cash from operating activities. Separation of operating cash paid or generated by a discontinued segment both before and after the measurement date, as defined under APB 30, from net cash provided or used in the disposal of the segment is clearly difficult and somewhat arbitrary. As part of a disposal of a segment, the cash flows attributable to transactions such as cash reversions accompanying pension plan terminations and settlements and payments of termination benefits on severance are all operating activities. All income taxes paid regardless of whether related to continuing or discontinued operations are designated as operating.

Exhibit 5 illustrates the treatment by First City Industries, Inc. of the cash flow effects of its discontinued operations. The gain on disposal is a reconciling adjustment to net income in deriving net cash from operating activities. There is a single line item under investments for proceeds received in 1986 and 1987 from the disposal. No separate amount is being provided for cash flows from operating activities associated with the segment disposal.
### Exhibit 5

*First City Industries, Inc.*

*Consolidated Statements of Cash Flows*

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1985</th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>(dollars in thousands)</em></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Cash Flows From Operating Activities:**

- **Net income (loss):** $(10,274)$, $(9,501)$, $73,316$
- **Adjustments to reconcile net income (loss) to net cash provided by operating activities:**
  - Depreciation and amortization: $6,445$, $7,699$, $8,502$
  - Provision for possible losses: $2,936$, $4,508$, $20,319$
  - Loss on foreign currency translation: $1,692$, $1,610$, $760$
  - Gain on foreign currency hedge: $1,692$, $1,610$, $760$
  - Gain on sale of discontinued operations: $9,800$, $92,110$
  - Equity in net income of unconsolidated affiliates: $(3,652)$, $(3,043)$, $(8,084)$
  - Other: $399$, $239$, $442$

**Decrease (increase) in noncash working capital:**

- Marketable securities: $1,042$, $(1,125)$
- Receivables, net: $10,812$, $4,095$, $(12,461)$
- Amount due from affiliate: $34,877$
- Inventories: $4,343$, $(13,362)$, $(2,216)$
- Other assets: $469$, $193$, $157$
- Accounts payable: $630$, $(1,246)$, $6,816$
- Accrued liabilities and income taxes: $(26,517)$, $(14,581)$, $8,980$
- Decrease in other assets and liabilities: $(17,103)$, $(9,345)$, $(3,483)$

**Net cash provided (used) by operating activities:** $6,099$, $(43,012)$, $(16,342)$

(continued)
### Exhibit 5 (continued)

#### Cash Flows From Investing Activities:

<table>
<thead>
<tr>
<th>Description</th>
<th>1985</th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisition of Scovill, Inc.</td>
<td>$(623,676)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds from sales of businesses</td>
<td>77,500</td>
<td>$139,239</td>
<td>$97,732</td>
</tr>
<tr>
<td>Increase (decrease) in net assets related to discontinued operations</td>
<td>49,440</td>
<td>43,764</td>
<td>(96,517)</td>
</tr>
<tr>
<td>Investments in unconsolidated affiliates</td>
<td>(54,984)</td>
<td>(19,760)</td>
<td>(1,953)</td>
</tr>
<tr>
<td>Proceeds from distributions from unconsolidated affiliates</td>
<td>9,135</td>
<td>5,362</td>
<td>16,723</td>
</tr>
<tr>
<td>Additions to property, plant, and equipment</td>
<td>(4,506)</td>
<td>(4,714)</td>
<td>(7,954)</td>
</tr>
<tr>
<td>Proceeds from sale of property, plant, and equipment</td>
<td>18,934</td>
<td>2,379</td>
<td>1,604</td>
</tr>
<tr>
<td>Additions to long-term receivables</td>
<td>(9,088)</td>
<td>(7,308)</td>
<td>(3,736)</td>
</tr>
<tr>
<td>Proceeds from collection of notes receivable</td>
<td>12,025</td>
<td>13,823</td>
<td>3,977</td>
</tr>
<tr>
<td>Investment in Valor preferred stock</td>
<td></td>
<td></td>
<td>(35,000)</td>
</tr>
<tr>
<td>Dividends received</td>
<td>462</td>
<td>887</td>
<td>60,499</td>
</tr>
<tr>
<td>Net cash provided (used) by investing activities</td>
<td>(524,758)</td>
<td>173,672</td>
<td>35,375</td>
</tr>
<tr>
<td>Effect of exchange rate changes on cash and cash equivalents</td>
<td>23</td>
<td>(873)</td>
<td>12</td>
</tr>
</tbody>
</table>

#### Cash Flows From Financing Activities:

<table>
<thead>
<tr>
<th>Description</th>
<th>1985</th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds from long-term debt</td>
<td>686,709</td>
<td>8,661</td>
<td>1,048</td>
</tr>
<tr>
<td>Payments of long-term debt</td>
<td>(381,574)</td>
<td>(77,023)</td>
<td>(7,857)</td>
</tr>
<tr>
<td>Redemption of subordinated debt</td>
<td></td>
<td></td>
<td>(37)</td>
</tr>
<tr>
<td>Issuance of common stock</td>
<td>4</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Issuance of preferred stock</td>
<td>195,000</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Redemption of preferred stock</td>
<td>(155,177)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payments of dividends</td>
<td>(6,853)</td>
<td>(2,800)</td>
<td></td>
</tr>
<tr>
<td>(Increase) decrease in accounts and notes receivable</td>
<td>(9,091)</td>
<td>7,288</td>
<td>(2,213)</td>
</tr>
<tr>
<td>Increase (decrease) in short-term debt</td>
<td>96,233</td>
<td>(92,089)</td>
<td>25,595</td>
</tr>
<tr>
<td>Increase (decrease) in current maturities of notes payable</td>
<td>2,066</td>
<td>(3,548)</td>
<td>(3,796)</td>
</tr>
<tr>
<td>Net cash provided (used) by financing activities</td>
<td>427,317</td>
<td>(158,506)</td>
<td>12,744</td>
</tr>
<tr>
<td>Net increase (decrease) in cash and cash equivalents</td>
<td>(91,319)</td>
<td>(28,719)</td>
<td>31,789</td>
</tr>
<tr>
<td>Cash and cash equivalents at beginning of year</td>
<td>127,914</td>
<td>36,595</td>
<td>7,876</td>
</tr>
<tr>
<td>Cash and cash equivalents at end of year</td>
<td>36,595</td>
<td>7,876</td>
<td>39,665</td>
</tr>
</tbody>
</table>

(dollars in thousands)
Exhibit 5 (continued)

See accompanying notes to consolidated financial statements. The following is a summary of supplemental cash flow and noncash investing and financing information:

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1985</th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>(dollars in thousands)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash paid (received):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest, net of amount capitalized</td>
<td>$45,579</td>
<td>$52,552</td>
<td>$48,097</td>
</tr>
<tr>
<td>Income taxes</td>
<td>9,601</td>
<td>(5,864)</td>
<td>1,892</td>
</tr>
<tr>
<td>Noncash investing and financing activities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Notes receivable received upon sale of NuTone and Yale Security</td>
<td></td>
<td></td>
<td>365,000</td>
</tr>
<tr>
<td>Liabilities assumed upon acquisition of Scovill, Inc.</td>
<td>101,529</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock dividends paid on convertible preferred stock</td>
<td></td>
<td>1,093</td>
<td>3,280</td>
</tr>
</tbody>
</table>

Note 1. Summary of Significant Accounting Policies

Cash Equivalents. Cash equivalents consist of highly liquid debt instruments purchased with a maturity of three months or less.

Consolidated Statements of Cash Flows. For the year ended December 31, 1987, Industries has elected to adopt the provisions of SFAS 95, Statement of Cash Flows. The statement establishes standards for providing a statement of cash flows and supersedes APB 19, which required a statement of changes in financial position. The statement also requires that specified information about noncash investing and financing transactions and other events be provided separately. Industries' statements of changes in financial position for the years ended December 31, 1985 and 1986 have been restated to conform with these provisions.

Exhibit 6 shows that Elxsi Corporation adjusted for reserves taken in 1986 and 1985, sublease revenue and other credits for 1985 through 1987, and a 1987 gain related to discontinued development activities. Investment-related activities show cash receipts from disposition of development-related assets.

Exhibit 7 provides an example from the 1988 report of Melville Corporation, which reports separately under net cash by operating activities $7,341 of cash flows required for discontinued operations and $46,993 of proceeds from discontinued operations under investment-related activities.
### ELXSI Corporation

#### Consolidated Statement of Cash Flows

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(dollars in thousands)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Cash Flows From Operating Activities:

- **Net income (loss)**
  - $850
  - $(17,337)
  - $(46,237)

- **Adjustments to reconcile net income (loss) to net cash used by operating activities:**
  - **Depreciation and amortization**
    - 2,470
    - 3,224
    - 6,045
  - **Gain on sale of investment**
    - (500)
  - **(Gain) loss on discontinued development activities (DDA)**
    - (3,526)
    - 8,000
    - 10,500
  - **Purchase of partnership assets**
    - 6,016
  - **Gain on sale of interconnector technology**
    - (12,915)
  - **Common stock portion of class action settlement**
    - 3,750
  - **Write-off of other assets**
    - 616
    - 1,738
  - **Share of related-party losses**
    - 249
    - 425
  - **(Increase) decrease in assets:**
    - **Accounts receivable**
      - (1,143)
      - 678
      - 727
    - **Receivables from related parties**
      - 270
      - 1,298
      - (1,592)
    - **Inventories**
      - (684)
      - 2,247
    - **Prepaid expenses and other current assets**
      - 357
      - 523
      - 835
    - **Deposits and other long-term assets**
      - (650)
      - 342
      - (2,744)
  - **Increase (decrease) in liabilities:**
    - **Accounts payable**
      - (294)
      - (1,668)
      - (2,941)
    - **Accrued compensation and employee benefits**
      - (612)
      - (535)
      - 720
    - **Other accrued liabilities**
      - (506)
      - (2,064)
      - 2,009
    - **Deferred contract research and development revenues from related parties**
      - $ (831)
      - $ 171
    - **(Charges) credits to DDA reserve**
      - 488
      - (5,298)
      - $(10,853)
    - **Sublease revenue and other credits to DDA reserve**
      - 1,639
      - 3,042
      - 1,597
    - **Net cash used by operating activities**
      - (1,841)
      - (14,413)
      - (35,850)
### Accounting for Cash Flows

#### Exhibit 6 (continued)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash Flows From Investing Activities:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Restriction) release of short-term investments</td>
<td>$4,324</td>
<td>$6,246</td>
<td>$(4,845)</td>
</tr>
<tr>
<td>Acquisition of property and equipment, net of debt</td>
<td>$(2,072)</td>
<td>$(1,566)</td>
<td>$(1,733)</td>
</tr>
<tr>
<td>Proceeds from disposal of property and equipment</td>
<td></td>
<td></td>
<td>297</td>
</tr>
<tr>
<td>Disposition of assets related to DDA</td>
<td></td>
<td>692</td>
<td>5,744</td>
</tr>
<tr>
<td>Proceeds from sale of interconnector technology, net of expenses</td>
<td></td>
<td>12,427</td>
<td></td>
</tr>
<tr>
<td>Investments in related parties</td>
<td></td>
<td>(100)</td>
<td>(925)</td>
</tr>
<tr>
<td>Cash proceeds from sale of investment</td>
<td>1,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net cash provided by (used by) investing activities</td>
<td>3,252</td>
<td>17,699</td>
<td>(1,462)</td>
</tr>
</tbody>
</table>

#### Cash Flows From Financing Activities:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net payments under line of credit agreement</td>
<td></td>
<td>(6,681)</td>
<td>(819)</td>
</tr>
<tr>
<td>Proceeds from issuance of long-term debt</td>
<td></td>
<td>34</td>
<td>296</td>
</tr>
<tr>
<td>Principal payments on notes payable and installment contracts</td>
<td>(1,251)</td>
<td>(2,430)</td>
<td>(3,854)</td>
</tr>
<tr>
<td>Principal payments on capital lease obligations</td>
<td>(5,872)</td>
<td>(7,615)</td>
<td>(7,007)</td>
</tr>
<tr>
<td>Principal payments on loans payable to shareholders</td>
<td>(265)</td>
<td>(1,215)</td>
<td>(3,379)</td>
</tr>
<tr>
<td>Proceeds from issuance of common stock</td>
<td>7,473</td>
<td>261</td>
<td>1,003</td>
</tr>
<tr>
<td>Retirement of common stock, purchase of treasury stock, and other equity transactions</td>
<td></td>
<td></td>
<td>(926)</td>
</tr>
<tr>
<td>Net cash provided by (used by) financing activities</td>
<td>$85</td>
<td>$(17,646)</td>
<td>$(14,686)</td>
</tr>
<tr>
<td>Net increase (decrease) in cash and cash equivalents</td>
<td>$1,496</td>
<td>$(14,360)</td>
<td>$(51,998)</td>
</tr>
<tr>
<td>Cash and cash equivalents, beginning of year</td>
<td>13,874</td>
<td>28,234</td>
<td>80,232</td>
</tr>
<tr>
<td>Cash and cash equivalents, end of year</td>
<td>$15,370</td>
<td>$13,874</td>
<td>$28,234</td>
</tr>
</tbody>
</table>

(continued)
Exhibit 6 (continued)

The accompanying notes are an integral part of these financial statements. Supplemental disclosures of cash flow information:

<table>
<thead>
<tr>
<th>Cash paid during the year for interest:</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charged to operations</td>
<td>$145</td>
<td>$1,120</td>
<td>$3,874</td>
</tr>
<tr>
<td>Charged to DDA reserve</td>
<td>962</td>
<td>2,351</td>
<td>2,641</td>
</tr>
<tr>
<td></td>
<td>$1,107</td>
<td>$3,471</td>
<td>$6,515</td>
</tr>
</tbody>
</table>

Supplemental disclosures of noncash investing and financing activities:

Capital lease obligations of $81 and $1,113 were incurred in 1986 and 1985, respectively, when the Company entered into leases for new equipment.

In conjunction with the disposition of certain DDA facilities and equipment, the Company surrendered $11,462 in future noncancellable sublease revenue in 1987 and was relieved of debt and other DDA obligations in the aggregate amounts of $14,988, $1,908, and $6,226 in 1987, 1986, and 1985, respectively.

Note 2. Summary of Significant Accounting Policies

Statement of Cash Flows. During 1987 the Company adopted SFAS 95, Statement of Cash Flows, retroactive to its inception. Accordingly, the accompanying consolidated financial statements for the fiscal year ended December 27, 1987, include a statement of cash flows, replacing the consolidated statement of changes in financial position. For purposes of the statement of cash flows, the Company considers all highly liquid debt instruments to be cash equivalents.
## Accounting for Cash Flows

### Exhibit 7  
*Melville Corporation and Subsidiary Companies*  
*Consolidated Statements of Cash Flows*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net earnings from continuing</td>
<td>$285,383</td>
<td>$238,332</td>
<td>$219,811</td>
</tr>
<tr>
<td>operations</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adjustments to reconcile to net</td>
<td>72,032</td>
<td>64,071</td>
<td>59,605</td>
</tr>
<tr>
<td>cash provided by operating activities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>3,961</td>
<td>3,618</td>
<td>3,463</td>
</tr>
<tr>
<td>Amortization of goodwill</td>
<td>42,495</td>
<td>47,753</td>
<td>47,969</td>
</tr>
<tr>
<td>Minority interests in net earnings</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in deferred federal income</td>
<td>7,133</td>
<td>11,540</td>
<td>10,304</td>
</tr>
<tr>
<td>taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common shares awarded under</td>
<td>1,365</td>
<td>1,249</td>
<td>1,224</td>
</tr>
<tr>
<td>restricted stock plan</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in assets and liabilities,</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>net of acquisitions and dispositions:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Decrease (increase) in deferred</td>
<td>353</td>
<td>(88)</td>
<td>552</td>
</tr>
<tr>
<td>charges and other assets:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in accounts payable</td>
<td>12,916</td>
<td>42,844</td>
<td>16,837</td>
</tr>
<tr>
<td>Increase in accrued expenses</td>
<td>29,621</td>
<td>13,909</td>
<td>24,024</td>
</tr>
<tr>
<td>Increase in accounts receivable</td>
<td>(3,324)</td>
<td>(15,228)</td>
<td>(8,450)</td>
</tr>
<tr>
<td>Increase in inventories</td>
<td>(87,370)</td>
<td>(96,968)</td>
<td>(84,132)</td>
</tr>
<tr>
<td>Increase in prepaid expenses</td>
<td>(16,032)</td>
<td>(12,554)</td>
<td>(6,070)</td>
</tr>
<tr>
<td>Increase (decrease) in federal</td>
<td>(10,835)</td>
<td>5,900</td>
<td>13,897</td>
</tr>
<tr>
<td>income taxes payable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net cash provided (used) by operating</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>activities of:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Continuing operations</td>
<td>338,000</td>
<td>304,380</td>
<td>299,038</td>
</tr>
<tr>
<td>Discontinued operations</td>
<td></td>
<td></td>
<td>(7,341)</td>
</tr>
<tr>
<td>Net cash provided by operating</td>
<td>338,000</td>
<td>304,380</td>
<td>291,696</td>
</tr>
<tr>
<td>activities</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Exhibit 7 (continued)

Cash Flows From Investing Activities:
Proceeds from the sale or disposal of:
- Discontinued operations, net of cash $ 46,993
- Property, plant, equipment, and leasehold improvements
  - 1987 $12,751 1986 $7,615 1985 13,444
- Leased property under capital leases 309 440 367
- Acquisitions, net of cash (63,667) (200) (9,491)
- Additions to property, plant, equipment, and leasehold improvements (129,464) (115,572) (101,570)
Net cash used in investing activities (180,070) (107,715) (50,256)

Cash Flows From Financing Activities:
Proceeds from the sale or issuance of common stock 3,980 5,649 5,853
- Reduction of long-term debt (7,967) (45,929) (5,723)
- Decrease in obligations under capital leases (3,398) (3,288) (2,941)
- Dividends paid (95,680) (84,584) (77,092)
- Dividends paid to minority interests (39,903) (46,529) (44,944)
- Other 74 126 259
Net cash used in financing activities (142,894) (174,555) (124,588)

Net increase in cash and cash equivalents 15,035 22,109 116,851
- Cash and cash equivalents at beginning of year 326,780 304,671 187,820
- Cash and cash equivalents at end of year $341,815 $326,780 $304,671

See accompanying notes to consolidated financial statements.

Note 1. Summary of Significant Accounting Policies

Changes in Presentation: In 1987, the Company adopted SFAS 95, Statement of Cash Flows, which requires the presentation of cash flows to differentiate between those from operations and from other activities. Accordingly, amounts previously reported in 1986 and 1985 have been reclassified to conform with the 1987 presentation.

Supplemental Cash Flow Information. Cash paid for income taxes and interest during the years ended December 31, 1987, 1986, and 1985 was as follows:
Accounting for Cash Flows

Exhibit 7 (continued)  

<table>
<thead>
<tr>
<th></th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income taxes</td>
<td>$251,302,170</td>
<td>$221,075,876</td>
<td>$176,696,726</td>
</tr>
<tr>
<td>Interest (net of amounts capitalized)</td>
<td>4,442,495</td>
<td>5,001,455</td>
<td>9,130,520</td>
</tr>
</tbody>
</table>

In addition, during the years ended December 31, 1987, 1986, and 1985, the Company had the following noncash financing and investing activities:

<table>
<thead>
<tr>
<th></th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conversion of 4 1/2% percent convertible subordinated debentures</td>
<td>$466,992</td>
<td>$77,968</td>
<td>$190,960</td>
</tr>
<tr>
<td>Capital leases entered into</td>
<td>5,133,915</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acquisition of subsidiary in exchange for common stock</td>
<td>6,422,124</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Extraordinary Items**

Companies having extraordinary items need not separately disclose cash (working capital) provided or used by those extraordinary items from that attributable to income before extraordinary items, as was required under earlier pronouncements.

A company can choose to separately show the cash flows from extraordinary items within operating activities using a treatment similar to that for discontinued operations.

Extraordinary items are classified according to the underlying nature of the transaction. Accordingly, a loss/gain on extinguishment of debt is a reconciling adjustment to net income in arriving at net cash from operations, and the related cash payments are financing related. Extraordinary gains without cash impact on operations or those that are investment/financing related are reconciling adjustments to net income in deriving net cash from operating activities.

Exhibit 8 shows the treatment of an extraordinary item by MAPCO, Inc. in its 1988 annual report. MAPCO shows other items not requiring cash to include an extraordinary loss from debt extinguishment (Note 2), which is a reconciling item in arriving at net cash from operating activities. Cash used for redemption of debt is included in financing-related activities of 1987. Another common extraordinary item is the extraordinary gain from use of net operating loss carryforwards under APB 11, *Accounting for Income Taxes*. Under SFAS 96, *Accounting for Income Taxes*, tax benefits from use of net operating loss carryforwards are no longer treated as extraordinary. In Exhibit 9 Tosco adds back the extraordinary credit from net
operating loss carryforwards to income (loss) before extraordinary items to arrive at net cash provided by operating activities. In contrast to the MAPCO presentation, which adjusted net income for loss on extinguishment of debt, in Exhibit 9 Tosco shows an extraordinary gain on debt refinancing under noncash transactions. The adjustment as a reconciling item is unnecessary because for each comparative period Tosco presents income before extraordinary items.

## Accounting Changes

The cumulative effect of accounting changes not involving cash are reconciling adjustments to net income in arriving at net cash from operating activities. MAPCO, Inc. (Exhibit 8), shows a reconciling adjustment for the cumulative impact of adopting SFAS 96 in 1985.

### Exhibit 8

**MAPCO, Inc.**  
*Consolidated Statement of Cash Flows (Note 2)*

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>(dollars in thousands)</em></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Cash Flows From Operating Activities:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>$108,391</td>
<td>$74,149</td>
<td>$104,065</td>
</tr>
<tr>
<td>Reconciliation of net income to net cash provided by operating activities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation, depletion, and impairments</td>
<td>88,330</td>
<td>72,209</td>
<td>65,873</td>
</tr>
<tr>
<td>Cumulative effect of change in method of accounting for income taxes</td>
<td></td>
<td></td>
<td>(51,129)</td>
</tr>
<tr>
<td>Provision for deferred income taxes</td>
<td>7,427</td>
<td>37,709</td>
<td>33,886</td>
</tr>
<tr>
<td>Other items not providing or requiring cash (Note 2)</td>
<td>8,770</td>
<td>7,697</td>
<td>10,242</td>
</tr>
<tr>
<td>Changes in operating assets and liabilities (Note 2)</td>
<td>45,676</td>
<td>(56,838)</td>
<td>(15,913)</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>207,465</td>
<td>134,926</td>
<td>198,153</td>
</tr>
</tbody>
</table>
### Exhibit 8 (continued)

<table>
<thead>
<tr>
<th></th>
<th>Years Ended December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1987</td>
</tr>
<tr>
<td>(dollars in thousands)</td>
<td></td>
</tr>
<tr>
<td><strong>Cash Flows From Investing Activities:</strong></td>
<td></td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>$(62,429)</td>
</tr>
<tr>
<td>Proceeds from sales of property, plant, and equipment</td>
<td>3,085</td>
</tr>
<tr>
<td>(Increase) decrease in marketable securities</td>
<td>(560)</td>
</tr>
<tr>
<td>Other</td>
<td>(7,661)</td>
</tr>
<tr>
<td>Net cash provided by (used in) investing activities</td>
<td>(67,565)</td>
</tr>
<tr>
<td><strong>Cash Flows From Financing Activities:</strong></td>
<td></td>
</tr>
<tr>
<td>Purchases of common stock</td>
<td>(65,717)</td>
</tr>
<tr>
<td>Payments on debt and capital leases</td>
<td>(25,664)</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>(20,847)</td>
</tr>
<tr>
<td>Proceeds from issuance of debt</td>
<td>8,752</td>
</tr>
<tr>
<td>Proceeds from exercise of stock options</td>
<td>1,059</td>
</tr>
<tr>
<td>Increase (decrease) in short-term borrowings</td>
<td>(142,644)</td>
</tr>
<tr>
<td>Payments for redemption of long-term debt</td>
<td></td>
</tr>
<tr>
<td>Net cash used in financing activities</td>
<td>(102,417)</td>
</tr>
<tr>
<td>Increase (decrease) in cash and cash equivalents</td>
<td>37,483</td>
</tr>
<tr>
<td>Cash and cash equivalents, January 1</td>
<td>95,932</td>
</tr>
<tr>
<td>Cash and cash equivalents, December 31</td>
<td>$133,415</td>
</tr>
</tbody>
</table>

See notes to consolidated financial statements.

**Note 2. Consolidated Statement of Cash Flows Supplemental Disclosures**

In 1987, MAPCO adopted SFAS 95, *Statement of Cash Flows*, and prior years' Statements of Changes in Financial Position have been restated for comparative purposes.

(continued)
Exhibit 8 (continued)

Other items not providing or requiring cash consist of (in thousands):

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss on sales of property, plant, and equipment</td>
<td>$10,493</td>
<td>$1,157</td>
<td>$3,491</td>
</tr>
<tr>
<td>Pension income</td>
<td>(5,199)</td>
<td>(5,247)</td>
<td></td>
</tr>
<tr>
<td>Loss of unconsolidated affiliate</td>
<td>$2,103</td>
<td>$3,891</td>
<td>$4,625</td>
</tr>
<tr>
<td>Provision for losses on trade accounts receivable</td>
<td>830</td>
<td>1,884</td>
<td>1,834</td>
</tr>
<tr>
<td>Extraordinary loss from debt extinguishment</td>
<td></td>
<td></td>
<td>4,133</td>
</tr>
<tr>
<td>Other noncash income and expense items</td>
<td>543</td>
<td>1,879</td>
<td>292</td>
</tr>
<tr>
<td></td>
<td>$8,770</td>
<td>$7,697</td>
<td>$10,242</td>
</tr>
</tbody>
</table>

Changes in operating assets and liabilities consist of (in thousands):

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decrease (increase) in trade accounts receivable</td>
<td>$50,396</td>
<td>$35,766</td>
<td>$(19,068)</td>
</tr>
<tr>
<td>Decrease in inventories</td>
<td>7,490</td>
<td>49,810</td>
<td>28,922</td>
</tr>
<tr>
<td>Decrease (increase) in prepaids and other current assets</td>
<td>(697)</td>
<td>1,683</td>
<td>(7,161)</td>
</tr>
<tr>
<td>(Increase) in other assets</td>
<td>(2,279)</td>
<td>(7,109)</td>
<td>(3,410)</td>
</tr>
<tr>
<td>Increase (decrease) in accounts payable and accrued expenses</td>
<td>(10,456)</td>
<td>(128,350)</td>
<td>40,665</td>
</tr>
<tr>
<td>Increase (decrease) in current income taxes payable</td>
<td>543</td>
<td>(13,385)</td>
<td>(55,022)</td>
</tr>
<tr>
<td>Increase (decrease) in other deferred items</td>
<td>679</td>
<td>4,747</td>
<td>(839)</td>
</tr>
<tr>
<td></td>
<td>$45,676</td>
<td>$(56,838)</td>
<td>$(15,913)</td>
</tr>
</tbody>
</table>

Cash income taxes paid were $11,943,000, $43,289,000, and $71,430,000 during 1987, 1986, and 1985, respectively. Interest paid, net of amounts capitalized, was $36,551,000, $42,773,000, and $41,166,000 during 1987, 1986, and 1985, respectively.

Noncash financing activities include the December 31, 1987, reclassification to short-term borrowings of $56,745,000 of commercial paper and bank loans and the issuance of 97,736 shares of common stock during 1986 upon conversion of $4,473,000 of the 10 percent convertible subordinated debentures.
### Exhibit 9

**Tosco Corporation and Subsidiaries**  
*Consolidated Statement of Cash Flows*

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1987</td>
<td>1986</td>
<td>1985</td>
</tr>
<tr>
<td></td>
<td>(dollars in thousands)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Cash Flows From Operating Activities:**

Income (loss) before extraordinary items  
$ 27,822 ($56,420) $ 8,867

Adjustments to arrive at net cash provided by operating activities:

Extraordinary credit resulting from utilization of net operating loss carryforwards  
25,133

Writedown of assets and related termination costs  
40,662 4,000

Depreciation and depletion  
22,094 21,834 20,966

Amortization of deferred items  
14,767 16,882 15,556

Amortization of deferred gains  
(2,206) (24,450) (16,942)

Interest earned on notes receivable from issuance of common stock  
(379) (436) (2,091)

Loss on equity investments  
1,694

Issuance of common stock in settlement of litigation  
5,250 5,500

Issuance of debt in payment of interest on debt  
23,455 35,295

(Increase) decrease:

Receivables  
(11,723) 43,184 24,157

Inventories  
1,787 (4,144) 37,510

Prepaid expenses and other current assets  
4,319 4,651 (2,660)

Increase (decrease):

Accounts payable and accrued liabilities  
27,868 (33,637) (17,941)

Other noncurrent liabilities  
(1,185) (9,331) (7,650)

Deferred income taxes  
(534) (690) (2,000)

Other  
(717) (1,529) (264)

Total adjustments  
79,224 81,701 95,130

Net cash provided by operating activities  
107,046 25,281 103,997

(continued)
Accounting for Cash Flows

**Exhibit 9 (continued)**

<table>
<thead>
<tr>
<th>Cash Flows From Investing Activities:</th>
<th>Years Ended December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1987</td>
</tr>
<tr>
<td>Proceeds from sales of property,</td>
<td></td>
</tr>
<tr>
<td>plant and equipment</td>
<td>$605</td>
</tr>
<tr>
<td>Purchase of property, plant, and</td>
<td></td>
</tr>
<tr>
<td>equipment</td>
<td>(15,587)</td>
</tr>
<tr>
<td>Increase in deferred turnarounds and</td>
<td></td>
</tr>
<tr>
<td>charges and other assets</td>
<td>(8,200)</td>
</tr>
<tr>
<td>Purchase of short-term investments</td>
<td></td>
</tr>
<tr>
<td>Net cash provided by (used in)</td>
<td></td>
</tr>
<tr>
<td>investing activities</td>
<td>(39,021)</td>
</tr>
</tbody>
</table>

| Cash Flows From Financing Activities: |       |       |       |
| Issuance of series E preferred stock| 12,100| 200,000|       |
| Issuance of long-term debt          |       | 150,000|       |
| Costs of refinancing debt           |       | (25,000)|       |
| Net borrowings under working capital|       |       |       |
|   facilities                        |       |       |       |
| Principal payments under debt       |       |       |       |
|   agreements:                       |       |       |       |
| Refinancing Agreement               |       | (275,000)|       |
| Other                               | (5,440) | (99,697) | (104,148) |
| Payments received from ESOP         |       | 806    | 2,507  |
| Preferred stock dividends           |       | (22,583)|       |
| Net cash used in financing activities|       | (15,117) | (47,190) | (69,148) |
| Net increase (decrease) in cash and |       | 52,908 | (7,674) | (6,695) |
| cash equivalents                    |       |       |       |
| Cash and cash equivalents at        |       |       |       |
|   beginning of year                 | 15,965 | 23,639 | 30,334 |
| Cash and cash equivalents at end of |       |       |       |
|   year                              | $68,873 | $15,965 | $23,639 |

The accompanying notes are an integral part of this statement.
Accounting for Cash Flows

Exhibit 9 (continued)

Supplemental Schedule of Noncash Investing and Financing Activities

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(dollars in thousands)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sale of property, plant, and equipment for notes receivable (net of cash received)</td>
<td>$1,676</td>
<td>$ 5,000</td>
<td>$7,300</td>
</tr>
<tr>
<td>Sale of secured assets held for sale (net of cash received) for assumption of debt</td>
<td></td>
<td>$7,500</td>
<td></td>
</tr>
<tr>
<td>Purchase of property, plant, and equipment (net of cash paid) for notes</td>
<td>$6,356</td>
<td>$ 2,553</td>
<td></td>
</tr>
<tr>
<td>Issuance of common stock in payment of floating rate subordinated notes</td>
<td>$7,991</td>
<td>$ 4,382</td>
<td></td>
</tr>
<tr>
<td>Extraordinary gain from refinancing of debt (Note 3)</td>
<td></td>
<td>$74,000</td>
<td></td>
</tr>
<tr>
<td>Surrender of series C preferred stock (Note 3)</td>
<td></td>
<td>$70,845</td>
<td></td>
</tr>
</tbody>
</table>

Supplemental Disclosures of Cash Flow Information

<table>
<thead>
<tr>
<th>Years Ended December 31</th>
<th>1987</th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash paid during year:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>$27,277</td>
<td>$5,868</td>
<td>$10,247</td>
</tr>
<tr>
<td>Income taxes</td>
<td>$ 567</td>
<td>$ 931</td>
<td>$ 3,082</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of this statement.

Note 1. Summary of Significant Accounting Policies

Reclassifications and Restatement. Certain previously reported amounts have been restated to conform to classifications adopted in 1987. In addition, in 1987 Tosco has adopted SFAS 95, which requires a statement of cash flows as part of a full set of financial statements in place of a statement of changes in financial position. Accordingly, the consolidated statements of changes in financial position for the years ended December 31, 1986, and 1985 have been replaced with statements of cash flows.

Transition

SFAS 95 is effective for annual statements for fiscal periods ended after July 15, 1988. Enterprises are encouraged, but not required, to restate comparative annual statements. Companies are not required
to apply SFAS 95 in interim statements in the year of adoption, but interim cash flow information included with the annual financial statements in the adoption year must be restated.

Cash Flow Per Share

SFAS 95 specifies that cash flow per share is not to be reported.

Classification Guidance

Additional guidance on classifying typical investing, financing, and operating activities is provided as follows.

Investing Activities

Cash outflows for —

- The acquisition of property, plant, and equipment or other productive assets.
- Purchase of debt instruments not designated as cash equivalents or equity instruments.
- Investments in another company.
- Loans made to another entity.

Cash inflows from —

- Proceeds from the disposal of property, plant, and equipment, as well as other productive assets.
- Proceeds from the sale or collection of loans and debt (not cash equivalents).
- The sale or return of investments on equity instruments.
- Collections on loans.

Financing Activities

Cash inflows from —

- Proceeds from the sale or issuance of equity securities.
- Proceeds from the issuance of bonds, mortgages, notes, and other short- or long-term borrowings.
**Accounting for Cash Flows**

*Cash outflows for*—

- Payment of dividends to shareholders.
- Other distributions to owners.
- Outlays for repurchase of equity securities.
- Repayment of short- or long-term borrowings.

**Operating Activities**

*Cash inflows from*—

- Receipts from the sale of goods or services, or the collection or sale of receivables arising from those sales.
- Interest on investment in debt securities and loans.
- Dividends on investments in equity securities.
- Receipts on other transactions not defined as investing or financing.

*Cash outflows for operating activities include*—

- Payments for the acquisition of inventory.
- Payments to employees for services.
- Payments for taxes.
- Interest payments, reduced by amounts capitalized.
- Payments to suppliers for other expenses.
- Payments on other transactions not defined as investing or financing.

**Survey of Annual Reports**

Exhibits 10 through 13 provide a survey abstracted from annual reports of reconciling items in converting net income to net cash flow from operations under the indirect method, common types of investing cash flows, common types of financing cash flows, and noncash items. Under the indirect method as shown in Exhibit 10, there are a number of gain and loss adjustments including gain on sale of investments, gain on debt extinguishments, gain on sale of hedges. Other adjustments in converting net income to net cash from operations may include extraordinary items, cumulative effect of accounting changes, and discontinued operations. Exhibit 11 shows transactions related to disposition of segments, discontinued operations,
investment in related parties, life insurance proceeds received from officers, and other related-party additions to other accounts receivable are among the events some companies have chosen to categorize as investment related. Proceeds from warrants, principal payments on loans payable to shareholders, payments received from ESOPs, and proceeds from sale and leaseback under operating leases are among the events included as financing related in Exhibit 12.

Exhibit 13 summarizes noncash items appearing in published financial statements. Some noncash disclosures include fair value of treasury stock issued for businesses acquired, surrender of leases and release from debt and other obligations on discontinuing development activities, bank borrowings and subsequent loan of proceeds to ESOPs, and transfer of property including debt to a real estate trust in exchange for trust shares.

**Exhibit 10** Types of Adjustments Under the Indirect Method in Arriving at Net Cash Provided by Operating Activities Appearing in Annual Reports

- Depreciation
- Depletion
- Cumulative effect of change in method of accounting for income taxes
- Extraordinary item
- Provision for loss on short-term investments
- Provision for losses on accounts receivable
- Provision for self-insurance reserves
- Nonrecurring charges
- Extraordinary item, net of deferred income taxes
- Extraordinary credit resulting from use of net operating loss carryforwards
- Writedown of assets and related termination costs
- Amortization of deferred gains
- Loss on equity investments
- Issuance of common stock in settlement of litigation
- Increase in cash surrender value of life insurance
- Issuance of debt in payment of interest on debt
- Accretion of note discount
- Manufacturing consolidation accrual
- Minority interest in subsidiaries' earnings
- Employee stock award program
- Common shares awarded under restricted stock plan
- Impairments
- Provision for possible losses on disposition of restaurant
- Provision for self-insurance reserve
Exhibit 10 (continued)

Equity in unremitted earnings of unconsolidated affiliates in excess of dividends received from unconsolidated affiliates
Restructuring charge
Customer advances
Disallowed plant cost
Allowance for funds used during construction
Deferred investment credit, net
Rate deferrals
Increase in escrow bonding arrangement
Gain on extinguishment of debt
Gain on sale of investments
Gain on discontinued development activities
Share of related-party losses
Gain on foreign currency hedge
Gain on discontinued operations
Gain on partial sale of subsidiary
Net earnings from discontinued operations
Loss from discontinued operations
Provisions for losses on direct financing leases
Loss on disposal of property and equipment
Income tax benefit from stock option plans
Pension settlement gain
Amortization of restricted award shares
Amortization of software products
Amortization of goodwill
Restructuring costs
Common stock portion of class action settlement
Changes in certain noncash assets and liabilities, net of effects of businesses acquired, and noncash transactions
Receivables
Inventories
Prepaid expenses and other current assets
Accounts payable
Accrued income taxes
Advanced revenue
Deferred revenue
Accrued compensation and employee benefits
Accrued interest payable
Deferred income taxes
Deferred compensation
Prepaid income taxes
Increase in deferred items

(continued)
Exhibit 10  *(continued)*

Other, principally insurance and pensions
Deferred contract research and development revenue from related parties
Sublease revenues and other credits
Amount due from affiliate
Accrued liabilities
Accrued retirement benefits
Assets held for resale
Decrease in refundable federal and local taxes

Exhibit 11  *Types of Investing Transactions Appearing in Corporate Annual Reports*

Capital expenditures
Proceeds from sales of property
Purchase of another company
Cash balances of another company
Proceeds from sale of property, plant, and equipment
Purchase of patents and other assets
Cash proceeds from sale of investments
Cash proceeds from divestiture and restructuring
Proceeds from sale of technology, net of expenses
(Restriction) release of short-term investments
Investments in related parties
Disposition of assets related to discontinued developmental activities
Investments in unconsolidated subsidiaries
Proceeds from dispositions of unconsolidated subsidiaries
Proceeds from collection of notes receivable
Dividends received (First Cities Industries, Inc. report)
Investment in preferred stock
Short-term investments
(Increase) decrease in marketable securities
Proceeds from sale of segment
Expenses and income taxes related to sale of segment (Quantum Chemical Corporation)
Proceeds from sale of insurance subsidiary
Increases in deferred turnarounds and charges and other assets
Dissolution of investment in affiliate
Additions to equipment and leasehold improvements
Additions to other accounts receivable
Additions to preopening costs
Collections of notes receivable
Distributions to minority interests (McFaddin Ventures)
Contributions to 50-percent-or-less owned affiliates
Exhibit 11 (continued)

Reduction of restricted investment in marketable securities
Equity investments
Increase in deferred acquisition cost
Purchase of tax benefits
Change in other assets
Disposals of leased assets
Additions to long-term notes receivable (Super Valu Stores)
Payments on long-term notes receivable (Super Valu Stores)
Acquisition of franchisees
Additions to software products
Reductions of investments in related companies
Capital contributions to unconsolidated subsidiaries
Investments in joint venture
Investments in life insurance policies
Nuclear fuel sales to lessors
Nuclear fuel expenditures
Expenditures on suspended construction project
Proceeds from disposition of carried interest
Proceeds from insurance claims
Net change in cattle breeding herd
Notes receivable advances to ESOP (Frozen Food Express Industries)
Payments received from officers and other related parties
Loans made for investments
CRDA deposits and bond purchases (Resorts International, Inc.)
Cash value of life insurance
Reduction in investment in direct financing lease

Exhibit 12  Types of Financing Transactions Appearing in Corporate Annual Reports

Proceeds from issuance of long-term debt
Payments of long-term debts, including current maturities
Net increase in privately placed paper
Net payments under line of credit
Payment of short-term debt assumed in acquisitions
Payments to acquire treasury stock
Dividends paid
Issuance of preferred stock
Redemption of preferred stock
Repurchase of common stock
Exercise of warrants
Principal payments on notes payable and installment contracts
Principal payments on capital lease obligations (continued)
Accounting for Cash Flows

Exhibit 12 (continued)
Principal payments on loans payable to shareholders
Retirement of common stock, purchase of treasury stock, and other equity transactions
Proceeds from exercise of stock options
Costs of refinancing debt
Net borrowings under working capital facilities
Loan to ESOP
Payments received from ESOP
Cost to issue debentures
Dividends to minority shareholders
Stock option plan
Net proceeds from public offerings
Proceeds from sale and leaseback under operating leases, less deferred gains
Exercise of stock options, including income tax benefit
Decrease in convertible subordinated debenture as a result of extinguishment
Redemption of common stock warrants
Cash transactions costs of exchange
Proceeds from issuance of pollution control bonds
Proceeds from revolving bank loans
Redemptions of revolving bank loans
Purchases of treasury stock
Escrow payments

Exhibit 13 Types of Noncash Transactions Appearing in Corporate Annual Reports

Conversion of convertible subordinated debenture
Preferred stock converted into common stock
Treasury stock issued for compensation plans
Treasury stock issued on conversion of debentures
Common stock exchanged for treasury stock
Fair value of treasury stock issued for businesses acquired
Note received on sale of business
Liabilities assumed in business acquisition
Capital lease obligations entered into for new leases
Surrender of leases and release from debt and other obligations on discontinuing development activities
Common stock dividends paid on convertible stock
Deferred assets and liabilities recognized
Sale of property, plant, and equipment for notes
Purchase of property, plant, and equipment for notes
Sale of secured assets held for sale for assumption of debt
Exhibit 13 (continued)
Issuance of common stock in payment of floating rate subordinated notes
Borrowing from a bank and subsequently loaning proceeds to ESOP
Transfer of real property, including debt assumed to a real estate trust in exchange for trust shares
Acquisition of limited partner interests in exchange for common shares
Issuance of common shares on conversion of director's note payable
Acquisition of company by contributing property, investments, and working capital
Reclassification of short-term borrowings of commercial paper and bank loans
Acquisition of equity interests of minority shareholders in subsidiaries
Reclassification of current marketable securities to noncurrent stock issued to employees
Deferred compensation from awarding restricted stock awards and restricted stock awards

PREPARATION GUIDANCE
Two cases have been prepared. The first examines step-by-step the preparation of each of the parts of the statement of cash flows; the second reviews modifications in reporting guidance in presenting exchange rate effects.

Case 1. Winner Corp. — Preparation of statement of cash flows
The following activities occurred in 19X1 for Winner Corporation, a diversified manufacturing company.

Facts

a. Winner Corp. wrote off $350 of accounts receivable upon the bankruptcy of a customer. A provision of $200 was included in Winner's selling, general, and administrative expenses.

b. Winner collected the final installment of $100 on notes receivable for the sale of inventory and collected installment payments of $150 on the sale of a plant. Interest of $55 on these notes was collected through December 31.
c. Winner received a dividend of $20 from an affiliate carried under the equity method of accounting.

d. Winner sold a facility with a book value of $520 and an original cost of $750 for $600 cash.

e. Winner accumulated expenditures of $1,000, which included $10 capitalized interest on a new facility constructed and placed in service for its own use.

f. Winner entered into a capital lease for new equipment with a fair value of $850. Principal payments under the lease obligation totaled $125.

g. Winner acquired all the capital stock of Poor Mgt. Corp. for $950. The acquisition was recorded under the purchase method. Fair values of assets and liabilities at the date of acquisition are as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 25</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>155</td>
</tr>
<tr>
<td>Inventory</td>
<td>350</td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td>900</td>
</tr>
<tr>
<td>Patents</td>
<td>80</td>
</tr>
<tr>
<td>Goodwill</td>
<td>70</td>
</tr>
<tr>
<td>Accrued expenses and payables</td>
<td>(255)</td>
</tr>
<tr>
<td>Long-term notes payable</td>
<td>(375)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$950</strong></td>
</tr>
</tbody>
</table>

h. Net borrowings against a line of credit, payable 30 days after demand, totaled $300.

i. Winner issued $400 of long-term debt securities.

j. The provision for income taxes included a deferral of $150.

k. Depreciation expenses totaled $430, and the amortization of intangibles totaled $15.

l. Winner's selling, general, and administrative expenses included a $50 accrual of incentive compensation, with the related obligation included in other liabilities.

m. Winner collected insurance proceeds of $15 from business interruption, attributable to the nondelivery of a shipment of inventory for one week.

n. Winner paid $30 to settle a patent infringement.
o. Winner issued $1,000 of additional common stock: $500 for cash and $500 upon conversion of long-term debt.

p. Winner paid $200 in dividends.

Winner’s consolidated statement of financial position and consolidated statement of income was as follows:

\[\text{Winner Corp.}\
\text{Consolidated Statement of Financial Position}\]

<table>
<thead>
<tr>
<th></th>
<th>January 1, 19X1</th>
<th>December 31, 19X1</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash</td>
<td>$ 600</td>
<td>$ 1,665</td>
<td>$1,065</td>
</tr>
<tr>
<td>equivalents</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>1,770</td>
<td>1,940</td>
<td>170</td>
</tr>
<tr>
<td>(net of allowance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>for losses of $600</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>and $450)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Notes receivable</td>
<td>400</td>
<td>150</td>
<td>(250)</td>
</tr>
<tr>
<td>Inventory</td>
<td>1,230</td>
<td>1,375</td>
<td>145</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>110</td>
<td>135</td>
<td>25</td>
</tr>
<tr>
<td>Investments</td>
<td>250</td>
<td>275</td>
<td>25</td>
</tr>
<tr>
<td>Property, plant,</td>
<td>6,460</td>
<td>8,460</td>
<td>2,000</td>
</tr>
<tr>
<td>and equipment, at</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>cost</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accumulated</td>
<td>(2,100)</td>
<td>(2,300)</td>
<td>(200)</td>
</tr>
<tr>
<td>depreciation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant,</td>
<td>4,360</td>
<td>6,160</td>
<td>1,800</td>
</tr>
<tr>
<td>and equipment, net</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intangible assets</td>
<td>40</td>
<td>175</td>
<td>135</td>
</tr>
<tr>
<td>Total assets</td>
<td>$ 8,760</td>
<td>$11,875</td>
<td>$3,115</td>
</tr>
</tbody>
</table>

| **Liabilities:**    |                |                   |        |
| Accounts payable    | $ 1,085        | $ 1,090           | $ 5    |
| Accrued expenses    | 225            | 275               | 50     |
| Interest payable    | 30             | 45                | 15     |
| Income taxes        | 50             | 85                | 35     |
| payable            |                |                   |        |
| Short-term debt     | 450            | 750               | 300    |
| Lease obligation    |                | 725               | 725    |
| Long-term debt      | 2,150          | 2,425             | 275    |
| Deferred taxes      | 375            | 525               | 150    |
| Total liabilities   | 4,365          | 5,920             | 1,555  |

(continued)
Accounting for Cash Flows

(continued)

<table>
<thead>
<tr>
<th>Stockholders’ equity:</th>
<th>January 1, 19X1</th>
<th>December 31, 19X1</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital stock</td>
<td>$2,000</td>
<td>$3,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,395</td>
<td>2,955</td>
<td>560</td>
</tr>
<tr>
<td><strong>Total stockholders’ equity</strong></td>
<td><strong>4,395</strong></td>
<td><strong>5,955</strong></td>
<td><strong>1,560</strong></td>
</tr>
<tr>
<td>Total liabilities and stockholders’ equity</td>
<td>$8,760</td>
<td>$11,875</td>
<td>$3,115</td>
</tr>
</tbody>
</table>

**Winner Corp.**

**Consolidated Statement of Income**

*for the Year Ended December 31, 19X1*

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$13,965</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(10,290)</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>(445)</td>
</tr>
<tr>
<td>Selling, general, and administrative expenses</td>
<td>(1,890)</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(235)</td>
</tr>
<tr>
<td>Equity in earnings of affiliate</td>
<td>45</td>
</tr>
<tr>
<td>Gain on sale of facility</td>
<td>80</td>
</tr>
<tr>
<td>Interest income</td>
<td>55</td>
</tr>
<tr>
<td>Insurance proceeds</td>
<td>15</td>
</tr>
<tr>
<td>Loss from patent infringement lawsuit</td>
<td>(30)</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>1,270</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>(510)</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td><strong>$760</strong></td>
</tr>
</tbody>
</table>

**Cash Flows Derivations**

The case is used to derive the following:

- Cash flows from operating activities under the indirect method
- Cash flows from activities designated as investing
- Cash flows from activities designated as financing
- Cash flows from operating activities under the direct method
- Noncash activities
- Samples of complete statements of cash flows under the direct and indirect methods
The worksheet in Exhibit 14 is used to categorize activities as either operating, investing, financing, or noncash. The first step in analysis is preparing the worksheet, taking the differences by individual account between the beginning and end of the period statements of financial position. The $1,065 change in cash and cash equivalents equals the changes in all remaining asset, liability, and equity accounts. The asset, liability, and equity accounts other than cash and cash equivalents are then analyzed for specific events that affected those accounts. The details of the changes are directly keyed into the facts of the case. Finally, events are classified into investing, financing, operating, and noncash (not used).
## Exhibit 14

**Winner Corp.**

**Cash Flow Worksheet**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Beginning</th>
<th>Ending</th>
<th>Change</th>
<th>Detail</th>
<th>Investing</th>
<th>Financing</th>
<th>Operating</th>
<th>Noncash Not Used</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td>600</td>
<td>1,665*</td>
<td>1,065</td>
<td>(350)a</td>
<td>155 g</td>
<td>215 net</td>
<td>(350)</td>
<td></td>
</tr>
<tr>
<td>Account receivable</td>
<td>2,370</td>
<td>2,390</td>
<td>20</td>
<td>(350)a</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bad debt write-off</td>
<td></td>
<td></td>
<td></td>
<td>(350)a</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase of Poor Mgt.</td>
<td></td>
<td></td>
<td></td>
<td>(155)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net increase</td>
<td></td>
<td></td>
<td></td>
<td>(215)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowance for bad debts</td>
<td>(600)</td>
<td>(450)</td>
<td>150</td>
<td>350 a</td>
<td></td>
<td></td>
<td>350</td>
<td></td>
</tr>
<tr>
<td>Bad debt write-off</td>
<td></td>
<td></td>
<td></td>
<td>(200)a</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bad debt provision</td>
<td></td>
<td></td>
<td></td>
<td>(200)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Notes receivable</td>
<td>400</td>
<td>150</td>
<td>(250)</td>
<td>(100)b</td>
<td>(150)b</td>
<td></td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Collect inventory note</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Collect plant note</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>1,230</td>
<td>1,375</td>
<td>145</td>
<td>350 g</td>
<td>(205)net</td>
<td></td>
<td>205</td>
<td></td>
</tr>
<tr>
<td>Purchase of Poor Mgt.</td>
<td></td>
<td></td>
<td></td>
<td>(350)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory reduction</td>
<td></td>
<td></td>
<td></td>
<td>(205)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>110</td>
<td>135</td>
<td>25</td>
<td>25 net</td>
<td></td>
<td></td>
<td>25</td>
<td></td>
</tr>
<tr>
<td>Investments</td>
<td>250</td>
<td>275</td>
<td>25</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Earnings of sub</td>
<td></td>
<td></td>
<td></td>
<td>45 I/S</td>
<td></td>
<td></td>
<td>(45)</td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td></td>
<td></td>
<td></td>
<td>(20)c</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed assets</td>
<td>6,460</td>
<td>8,460</td>
<td>2,000</td>
<td></td>
<td>(750)d</td>
<td>750*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sold plant</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proceeds = 600</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net gain on sale</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New facility</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital leases</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase of Poor Mgt.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(2,100)</td>
<td>(2,300)</td>
<td>(200)</td>
<td>230 d</td>
<td></td>
<td></td>
<td>(230)</td>
<td></td>
</tr>
<tr>
<td>Sold plant</td>
<td></td>
<td></td>
<td></td>
<td>(430)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>430</td>
</tr>
<tr>
<td>Intangibles</td>
<td>40</td>
<td>175</td>
<td>135</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>------------</td>
<td>----</td>
<td>-----</td>
<td>-----</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchased patents</td>
<td></td>
<td></td>
<td>80 g (80)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchased goodwill</td>
<td></td>
<td></td>
<td>70 g (70)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization</td>
<td></td>
<td></td>
<td>(15)k</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>8,760</td>
<td>11,875</td>
<td>3,115</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>255 g 255</td>
</tr>
<tr>
<td>Purchase of Poor Mgt.</td>
<td>(250)net (250)</td>
</tr>
<tr>
<td>Reduction of accounts payable</td>
<td>150 j 150</td>
</tr>
<tr>
<td>Deferred taxes</td>
<td>375 525 150</td>
</tr>
<tr>
<td>255 g</td>
<td>(150)j</td>
</tr>
<tr>
<td>Accrued expense</td>
<td>225 275 50</td>
</tr>
<tr>
<td>Interest payable</td>
<td>30 45 15</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>50 85 35</td>
</tr>
<tr>
<td>Short-term debt</td>
<td>450 750 300</td>
</tr>
<tr>
<td>Lease obligation</td>
<td>725 725</td>
</tr>
<tr>
<td>New lease</td>
<td>850 f</td>
</tr>
<tr>
<td>Lease payments</td>
<td>(125)f (125)</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>2,150 2,425 275</td>
</tr>
<tr>
<td>Purchase of Poor Mgt.</td>
<td>375 g 375</td>
</tr>
<tr>
<td>Debt issued</td>
<td>400 i 400</td>
</tr>
<tr>
<td>Stock conversion</td>
<td>(500)o 500</td>
</tr>
<tr>
<td>Stockholders’ equity</td>
<td>2,000 3,000 1,000</td>
</tr>
<tr>
<td>500 o 500</td>
<td></td>
</tr>
<tr>
<td>Stock issued—cash</td>
<td>500 o (500)</td>
</tr>
<tr>
<td>Stock issued—debt</td>
<td>500 o (500)</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,395 2,955 560</td>
</tr>
<tr>
<td>Net income</td>
<td>760 I/S 760</td>
</tr>
<tr>
<td>Dividends</td>
<td>(200)p (200)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>8,760</td>
</tr>
</tbody>
</table>

*750 - 230 + 80 = 600.*

**\((1,175) + 875 + 1,365 = 1,065\)**
Cash Flows From Operating Activities (Indirect Approach)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$760</td>
</tr>
<tr>
<td>Adjustments to reconcile net income to net cash provided by operating activities:</td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>$445</td>
</tr>
<tr>
<td>Provision for losses on accounts receivable</td>
<td>200</td>
</tr>
<tr>
<td>Gain on sale of facility</td>
<td>(80)</td>
</tr>
<tr>
<td>Undistributed earnings of affiliate</td>
<td>(25)</td>
</tr>
<tr>
<td>Receipt on note for sale of inventory</td>
<td>100</td>
</tr>
<tr>
<td>Change in assets and liabilities net effects from purchase of Poor Mgt. Corp.:</td>
<td></td>
</tr>
<tr>
<td>Increase in accounts receivable</td>
<td>(215)</td>
</tr>
<tr>
<td>Decrease in inventory</td>
<td>205</td>
</tr>
<tr>
<td>Increase in prepaid expenses</td>
<td>(25)</td>
</tr>
<tr>
<td>Decrease in accounts payable and accrued expense</td>
<td>(250)</td>
</tr>
<tr>
<td>Increase in interest and income taxes payable</td>
<td>50</td>
</tr>
<tr>
<td>Increase in deferred taxes</td>
<td>150</td>
</tr>
<tr>
<td>Increase in other liabilities</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net cash provided by operating activities</strong></td>
<td><strong>$1,365</strong></td>
</tr>
</tbody>
</table>

Schedule of Operating Activities—Indirect Method

Cash flows from operating activities under the indirect method are presented in Exhibit 15 and total $1,365.

Exhibit 15 shows the following reconciling adjustments in converting net income to net cash provided by operating activities (see case facts on pages 411-413):

- Depreciation and amortization of intangibles (k) is $445.
- Provision for losses (a) is $200. The provision is an amount picked up in income under an accrual based accounting system and is without impact on cash flows from operating activities.
- Gain of $80 is the difference between the proceeds on the plant of $600 and the book value of $520 (d). The pronouncement requires that the investing activity be reported using the proceeds of disposal of property, plant, and equipment. Previously, practice was mixed: Some companies used book value of the disposition as the investing outflow. Accordingly, the gain is added back (that is, removed from operating activities) and included in investing inflows.
• Equity in earnings in excess of dividends has no impact on net cash flows from operating activities.

• A note of $100 on installment sales was collected even though recognized in income in an earlier period (b).

• Changes in assets and liabilities net of acquisition of Poor Mgt. Corp. converts revenues to cash collected on sales, cost of goods sold to purchases, and then to cash payments for merchandise, general, selling, and administrative to cash paid for these activities.

• The adjustments for interest ($35 + $15) and deferred taxes ($150) converts generally accepted accounting principle accruals for interest and taxes to cash paid for interest and taxes.

• The change in net assets attributable to the acquisition of Poor Mgt., net of cash received which was on books of Poor Mgt. is an investing activity (g).

Schedule of Investing Activities

Exhibit 16 presents the schedule of investing activities. The $600 represents the proceeds from the disposition of assets. The investment of $925 in Poor Mgt. is derived as follows:

\[
\begin{align*}
\text{Accounts receivable} & \quad $155 \\
\text{Inventory} & \quad 350 \\
\text{Fixed assets} & \quad 900 \\
\text{Goodwill} & \quad 70 \\
\text{Patents} & \quad 80 \\
\text{Accounts payable} & \quad (255) \\
\text{Noncurrent debt} & \quad (375) \\
\hline
\text{Total} & \quad $925
\end{align*}
\]

The collection on notes receivable attributable to proceeds from a previous sale of plant is also investing related.

Exhibit 16

Winner Corp.

Cash Flows From Investing Activities

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds from sale of facility</td>
<td>$600</td>
</tr>
<tr>
<td>Payment on note for sale of plant</td>
<td>150</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Payment for purchase of Poor Mgt. Corp., net of cash received</td>
<td>(925)</td>
</tr>
<tr>
<td>Net cash used in investing</td>
<td>$(1,175)</td>
</tr>
</tbody>
</table>
Schedule of Financing Activities

Exhibit 17 presents the schedule of financing activities. Following SFAS 95, gross proceeds and payments on borrowings are presented separately. Only the principal payments for leases appear under investing activities; entering into the lease is disclosed in a supplemental note. Dividends paid are financing related, while interest paid and interest received are classified as operating activities. Borrowing under the line of credit is reported at a net amount, which is permitted as an exception under SFAS 95.

Exhibit 17

Winner Corp.
Cash Flows From Financing Activities

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net borrowing from line of credit</td>
<td>$300</td>
</tr>
<tr>
<td>Principal payments under capital lease</td>
<td>(125)</td>
</tr>
<tr>
<td>Proceeds from issuance of long-term debt</td>
<td>400</td>
</tr>
<tr>
<td>Proceeds from issuance of capital stock</td>
<td>500</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>(200)</td>
</tr>
<tr>
<td>Net cash provided by financing activities</td>
<td>$875</td>
</tr>
</tbody>
</table>

Schedule of Operating Cash Flows—Direct Method

Cash from operating activities prepared under the direct method is presented in Exhibit 18. SFAS 95 requires that the following be presented separately: cash collected from customers, interest, and dividend receipts; interest paid; and income taxes paid. Other operating receipts include insurance proceeds. Other cash payments include the settlement of the lawsuit.

Exhibit 18

Winner Corp.
Cash Flows From Operating Activities—Direct Approach

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Exhibit Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from customers</td>
<td>$13,850</td>
<td>18D</td>
</tr>
<tr>
<td>Cash paid to suppliers and employees</td>
<td>(12,000)</td>
<td>18B</td>
</tr>
<tr>
<td>Dividends received from affiliate</td>
<td>20</td>
<td>18E</td>
</tr>
<tr>
<td>Interest received</td>
<td>55</td>
<td>18A</td>
</tr>
<tr>
<td>Interest paid (net of capitalized amount)</td>
<td>(220)</td>
<td>18E</td>
</tr>
<tr>
<td>Income taxes paid</td>
<td>(325)</td>
<td>18E</td>
</tr>
<tr>
<td>Insurance proceeds received</td>
<td>15</td>
<td>18A</td>
</tr>
<tr>
<td>Cash paid to settle lawsuit</td>
<td>(30)</td>
<td>18A</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>$1,365</td>
<td></td>
</tr>
</tbody>
</table>
Derivation

To derive the statement of operating cash flows under the direct method, substitute for net income into the schedule of operating cash flows under the indirect method the components of the income statement as follows (see Exhibit 18A).

Exhibit 18A  Derivation of Direct Method Cash Flows

<table>
<thead>
<tr>
<th>Source</th>
<th>Amount</th>
<th>Exhibit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$13,965</td>
<td>18D</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(10,290)</td>
<td>18B</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(445)*</td>
<td></td>
</tr>
<tr>
<td>Selling, general, and administrative</td>
<td>(1,890)</td>
<td>18C</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(235)</td>
<td>18E</td>
</tr>
<tr>
<td>Equity in earnings of subsidiary</td>
<td>45</td>
<td>18E</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>80**</td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>55</td>
<td>18</td>
</tr>
<tr>
<td>Insurance proceeds</td>
<td>15</td>
<td>18</td>
</tr>
<tr>
<td>Loss from patent infringement</td>
<td>(30)</td>
<td>18</td>
</tr>
<tr>
<td>Provision for taxes</td>
<td>(510)</td>
<td>18E</td>
</tr>
<tr>
<td>Net income</td>
<td>760</td>
<td></td>
</tr>
</tbody>
</table>

Adjustments to reconcile net income to cash
- Depreciation and amortization $445*
- Provision for losses on accounts 200 18C
- Gain on sale of facility (80)**
- Undistributed earnings of affiliate (25) 18E
- Payment on note for sale of inventory 100 18D

Change in assets and liabilities net effects from purchase of Poor Mgt. :
- Increase accounts receivable (215) 18D
- Decrease in inventory 205 18B
- Increase in prepaid expenses (25) 1C
- Decrease in accounts payable (250) 18C
- Increase in interest and income taxes payable 50 18E
- Increase in deferred taxes 150 18E
- Increase in accrued expenses 50 605

Net cash provided by operating activities $1,365

*Offsetting item.
**Offsetting item.
Rearranging the above information contained in Exhibit 18A in the following manner, as derived in Exhibit 18B through Exhibit 18E, yields the operating cash flows under the direct method.

### Exhibit 18B Derivation of Cash Paid to Suppliers

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td>$10,290</td>
</tr>
<tr>
<td>Inventory at beginning of year</td>
<td>(1,230)</td>
</tr>
<tr>
<td>Inventory acquired in purchase of Poor Mgt. Corp.</td>
<td>(350)</td>
</tr>
<tr>
<td>Inventory at end of year</td>
<td>1,375</td>
</tr>
<tr>
<td>Merchandise purchased</td>
<td></td>
</tr>
<tr>
<td>Accounts payable beginning of year</td>
<td>1,085</td>
</tr>
<tr>
<td>Accounts payable acquired in purchase of Poor Mgt. Corp.</td>
<td>255</td>
</tr>
<tr>
<td>Accounts payable end of year</td>
<td>(1,090)</td>
</tr>
<tr>
<td>Cash payments for merchandise</td>
<td>250</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash paid for merchandise</td>
<td>$10,335</td>
</tr>
</tbody>
</table>

### Exhibit 18C Derivation of Cash Paid for General, Administrative, and Selling

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>General and administrative</td>
<td>$1,890</td>
</tr>
<tr>
<td>Provision for uncollectibles</td>
<td>(200)</td>
</tr>
<tr>
<td></td>
<td>1,690</td>
</tr>
<tr>
<td>Accrued liabilities—beginning of year</td>
<td>$225</td>
</tr>
<tr>
<td>Prepaid expenses—beginning of year</td>
<td>(110)</td>
</tr>
<tr>
<td>Accrued liabilities—end of year</td>
<td>(275)</td>
</tr>
<tr>
<td>Prepaid expenses—end of year</td>
<td>135</td>
</tr>
<tr>
<td></td>
<td>(25)</td>
</tr>
<tr>
<td>Cash paid for general, administrative, and selling</td>
<td>$1,665</td>
</tr>
</tbody>
</table>

**Note:** Cash paid to suppliers and employees during year is $12,000 ($1,665 + $10,335).
Exhibit 18D  Derivations of Cash Received from Customers

Cash Received From Customers During the Year:
Customer sales $13,965
Collection of installment payment for sale of inventory 100
Gross accounts receivable at beginning of year $2,370
Accounts receivable acquired in purchase of Company 5 155
Accounts receivable written off (350)
Gross accounts receivable at end of year (2,390)
Excess of new accounts receivable over collections from customers (215)
Cash received from customers during the year $13,850

Exhibit 18E  Other Derivations

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity earnings</td>
<td>$45</td>
</tr>
<tr>
<td>Undistributed earnings of affiliate</td>
<td>(25)</td>
</tr>
<tr>
<td>Dividends received from affiliate</td>
<td>$20</td>
</tr>
<tr>
<td>Interest expense</td>
<td>$235</td>
</tr>
<tr>
<td>Interest payable</td>
<td>(15)</td>
</tr>
<tr>
<td>Interest paid</td>
<td>$220</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>$510</td>
</tr>
<tr>
<td>Deferred taxes</td>
<td>(150)</td>
</tr>
<tr>
<td>Taxes payable</td>
<td>(35)</td>
</tr>
<tr>
<td>Taxes paid</td>
<td>$325</td>
</tr>
</tbody>
</table>

Noncash Activities and Supplemental Schedule Under Direct Method

The supplemental schedule for noncash activities and the additional reconciliation of net income to net cash from operating activities under the direct method is shown in Exhibit 19. This could be omitted under the indirect method; then, disclosure of cash paid for interest net of amounts capitalized and amounts paid for income taxes would be separately disclosed.
Reconciliation of Net Income to Net Cash Provided by Operating Activities:

Winner Corp.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$ 760</td>
</tr>
<tr>
<td>Adjustments to reconcile net income to net cash</td>
<td></td>
</tr>
<tr>
<td>provided by operating activities:</td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>$445</td>
</tr>
<tr>
<td>Provision for losses on accounts receivable</td>
<td>200</td>
</tr>
<tr>
<td>Gain on sale of facility</td>
<td>(80)</td>
</tr>
<tr>
<td>Undistributed earnings of affiliate</td>
<td>(25)</td>
</tr>
<tr>
<td>Payment received on installment note receivable for sale of inventory</td>
<td>100</td>
</tr>
<tr>
<td>Change in assets and liabilities net of effects from purchase of Poor Mgt. Corp.</td>
<td></td>
</tr>
<tr>
<td>Increase in accounts receivable</td>
<td>(215)</td>
</tr>
<tr>
<td>Decrease in inventory</td>
<td>205</td>
</tr>
<tr>
<td>Increase in prepaid expenses</td>
<td>(25)</td>
</tr>
<tr>
<td>Decrease in accounts payable and accrued expenses</td>
<td>(250)</td>
</tr>
<tr>
<td>Increase in interest and income taxes payable</td>
<td>50</td>
</tr>
<tr>
<td>Increase in deferred taxes</td>
<td>150</td>
</tr>
<tr>
<td>Increase in other liabilities</td>
<td>50</td>
</tr>
<tr>
<td>Total adjustments</td>
<td>605</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>$1,365</td>
</tr>
</tbody>
</table>

Supplemental Schedule of Noncash Investing and Financing Activities:

Winner Corp. purchased all of the capital stock of Poor Mgt. Corp. for $950. In conjunction with the acquisition, liabilities were assumed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of assets acquired</td>
<td>$1,580</td>
</tr>
<tr>
<td>Cash paid for the capital stock</td>
<td>(950)</td>
</tr>
<tr>
<td>Liabilities assumed</td>
<td>$ 630</td>
</tr>
</tbody>
</table>

Capital lease obligation of $850 was incurred when Winner Corp. entered into a lease for new equipment.

Additional common stock was issued upon the conversion of $500 of long-term debt.

Disclosure of Accounting Policy:

For purposes of the statement of cash flows, Winner Corp. considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

Appendix A for this chapter provides samples of the statement of cash flows using both the direct and indirect methods for Winner
Accounting for Cash Flows

Corp. Appendix B illustrates the application of SFAS 95 as amended to a financial institution.

**Case 2. Inactive Overseas Company—Modifications in reporting guidance**

Inactive Overseas Company, a foreign subsidiary whose functional currency is the foreign currency (FC), had little activity in 19X7. In fact, the only event occurring was the sale of land on June 30, 19X7, for 20FC, which was at the book value.

*Other Information:*

Cash January 1, 19X7: (FC) 100
Cash December 31, 19X7: (FC) 120

Exchange rates from FC to U.S. dollars were .12 at January 1, 19X7, .13 at June 30, 19X7, and .15 at December 31, 19X7.

When preparing the statement of cash flows the dollar amount used in reporting sale of land and exchange rate gain or loss is as follows:

### Dollar Amount for Reporting Sale of Land

<table>
<thead>
<tr>
<th>Under SFAS 95, companies would report as follows:</th>
<th>Foreign Currency</th>
<th>Exchange Rate</th>
<th>Translated Amount (Amount Reported)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investing activities: Cash from sale of land</td>
<td>20FC</td>
<td>.13</td>
<td>$2.60</td>
</tr>
<tr>
<td>Exchange gain</td>
<td></td>
<td></td>
<td>$3.40</td>
</tr>
</tbody>
</table>

Prior to SFAS 95, SFAS 52, *Foreign Currency Translation*, provided no guidance for the preparation of the statement of changes in financial position. One solution that had been used in practice is as follows:

### Exchange Rate Gain or Loss

<table>
<thead>
<tr>
<th>Investing activities: Cash from sale of land</th>
<th>Foreign Currency</th>
<th>Exchange Rate</th>
<th>Translated Amount (Amount Reported)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20FC</td>
<td>.15</td>
<td>$3.00</td>
</tr>
<tr>
<td>Exchange gain</td>
<td></td>
<td></td>
<td>$3.00</td>
</tr>
</tbody>
</table>
The $3 exchange gain presented under past practice was calculated by holding $100 over the entire year ($100) (.15-.12). SFAS 95 translates cash inflows and outflows using the exchange rate at the date of the transaction: 20FC (.13). Accordingly, the exchange gain of $3.40 is calculated as the sum of the exchange gain from holding 100 FC for the year and 20 FC for half a year: 100FC (.15-.12) + 20FC (.15-.13). The exchange gain must be identified separately in the statement of cash flows.

**SFAS 102, STATEMENT OF CASH FLOWS—EXEMPTION OF CERTAIN ENTERPRISES AND CLASSIFICATION OF CASH FLOWS FROM CERTAIN SECURITIES ACQUIRED FOR RESALE**

The statement exempts defined benefit plans covered by SFAS 35, *Accounting and Reporting by Defined Benefit Plans*, and certain other employee benefit plans and highly liquid investment companies that meet specified conditions from the requirements of SFAS 95. SFAS 102 also requires that cash receipts and cash payments resulting from acquisitions and sales of securities and other assets that are acquired specifically for resale and are carried at market value or the lower of cost or market value be classified as operating cash flows in the statement of cash flows.

As of July 25, 1989, an exposure draft has been released that would require cash flows resulting from a futures contract, forward contract, or option contract that is accounted for as a hedge of an identifiable transaction or event to be classified consistent with the cash flows from the item being hedged. Cash flows from an instrument that is not accounted for as a hedge or from an instrument that does not hedge an identifiable transaction or event should be classified based on the nature of the instrument.
APPENDIX A

Presenting Winner Corp.
Statement of Cash Flows

DIRECT METHOD

Winner Corp.
Consolidated Statement of Cash Flows
for the Year Ended December 31, 19X1

Increase (Decrease) in Cash and Cash Equivalents—Direct Method

<table>
<thead>
<tr>
<th>Cash Flows From Operating Activities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from customers</td>
<td>$13,850</td>
</tr>
<tr>
<td>Cash paid to suppliers and employees</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Dividend received from affiliate</td>
<td>20</td>
</tr>
<tr>
<td>Interest received</td>
<td>55</td>
</tr>
<tr>
<td>Interest paid (net of amount capitalized)</td>
<td>(220)</td>
</tr>
<tr>
<td>Income taxes paid</td>
<td>(325)</td>
</tr>
<tr>
<td>Insurance proceeds received</td>
<td>15</td>
</tr>
<tr>
<td>Cash paid to settle lawsuit for patent infringement</td>
<td>(30)</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>$1,365</td>
</tr>
</tbody>
</table>

Cash Flows From Investing Activities:

| Proceeds from sale of facility                             | 600 |
| Payment received on note for sale of plant                 | 150 |
| Capital expenditures                                       | (1,000) |
| Payment for purchase of Poor Mgt. Corp., net of cash acquired | (925) |
| Net cash used in investing activities                       | (1,175) |

Cash Flows From Financing Activities:

| Net borrowings under line-of-credit agreement               | 300 |
| Principal payments under capital lease obligation           | (125) |
| Proceeds from issuance of long-term debt                    | 400 |
| Proceeds from issuance of common stock                      | 500 |
| Dividends paid                                              | (200) |
| Net cash provided by financing activities                   | 875 |

(continued)

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(continued)

Net increase in cash and cash equivalents $1,065
Cash and cash equivalents at beginning of year 600
Cash and cash equivalents at end of year $1,665

Reconciliation of Net Income to Net Cash Provided by Operating Activities:

Net income $ 760

Adjustments to reconcile net income to net cash provided by operating activities:

Depreciation and amortization $445
Provision for losses on accounts receivable 200
Gain on sale of facility (80)
Undistributed earnings of affiliate (25)
Payment received on installment note receivable for sale of inventory 100

Change in assets and liabilities net of effects from purchase of Poor Mgt. Corp.

Increase in accounts receivable (215)
Decrease in inventory 205
Increase in prepaid expenses (25)
Decrease in accounts payable and accrued expenses (250)
Increase in interest and income taxes payable 50
Increase in deferred taxes 150
Increase in other liabilities 50

Total adjustments 605

Net cash provided by operating activities $1,365

Supplemental Schedule of Noncash Investing and Financing Activities:

Winner Corp. purchased all of the capital stock of Poor Mgt. Corp. for $950. In conjunction with the acquisition, liabilities were assumed as follows:

Fair value of assets acquired $1,580
Cash paid for the capital stock (950)
Liabilities assumed $ 630

A capital lease obligation of $850 was incurred when Winner Corp. entered into a lease for new equipment.

Additional common stock was issued upon the conversion of $500 of long-term debt.
Accounting for Cash Flows

Disclosure of Accounting Policy:
For purposes of the statement of cash flows, Winner Corp. considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

INDIRECT METHOD

Winner Corp.
Consolidated Statement of Cash Flows
for the Year Ended December 31, 19X1
Increase/Decrease in Cash and Cash Equivalents: Indirect Method

<table>
<thead>
<tr>
<th>Cash Flows From Operating Activities:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
</tr>
<tr>
<td>Adjustments to reconcile net income to net cash provided by operating activities:</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
</tr>
<tr>
<td>Provision for losses on accounts receivable</td>
</tr>
<tr>
<td>Gain on sale of facility</td>
</tr>
<tr>
<td>Undistributed earnings of affiliate</td>
</tr>
<tr>
<td>Payment received on installment note receivable for sale of inventory</td>
</tr>
<tr>
<td>Change in assets and liabilities net of effects from purchase of Poor Mgt. Corp.</td>
</tr>
<tr>
<td>Increase in accounts receivable</td>
</tr>
<tr>
<td>Decrease in inventory</td>
</tr>
<tr>
<td>Increase in prepaid expenses</td>
</tr>
<tr>
<td>Decrease in accounts payable and accrued expenses</td>
</tr>
<tr>
<td>Increase in interest and income taxes payable</td>
</tr>
<tr>
<td>Increase in deferred taxes</td>
</tr>
<tr>
<td>Increase in other liabilities</td>
</tr>
<tr>
<td>Total adjustments</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
</tr>
</tbody>
</table>

Cash Flows From Investing Activities:

| Proceeds from sale of facility         | 600  |
| Payment received on note for sale of plant | 150  |
| Capital expenditures                   | (1,000)|
| Payment for purchase of Poor Mgt. Corp., net of cash acquired | (925) |
| Net cash used in investing activities  | (1,175) |

(continued)
Cash Flows From Financing Activities:

Net borrowings under line-of-credit agreement $300
Principal payments under capital lease obligation (125)
Proceeds from issuance of long-term debt 400
Proceeds from issuance of common stock 500
Dividends paid (200)

Net cash provided by financing activities $ 875
Net increase in cash and cash equivalents 1,065
Cash and cash equivalents at beginning of year 600
Cash and cash equivalents at end of year $1,665

Supplemental Disclosures of Cash Flow Information:
Cash paid during the year for:
Interest (net of amount capitalized) $220
Income taxes 325

Supplemental Schedule of Noncash Investing and Financing Activities:
Winner Corp. purchased all of the capital stock of Poor Mgt. Corp. for $950. In conjunction with the acquisition, liabilities were assumed as follows:

Fair value of assets acquired $1,580
Cash paid for the capital stock (950)
Liabilities assumed $ 630

A capital lease obligation of $850 was incurred when Winner Corp. entered into a lease for new equipment.

Additional common stock was issued upon the conversion of $500 of long-term debt.

Disclosure of Accounting Policy:
For purposes of the statement of cash flows, Winner Corp. considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.
APPENDIX B
Application of SFAS 95
to a Financial Institution

Presented below is a statement of cash flows for Financial Institution, Inc., a U.S. Corporation that provides a broad range of services. The statement illustrates the direct method of presenting cash flows from operating activities.

**FINANCIAL INSTITUTION, INC.**
**STATEMENT OF CASH FLOWS**
**FOR THE YEAR ENDED DECEMBER 31, 19X1**
*Increase (Decrease) in Cash and Cash Equivalents*

<table>
<thead>
<tr>
<th>Cash Flows From Operating Activities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest received</td>
<td>$ 5,350</td>
</tr>
<tr>
<td>Fees and commissions received</td>
<td>1,320</td>
</tr>
<tr>
<td>Proceeds from sales of trading securities</td>
<td>20,550</td>
</tr>
<tr>
<td>Purchase of trading securities</td>
<td>(21,075)</td>
</tr>
<tr>
<td>Financing revenue received under leases</td>
<td>60</td>
</tr>
<tr>
<td>Interest paid</td>
<td>(3,925)</td>
</tr>
<tr>
<td>Cash paid to suppliers and employees</td>
<td>(795)</td>
</tr>
<tr>
<td>Income taxes paid</td>
<td>(471)</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>$ 1,014</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash Flows From Investing Activities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds from sales of investment securities</td>
<td>2,225</td>
</tr>
<tr>
<td>Purchase of investment securities</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Net increase in credit card receivables</td>
<td>(1,300)</td>
</tr>
<tr>
<td>Net decrease in customer loans with maturities of 3 months or less</td>
<td>2,250</td>
</tr>
<tr>
<td>Principal collected on longer term loans</td>
<td>26,550</td>
</tr>
<tr>
<td>Longer term loans made to customers</td>
<td>(36,300)</td>
</tr>
<tr>
<td>Purchase of assets to be leased</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Principal payments received under leases</td>
<td>107</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>(450)</td>
</tr>
<tr>
<td>Proceeds from sale of property, plant, and equipment</td>
<td>260</td>
</tr>
<tr>
<td>Net cash used in investing activities</td>
<td>(12,158)</td>
</tr>
</tbody>
</table>

(continued)
Cash Flows From Financing Activities:

Net increase in demand deposits, NOW accounts, and savings accounts $3,000
Proceeds from sales of certificates of deposit 63,000
Payments for maturing certificates of deposit (61,000)
Net increase in federal funds purchased 4,500
Net increase in 90-day borrowings 50
Proceeds from issuance of nonrecourse debt 600
Principal payment on nonrecourse debt (20)
Proceeds from issuance of 6-month note 100
Proceeds from issuance of long-term debt 1,000
Repayment of long-term debt (200)
Proceeds from issuance of common stock 350
Payments to acquire treasury stock (175)
Dividends paid (240)

Net cash provided by financing activities $10,965
Net decrease in cash and cash equivalents (179)
Cash and cash equivalents at beginning of year 6,700
Cash and cash equivalents at end of year $6,521

Reconciliation of net income to net cash provided by operating activities:

Net income $1,056

Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:

Depreciation $100
 Provision for probable credit losses 300
 Provision for deferred taxes 58
 Loss on sales of investment securities 75
 Gain on sale of equipment (50)
 Increase in trading securities (including unrealized appreciation of $25) (700)
 Increase in taxes payable 175
 Increase in interest receivable (150)
 Increase in interest payable 75
 Decrease in fees and commissions receivable 20
 Increase in accrued expenses

Total adjustments (42)

Net cash provided by operating activities $1,014

Summarized on the following pages is financial information for the current year for Financial Institution, Inc., which provides the basis for the statement of cash flows.
# FINANCIAL INSTITUTION, INC.

## STATEMENT OF FINANCIAL POSITION

<table>
<thead>
<tr>
<th></th>
<th>January 1, 19X1</th>
<th>December 31, 19X1</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and due from banks</td>
<td>$4,400</td>
<td>$3,121</td>
<td>$(1,279)</td>
</tr>
<tr>
<td>Federal funds sold</td>
<td>2,300</td>
<td>3,400</td>
<td>1,100</td>
</tr>
<tr>
<td>Total cash and cash equivalents</td>
<td>6,700</td>
<td>6,521</td>
<td>(179)</td>
</tr>
<tr>
<td>Trading securities</td>
<td>4,000</td>
<td>4,700</td>
<td>700</td>
</tr>
<tr>
<td>Investment securities</td>
<td>5,000</td>
<td>6,700</td>
<td>1,700</td>
</tr>
<tr>
<td>Credit card receivables</td>
<td>8,500</td>
<td>9,800</td>
<td>1,300</td>
</tr>
<tr>
<td>Loans</td>
<td>28,000</td>
<td>35,250</td>
<td>7,250</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>(800)</td>
<td>(850)</td>
<td>(50)</td>
</tr>
<tr>
<td>Interest receivable</td>
<td>600</td>
<td>750</td>
<td>150</td>
</tr>
<tr>
<td>Fees and commissions receivable</td>
<td>60</td>
<td>40</td>
<td>(20)</td>
</tr>
<tr>
<td>Investment in direct financing lease</td>
<td>—</td>
<td>421</td>
<td>421</td>
</tr>
<tr>
<td>Investment in leveraged lease</td>
<td>—</td>
<td>392</td>
<td>392</td>
</tr>
<tr>
<td>Property, plant, and equipment, net</td>
<td>525</td>
<td>665</td>
<td>140</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$52,585</td>
<td>$64,389</td>
<td>$11,804</td>
</tr>
<tr>
<td><strong>Liabilities:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deposits</td>
<td>$38,000</td>
<td>$43,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Federal funds purchased</td>
<td>7,500</td>
<td>12,000</td>
<td>4,500</td>
</tr>
<tr>
<td>Short-term borrowings</td>
<td>1,200</td>
<td>1,350</td>
<td>150</td>
</tr>
<tr>
<td>Interest payable</td>
<td>350</td>
<td>425</td>
<td>75</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>275</td>
<td>330</td>
<td>55</td>
</tr>
<tr>
<td>Taxes payable</td>
<td>75</td>
<td>250</td>
<td>175</td>
</tr>
<tr>
<td>Dividends payable</td>
<td>—</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>2,000</td>
<td>2,300</td>
<td>300</td>
</tr>
<tr>
<td>Deferred taxes</td>
<td>—</td>
<td>58</td>
<td>58</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>$49,400</td>
<td>$59,793</td>
<td>$10,393</td>
</tr>
<tr>
<td><strong>Stockholders’ equity:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>1,250</td>
<td>2,100</td>
<td>850</td>
</tr>
<tr>
<td>Treasury stock</td>
<td>—</td>
<td>(175)</td>
<td>(175)</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,935</td>
<td>2,671</td>
<td>736</td>
</tr>
<tr>
<td><strong>Total stockholders’ equity</strong></td>
<td>3,185</td>
<td>4,596</td>
<td>1,411</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders’ equity</strong></td>
<td>$52,585</td>
<td>$64,389</td>
<td>$11,804</td>
</tr>
</tbody>
</table>
**FINANCIAL INSTITUTION, INC.**
**STATEMENT OF OPERATIONS**
**FOR THE YEAR ENDED DECEMBER 31, 19X1**

Revenues:
- Interest income $5,500
- Fees and commissions 1,300
- Net gain on sales of trading and investment securities 75
- Unrealized appreciation of trading securities 25
- Lease income 60
- Gain on sale of equipment 50
  
  **Total revenues** $7,010

Expenses:
- Interest expense 4,000
- Provision for probable credit losses 300
- Operating expenses 850
- Depreciation 100
  
  **Total expenses** 5,250

Income before income taxes 1,760
Provision for income taxes 704

Net income $1,056

The following transactions of Financial Institution, Inc., were entered into in 19X1 and are reflected in the foregoing statements.

a. Financial Institution sold trading securities with a carrying value of $20,400 for $20,550 and purchased trading securities for $21,075. Financial Institution recorded unrealized appreciation of trading securities of $25. Financial Institution also sold investment securities with a carrying value of $2,300 for $2,225 and purchased investment securities for $4,000.

b. Financial Institution had a net decrease in short-term loans receivable (those with original maturities of 3 months or less) of $2,250. Financial Institution made longer term loans of $36,300 and collected $26,550 on those loans. Financial Institution wrote off $250 of loans as uncollectible.

c. Financial Institution purchased property for $500 to be leased under a direct financing lease. The first annual rental payment of $131 was collected. The portion of the rental payment representing interest income totaled $52.
d. Financial Institution purchased equipment for $1,000 to be leased under a leveraged lease. The cost of the leased asset was financed by an equity investment of $400 and a long-term non-recourse bank loan of $600. The first annual rental payment of $90, of which $28 represented principal, was collected, and the first annual loan installment of $74, of which $20 represented principal, was paid. Pretax income of $8 was recorded.

e. Financial Institution purchased new property, plant, and equipment for $450 and sold property, plant, and equipment with a book value of $210 for $260.

f. Customer deposits with Financial Institution consisted of the following:

<table>
<thead>
<tr>
<th></th>
<th>1/1/XI</th>
<th>12/31/XI</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Demand deposits</td>
<td>$8,000</td>
<td>$8,600</td>
<td>$600</td>
</tr>
<tr>
<td>NOW accounts and savings accounts</td>
<td>15,200</td>
<td>17,600</td>
<td>2,400</td>
</tr>
<tr>
<td>Certificates of deposit</td>
<td>14,800</td>
<td>16,800</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>Total deposits</strong></td>
<td><strong>$38,000</strong></td>
<td><strong>$43,000</strong></td>
<td><strong>$5,000</strong></td>
</tr>
</tbody>
</table>

Sales of certificates of deposit during the year totaled $63,000; certificates of deposit with principal amounts totaling $61,000 matured. For presentation in the statement of cash flows, Financial Institution chose to report gross cash receipts and payments for both certificates of deposit with maturities of three months or less and those with maturities of more than three months.

g. Short-term borrowing activity for Financial Institution consisted of repayment of a $200 90-day note and issuance of a 90-day note for $250 and a 6-month note for $100.

h. Financial Institution repaid $200 of long-term debt and issued 5-year notes for $600 and 10-year notes for $400.

i. Financial Institution issued $850 of common stock, $500 of which was issued upon conversion of long-term debt and $350 of which was issued for cash.

j. Financial Institution acquired $175 of treasury stock.

k. Financial Institution declared dividends of $320. The fourth quarter dividend of $80 was payable the following January.
1. Financial Institution’s provision for income taxes included a deferred provision of $58.

m. In accordance with paragraph 7, footnote 1, of this Statement [SFAS 95], interest paid includes amounts credited directly to demand deposit, NOW, and savings accounts.
CHAPTER 9
Real Estate Sale-Leasebacks Under FASB Statement No. 98

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INTRODUCTION

Inconsistent Accounting Practices

Practices of accounting for sale-leaseback transactions involving real estate have varied, in part, because of differing interpretations of paragraph 40 of FASB Statement (SFAS) No. 66, Accounting for Sales of Real Estate.

*The sale of the property is accompanied by a leaseback to the seller of all or any part of the property for all or part of its remaining economic life. Real estate sale and leaseback transactions shall be accounted for in accordance with the provisions of this Statement and FASB Statements No. 13, Accounting for Leases, and 28, Accounting for Sales With Leasebacks. Statement 13, as amended by Statement 28, provides criteria for determining if a leaseback is a capital lease or an operating lease. If the leaseback is a capital lease, the seller-lessee shall record an asset and an obligation as prescribed by Statement 13. Regardless of whether the leaseback is a capital lease or an operating lease, a sale shall be recorded, and the property sold and any related debt assumed by the buyer shall be removed from the seller-lessee’s balance sheet. The criteria in this Statement then shall be used to determine the amount of profit that would be recognized at the date of sale, absent the leaseback provisions. The profit so determined shall be accounted for in accordance with the provisions of Statements 13 and 28 (usually deferred and amortized over the term of the lease) unless other provisions of this Statement require postponement of profit recognition until a later event.*

Irrespective of the terms of the sale-leaseback agreement, some have accounted for sale-leaseback transactions solely under the pro-
visions of SFAS 13, _Accounting for Leases_, as amended by SFAS 28, _Accounting for Sales With Leasebacks_. Others have determined first whether sale-leaseback transactions comply with the criteria of SFAS 66 for sales recognition. If they do not, the transaction is accounted for either as a “financing” or as a “deposit,” depending on the terms of the transaction. SFAS 98, issued in May 1988, is designed to eliminate this inconsistency.

**New Approach Under SFAS 98**

A sale-leaseback transaction that involves _real estate_ including _real estate with equipment_ must now be accounted for under SFAS 98, _Accounting for Leases: Sale and Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases_, which amends SFAS 13 and SFAS 66, among others. If a transaction does not involve real estate, it continues to be accounted for under the provisions of SFAS 28.

The procedure for accounting for a sale-leaseback transaction that involves real estate or real estate with equipment under SFAS 98 is described in greater detail below.

**Sale Consummation.** Before the seller-lessee can account for the transaction as a sale, it must be determined whether the terms of the sale comply with the provisions of SFAS 66. Essentially, the transaction must be consummated for it to be considered a sale. Consummation under SFAS 66, paragraph 6, requires that—

- The parties are bound by the terms of a contract.
- All consideration has been exchanged.
- Any permanent financing for which the seller is responsible has been arranged.
- All conditions precedent to closing have been performed.

Note that the consummation of a sale under SFAS 66 would generally provide for the transfer of title to the buyer. SFAS 13 allows a sale to be recognized in a sales-type lease of real estate even if title is never transferred, provided that the transaction qualifies for full accrual method of profit recognition. SFAS 98 eliminates this incon-
sistency by requiring the transfer of title to the buyer for a transac-
tion to qualify as a sales-type lease of real estate.

**Sale Consummated and Full Accrual.** If a sale has been consum-
mated, recognition of profit under the full accrual method would
require that—

- The buyer’s initial and continuing investments are adequate to
demonstrate a commitment to pay for the property (SFAS 66,
paragraphs 6 through 18).
- The seller’s receivable is not subject to future subordination
(SFAS 66, paragraph 17).
- The seller has transferred to the buyer the usual risks and
rewards of ownership in a transaction that is in substance a sale
and does not have a substantial continuing involvement with the
property (SFAS 66, paragraph 18).

**Sale Not Consummated.** If a sale has not been consummated, the
sale-leaseback would be accounted for as a deposit (SFAS 66, para-
graph 20).

**Sale Consummated With Continuing Involvement—No Gain Rec-
ognition.** If the sale has been consummated but the seller-lessee has a
substantial continuing involvement with the property, other than the
leaseback agreement under which the lessee intends to occupy the
property from the inception of the lease,* the proper accounting
would be either the deposit or financing method under SFAS 66. The
term *continuing involvement* is discussed below.

**Sale Consummated With No Continuing Involvement—Leaseback
Minor.** If the sale has been consummated and the seller-lessee has no
continuing involvement in the property, the gain on the sale is recog-
nized immediately as long as the leaseback is considered minor
(SFAS 28, paragraph 3a). The use of the property would be consid-
ered minor if the present value of a reasonable amount of rental for

---

*The existence of a clause in the lease that permits subleasing of the property would
not preclude sale-leaseback accounting if it was the intent of the seller-lessee
to actively use the property for the duration of the lease at the date of the
transaction.
the leaseback represents 10 percent or less of the fair value of the asset sold. The amount of the gain would be determined under the provisions of SFAS 66.

Sale Consummated With No Continuing Involvement—Leaseback Not Minor. If a sale has been consummated, the seller-lessee has no continuing involvement, and the leaseback is not minor, the gain on sale would be deferred and amortized over the term of the leaseback, as long as the gain on the sale does not exceed the present value of the minimum lease payments for an operating lease or the value of the recorded asset for a capital lease.

If the gain on the sale exceeds the present value of the minimum lease payments, the excess is recognized in income currently.

FINANCING METHOD

Under the financing method, the asset is retained in the seller-lessee's balance sheet and continues to be depreciated. The sale's proceeds received by the seller-lessee are reported as a liability. Lease payments by the seller-lessee are treated as a combination of interest expense and a reduction of the liability. Collections of principal and interest on the buyer-lessor's obligation are treated as an increase in the liability. The financing method is required when the seller-lessee guarantees a return of the buyer's investment for an extended period of time.

Subsequent Qualification for Sales Recognition

Upon subsequent qualification for sales recognition, the transaction is recorded using sale-leaseback accounting. The cumulative change in the related balance sheet accounts is included in the computation of the gain recognized, in accordance with SFAS 98, paragraph 27. The leaseback is classified and accounted for as if the sale had been recognized at the inception of the lease, in accordance with SFAS 13. Cases A and B illustrate application of SFAS 98.
ILLUSTRATIONS OF SALE-LEASEBACK TRANSACTIONS

Case A. Sale-leaseback transaction (all cash) accounted for as a financing with subsequent sales recognition

- Company A sells a manufacturing facility (land and building) to a buyer-lessee at fair value of $950,000.
- Company A's leaseback for five years at a rental of $100,000 a year includes an option to renew for five years at $110,000, fair value.
- There is a fair value repurchase option during the initial term.
- Seller-lessee guarantees a residual of $950,000 at the end of the first five years.
- The property costs $1,200,000. Accumulated depreciation is $400,000, and the useful life is 15 years. Annual depreciation is $80,000.
- The transaction is accounted for as a financing because of the continuing involvement of the seller-lessee, as evidenced by the guarantee and repurchase option.
- Assume that the seller-lessee vacates the property at the end of the first five years. Assume that at that time the guarantee requires a payment to the buyer-lessee of $35,000.

In Case A, the transaction is recorded as follows:

<table>
<thead>
<tr>
<th>Date of sale</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>950,000</td>
</tr>
<tr>
<td>Finance obligation (proceeds of sale)</td>
<td>950,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Annual entries, Years 1 through 5</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expense</td>
<td>80,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>80,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>100,000</td>
</tr>
<tr>
<td>Cash</td>
<td>100,000</td>
</tr>
</tbody>
</table>

These illustrations are derived and adapted with permission from FASB Statement No. 98, Accounting for Leases, May 1988, © 1988 by the Financial Accounting Standards Board.
Note: The effective yield on an obligation of $950,000, with payments of $100,000 a year for five years, and a residual payment of $950,000 is 10.5263 percent. Each annual rental payment of $100,000 exactly equals the annual interest on the debt ($950,000 × 10.5263 percent). Therefore, there is no amortization until the last payment of $950,000.

Seller-lessee vacates property at end of Year 5. The sale is recorded as follows:

End of Year 5
Finance obligation 950,000
Accumulated depreciation 800,000
   Property 1,200,000
   Cash (guarantees) 35,000
   Gain on sale of property 515,000

The gain is determined as follows:
Sales price $950,000
Cost less accumulated depreciation 400,000
   Residual guarantees payment 35,000
   Gain on sale $515,000

Case B. Sale-leaseback transaction (seller-lessee provides financing) accounted for as a financing with subsequent sales recognition and the leaseback classified as an operating lease

- Company B sells its manufacturing facility to a buyer-lessee for $950,000, its fair value.
- Seller-lessee receives $50,000 and a 10-year $900,000 recourse note with a 10-percent annual interest rate.
- Company B's leaseback for five years at a rental of $100,000 a year includes a renewal for five years at $100,000, fair value.
- There is a fair value repurchase option during the initial term.
- Seller-lessee guarantees a residual of $920,000 at the end of the first of five years.
• The building cost $3,510,000, and accumulated depreciation at date of sale-leaseback is $2,660,000. Annual depreciation is $70,000.

• Seller-lessee accounts for the transaction as a financing because of continuing involvement in the guarantee and the repurchase options.

• At the end of the initial term of the lease, the seller-lessee exercises the renewal option, and the guarantee and repurchase options lapse.

• At the end of the initial term of the lease, the seller-lessee recognizes the transaction as a sale and as an operating lease.

The transaction is recorded as follows:

**Date of sale**

<table>
<thead>
<tr>
<th>Cash</th>
<th>50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance obligation</td>
<td>50,000</td>
</tr>
<tr>
<td>(Receipt of down payment)</td>
<td></td>
</tr>
</tbody>
</table>

**Annual entries, Years 1 through 5 (recurring)**

<table>
<thead>
<tr>
<th>Cash</th>
<th>146,471</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance obligation</td>
<td>146,471</td>
</tr>
<tr>
<td>(Receipt from buyer-lessee of principal and interest on a $900,000 10-year note with interest at 10 percent)</td>
<td></td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>70,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>70,000</td>
</tr>
<tr>
<td>(To record depreciation)</td>
<td></td>
</tr>
</tbody>
</table>

**Annual entries (nonrecurring amounts)**

**Year 1**

<table>
<thead>
<tr>
<th>Finance obligation</th>
<th>94,972</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>5,028</td>
</tr>
<tr>
<td>Cash</td>
<td>100,000</td>
</tr>
</tbody>
</table>

To record lease payments by the seller-lessee that are treated as amortization of the finance obligation with interest expense calculated under the interest method using an effective yield of 10.0562 percent and the guaranteed residual of $920,000 as the last payment. See Table 1 for corresponding amounts for Years 2 through 5. The balance of the finance obligation at the end of Year 5 is $364,760.
### Table 1

**Seller-Lessee**

**Table of Finance Obligation**

<table>
<thead>
<tr>
<th>At lease inception</th>
<th>End of Year</th>
<th>Cash Received From Buyer-Lessor</th>
<th>Annual $100,000 Cash Payment to Buyer-Lessor</th>
<th>Balance of Finance Obligation*</th>
</tr>
</thead>
<tbody>
<tr>
<td>50,000</td>
<td>50,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>146,471</td>
<td>94,972</td>
<td>5,028</td>
<td>101,499</td>
</tr>
<tr>
<td>2</td>
<td>146,471</td>
<td>89,793</td>
<td>10,207</td>
<td>158,177</td>
</tr>
<tr>
<td>3</td>
<td>146,471</td>
<td>84,093</td>
<td>15,907</td>
<td>220,555</td>
</tr>
<tr>
<td>4</td>
<td>146,471</td>
<td>77,820</td>
<td>22,180</td>
<td>289,206</td>
</tr>
<tr>
<td>5</td>
<td>146,471</td>
<td>70,917</td>
<td>29,083</td>
<td>364,760</td>
</tr>
<tr>
<td></td>
<td></td>
<td>417,595</td>
<td>82,405</td>
<td></td>
</tr>
</tbody>
</table>

**Note:** Annual payments of $100,000 to the buyer-lessor amortize principal and cover interest expense. Journal entries for each year are as indicated in the columns for cash paid to buyer-lessor.

*Collection on the buyer-lessor’s note net of payments on the lease applied to the finance obligation account.

**Interest rate is 10.0562 percent.**

**Recognition of Sale.** At the end of Year 5 the gain is determined as follows:

- **Sales price**
  - $950,000
- **Book value of property (end of Year 5)**
  - $500,000
  - $450,000

**Adjustment required by SFAS 98:**

- **Rent charged to finance obligation**
  - Years 1 through 5
  - $(500,000)
- **Interest expense charged to income in Years 1 through 5**
  - 82,405
- **Interest income credited to the finance obligation Years 1 through 5**
  - (See Table 2)
  - 387,595
- **Total gain to be recognized**
  - $420,000
Journal entry to record gain at end of Year 5

Finance obligation (Table 1) 364,760
Note receivable (Table 2) 555,240
Accumulated depreciation 3,010,000
Property and equipment 3,510,000
Deferred gain 385,940
Gain on sale 34,060

The total gain of $420,000 exceeds by $34,060 the present value of the future minimum lease payments for the operating lease discounted at the seller-lessee’s incremental borrowing rate assumed to be 9.301595 percent. Therefore, under SFAS 98, the excess is taken into income. The remainder is deferred and amortized over the life of the lease at $77,188 per year.

Table 2

<table>
<thead>
<tr>
<th>Gross Note Receivable*</th>
<th>Interest Deferred</th>
<th>Net Note Receivable**</th>
<th>Gross Interest (10% Net Note)</th>
<th>Amortization of Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>At lease inception</td>
<td>$1,464,710</td>
<td>$564,710</td>
<td>$900,000</td>
<td></td>
</tr>
<tr>
<td>End of Year</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>1,318,239</td>
<td>474,710</td>
<td>843,529</td>
<td>$146,471</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$90,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$56,471</td>
</tr>
<tr>
<td>2</td>
<td>1,711,768</td>
<td>390,357</td>
<td>781,411</td>
<td>146,471</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>84,353</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>62,118</td>
</tr>
<tr>
<td>3</td>
<td>1,025,297</td>
<td>312,215</td>
<td>713,082</td>
<td>146,471</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>78,142</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>68,329</td>
</tr>
<tr>
<td>4</td>
<td>878,826</td>
<td>240,907</td>
<td>637,919</td>
<td>146,471</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>71,308</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>75,163</td>
</tr>
<tr>
<td>5</td>
<td>732,355</td>
<td>177,115</td>
<td>555,240</td>
<td>146,471</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>63,792</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>82,679</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$387,595</td>
</tr>
</tbody>
</table>

*Balance of remaining payments on buyer-lessee’s note.
**Present value of remaining note payments, discounted at 10 percent.

DEPOSIT METHOD

Under the deposit method, the seller-lessee retains the asset in the balance sheet and depreciates the asset. Amounts received from the buyer-lessee for down payment and for principal and interest on a
note are credited to the deposit account. Total lease payments decrease the deposit liability account without separation of principal and interest.

The deposit method is required when the seller-lessee guarantees a return of the buyer-lessor’s investment for a limited period or if there is doubt about cost recovery in a default.

**Recording a Loss**

Under the deposit method, it is necessary to record a loss if at any time the book value of the property exceeds the sum of the deposit received plus the fair value of the unrecorded note receivable and the debt assumed by the buyer. It is also necessary for the seller-lessee to record a loss if the buyer-lessor defaults or a default becomes probable and the property’s value has declined.

**Subsequent Qualification for Sales Recognition**

If a sale-leaseback transaction accounted for by the deposit method later qualifies for sales recognition, the transaction is accounted for using sale-leaseback accounting, and gain or loss may be recognized as if the transaction had been recorded initially in accordance with SFAS 98, paragraph 27. Case C illustrates the deposit method.

*Case C. Sale-leaseback transaction accounted for by the deposit method with subsequent sales recognition and the leaseback classified as a capital lease*

- Company C sells one of its plant buildings to a buyer-lessor for $950,000 (fair value), $50,000 cash, and a 10-year $900,000 recourse note with a 10 percent annual interest rate. Annual payments are $146,471.
- Company C leases the building back under a 10-year lease, with annual rentals of $150,000.
- The leaseback meets the criteria for a capital lease.
- The property costs $1,300,000. Accumulated depreciation to the date of the sale is $400,000. Annual depreciation is $80,000.
- The buyer-lessor has a questionable credit rating. The initial down payment is inadequate for using the full accrual method (down payment must equal 20 percent of the sales price).
Real Estate Sale-Leasebacks Under FASB Statement No. 98

- Assume that the full accrual method becomes appropriate at the end of the third year because the buyer-lessor makes additional payments and has an improved credit rating.
- The seller-lessee records the transaction under the deposit method.

The journal entries to record the transaction are as follows:

\textit{At inception}

\begin{align*}
\text{Cash} & \quad 50,000 \\
\text{Deposit} & \quad 50,000 \\
\end{align*}

(to record down payment on the property)

\textit{Recurring entries Years 1 through 3}

\begin{align*}
\text{Cash} & \quad 146,471 \\
\text{Deposit} & \quad 146,471 \\
\end{align*}

(to record annual receipts from the buyer-lessor on the $900,000 note)

\begin{align*}
\text{Deposit} & \quad 150,000 \\
\text{Cash} & \quad 150,000 \\
\end{align*}

(to record lease payments)

\begin{align*}
\text{Depreciation} & \quad 80,000 \\
\text{Accumulated depreciation} & \quad 80,000 \\
\end{align*}

(to record depreciation)

Up to the date of sale recognition, the balance of the deposit account is $39,413.

\textit{Memorandum Accounts.} The relevant memorandum balances of the sale-leaseback transaction are as follows:

\begin{table}
\begin{tabular}{|c|c|c|c|c|}
\hline
 & Gross Note Receivable & Net Note Receivable* & Deferred Interest Income & Gross Lease Obligation & Net Lease Obligation** \\
\hline
At lease inception & $1,464,710 & $900,000 & $564,710 & $1,500,000 & $950,000 \\
End of Year & & & & & \\
1 & $1,318,239 & 843,529 & 474,710 & 1,350,000 & 888,365 & 461,635 \\
2 & $1,171,768 & 781,411 & 390,357 & 1,200,000 & 820,997 & 379,003 \\
3 & $1,025,297 & 713,082 & 312,215 & 1,050,000 & 747,363 & 302,637 \\
\hline
\end{tabular}
\end{table}

*Present value of remaining note payments discounted at 10 percent.

**Present value of remaining lease payments discounted at 9.30195 percent, the seller's incremental borrowing rate.
On the gross note receivable in Year 1 the receipt of $146,471 consists of $90,000 of interest (10 percent of $900,000) and $56,471 principal. The initial balances are reduced as follows:

<table>
<thead>
<tr>
<th>Gross Note Receivable</th>
<th>Net Note Receivable</th>
<th>Deferred Interest Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>At lease inception</td>
<td>$1,464,710</td>
<td>$900,000</td>
</tr>
<tr>
<td>Year 1 receipt</td>
<td>(146,471)</td>
<td>(56,471)</td>
</tr>
<tr>
<td>Balance</td>
<td>$1,318,239</td>
<td>$843,529</td>
</tr>
</tbody>
</table>

A similar procedure is followed to reduce the balances of the memorandum lease obligation. If the lease had been recognized initially as a capital asset, it would have been recorded at $950,000 with an annual amortization of $95,000, leaving an unamortized balance at the end of the third year of $665,000.

**Recognition of Sale.** When the sale is recognized at the end of the third year, the following journal entry would be made:

| Deposit                      | 39,413 |
| Capital asset                | 950,000|
| Note receivable              | 713,082|
| Accumulated depreciation     | 640,000|
| Property, plant and equipment| 1,300,000|
| Capital lease obligation     | 747,363|
| Accumulated amortization of  | 285,000|
| capital asset                |        |
| Deferred gain                | 10,132 |

(to record the sale and leaseback transaction at the end of Year 3)

**Note:** The amounts recognized reflect balances that would have been recorded in the accounts had the sale-leaseback transaction been recognized at the date of the transaction.

The gain is determined as follows:

- Sales price $950,000
- Cost less accumulated depreciation (end of Year 3) 660,000
- 290,000
Adjustments required by the deposit method and SFAS 98:

- Amortization of capital asset: $(285,000)
- Interest income credited to the deposit account in Years 1 through 3: $(564,710–312,215) = 252,495
- Interest expense charged to the deposit account in Years 1 through 3: $(550,000–302,637) = (247,363)
- Gain to be recognized: $10,132

**RECOGNITION OF SALE UNDER INSTALLMENT METHOD**

Under SFAS 66, a sale-leaseback that does not qualify for profit recognition under the full accrual method may nevertheless qualify for the installment method of profit recognition. In that event, the amount of profit recognized would still be deferred because of the leaseback and taken into income over the life of the lease. The amount of profit taken into income each year would vary as the portion of the profit recognized under the installment method increases.

**CONTINUING INVOLVEMENT**

One of the key elements that differentiates a sale-leaseback that is a "sale" from a sale-leaseback that is merely a "financing" or a "deposit" is whether the seller-lessee retains any substantial continuing involvement in the property.

A sale-leaseback involving real estate or real estate with equipment would be accounted for either under the deposit method or as a financing transaction if the sale-leaseback includes any continuing involvement apart from the seller-lessee’s intent to occupy the property from the lease’s inception.

**Examples of Continuing Involvement**

SFAS 66 describes some transactions that contain forms of continuing involvement with the property by the seller that result in the
seller-lessee not transferring the risks of ownership to the buyer. Two examples of continuing involvement most frequently found in sales-leasebacks are these:

- *Obligation to repurchase*. The seller-lessee is obligated to repurchase the property or the buyer-lesser can either compel the seller-lessee to repurchase or give the seller-lessee an option to repurchase the property. (Excludes a right of first refusal based on a bona fide offer by a third party.)

- *Guarantees*. The seller-lessee guarantees the buyer-lessee’s investment for a limited or extended period of time.

Other provisions or conditions that result in no transfer of the risk of ownership through a guarantee that therefore constitute continuing involvement include, but are not limited to, the following:

- *Payment for decline in value*. The seller-lessee is required to pay the buyer-lessee at the end of the lease term for a decline in the fair value of the property below the estimated residual value, unless the payment is based on excess wear and tear of the property and is levied on inspection of the property at the termination of the lease.

- *Nonrecourse financing*. The seller-lessee provides nonrecourse financing to the buyer-lessee for any portion of the sales proceeds.

- *Existing debt*. The seller-lessee is not relieved of the obligation under any existing debt related to the property.

- *Collateral*. The seller-lessee provides collateral on behalf of the buyer-lessee other than the property directly involved in the sale-leaseback, or a party related to the seller-lessee issues a guarantee.

The following provisions or conditions are also considered examples of continuing involvement for the purposes of applying SFAS 98:

- *Retention of land*. The seller-lessee sells property improvements or equipment, or both, to a buyer-lessee and leases them back while retaining the underlying land.
• Appreciation shared. The buyer-lessee is obligated to share with the seller-lessee any portion of the appreciation of the property.

• Participation in future profits. A provision exists or a circumstance occurs that allows the seller-lessee to participate in any future profits or the appreciation of the leased property, for example, if the seller-lessee owns or has an option to acquire any interest in the buyer-lessee.
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CHAPTER 10
FASB Exposure Drafts

EMPLOYERS' ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

In February 1989, the Financial Accounting Standards Board (FASB) issued an exposure draft of a proposed Statement, *Employers’ Accounting for Postretirement Benefits Other Than Pensions*, which could have a significant impact on the financial statements of companies that have such plans. The proposed Statement would require a change in accounting for such benefits from the pay-as-you-go method of accounting, which currently is predominant practice, to an accrual basis.

Would Apply Principles of SFASs 87 and 88

The proposed Statement would establish standards of financial accounting and reporting for an employer that offers postretirement benefits other than pensions (postretirement benefits) to its employees.

Currently, most employers account for postretirement benefits on a pay-as-you-go basis. The proposed Statement would require the use of accrual accounting principles as promulgated in FASB Statement No. (SFAS) 87, *Employers’ Accounting for Pensions*, and SFAS 88, *Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*. To the extent that the promise of postretirement benefits is similar to the promise to provide pension benefits, the provisions in the proposed Statement would be the same or similar to those prescribed by SFASs 87 and 88.
The FASB essentially views a postretirement plan as a deferred compensation arrangement. Consequently, the proposed Statement would require employers to —

- Recognize net periodic postretirement benefit cost as employees render the services.
- Include a measure of the obligation on the statement of financial position.
- Apply a uniform method for similar plans to measure the accumulated postretirement benefit obligation and the related cost of postretirement benefits.

Different accounting treatment would be prescribed only when there are compelling reasons for different treatment.

In applying accrual accounting to postretirement benefits, the proposed Statement would adopt the three fundamental aspects of pension accounting:

1. Delayed recognition of certain events:
   - Changes in the obligation arising from plan initiation or amendment
   - Certain changes in the value of plan assets
2. Reporting net cost:
   - Service cost
   - Return on plan assets
3. Offsetting:
   - Plan assets would be offset against the accumulated post-retirement obligation.
   - Return on plan assets would offset postretirement benefit costs.

In addition, the proposed Statement would call for the disclosure of certain unrecognized items as is required by SFAS 87.

**Applicable to All Postretirement Benefits**

The proposed Statement applies to all postretirement benefit plans. A postretirement benefit plan is defined as "an arrangement whereby an employer undertakes to provide its employees with benefits dur-
ing their retirement in exchange for their services over a specified period of time, upon attaining a specified age while in service, or both. Benefits may commence immediately upon termination of service or may be deferred for payment upon attaining a specified age.”

Postretirement benefits may include health care, life insurance outside a pension plan, and other welfare benefits such as tuition assistance, day care, legal services, and housing subsidies provided after retirement.

**Health Care.** The proposed Statement focuses principally on postretirement health care benefits, which in fact make up the overwhelming portion of such costs.

**Settlements and Curtailments.** The proposed Statement also applies to the following:
- Settlements of all or part of a plan
- Curtailment of a plan
- Benefits provided as part of a special termination benefit offer

**Defined Benefits.** The proposed Statement primarily focuses on an employer’s accounting for a single-employer plan. A defined benefit postretirement plan is one that defines the postretirement benefits in terms of either of the following:
- Monetary amounts ($100,000 of life insurance)
- Benefit coverage (up to $200 a day for hospitalization; 80 percent of cost of specified procedures)

**Full Eligibility.** A plan may define full eligibility for postretirement benefits in terms of compensation levels, years of service, attained age while in service, or a combination of these factors.

**Benefit Formula.** The amount of the benefits depends on the benefit formula, which includes the eligibility factors, how long the retiree and any beneficiaries and covered dependents live, and the incidence of events requiring benefit payments.

**Not Applicable to Certain Plans**

The proposed Statement does not apply to the following:
• Benefits to selected employees under individual contracts with specific terms determined on an individual-by-individual basis
• Benefits provided currently to active employees
• Pension or life insurance benefits provided through a pension plan
• Temporary benefits provided only to certain employees after their employment, but not provided to employees who retire

**Basic Elements of Accounting**

The basic elements of accounting for postretirement benefits are discussed below.

**Expected Postretirement Benefit Obligation**

For an employee this is the actuarial present value, as of a date, of the postretirement benefits expected to be paid to the employee, the employee’s beneficiaries, and any covered dependents pursuant to the plan. Future compensation levels would be relevant if benefits are based on future compensation (pay-related plans).

**Accumulated Postretirement Benefit Obligation**

This is the actuarial present value, as of a date, of all future benefits attributed to employee service rendered to that date. This computation requires that increases in benefits be attributed to years of service as provided by the plan and subject to the provisions of the proposed Statement to be discussed later. Prior to full eligibility, the accumulated postretirement benefit for an employee is a portion of the expected obligation. On and after full eligibility, the two amounts are the same.

Given the delayed-recognition approach to accounting for experience gains and losses and other effects, the net periodic postretirement benefit cost is not tied to the change in the unfunded accumulated postretirement benefit obligation for the period, exclusive of employer contributions to the plan, plan settlements, and payments made directly to retirees.

**Net Periodic Postretirement Benefit Cost**

This consists of the following components:
Service Cost. The actuarial present value of the expected post-retirement benefit obligation attributed to employee service during the reporting period is service cost.

Interest Cost. The increase in the accumulated postretirement benefit obligation to recognize the effects of the passage of time is interest cost.

Actual Return on Plan Assets. The actual return on plan assets would be determined on the basis of the fair value of plan assets at the beginning and end of the period adjusted for contributions and benefit payments.

Amortization of Prior Service Cost. In the absence of plan provisions defining the specific period of service to which the plan amendment applies, plan amendments would be viewed as retroactive. The prior service cost would be amortized by assigning an equal amount to each remaining year of service to full eligibility for benefits of each plan participant active at the date of the amendment. To reduce complexity a straight-line amortization of the cost over the average remaining years of service to full eligibility for benefits of the active plan participation would be acceptable. A plan amendment that reduces the accumulated postretirement benefits obligation would be used first to reduce any existing unrecognized prior service cost, then any remaining transition obligation.

Amortization of Transition Obligation or Asset. As of the beginning of the fiscal year in which the proposed Statement would be first applied (the transition date), the accumulated postretirement benefit obligation and the fair value of plan assets plus any recognized accrued postretirement benefit cost less any recognized prepaid benefit cost would be determined. The unrecognized transition obligation or asset would be amortized on a straight-line basis over the average remaining service period of active plan participants. If that average is less than 15 years, the employer may elect to use a 15-year period.

The proposed Statement would provide for a more rapid amortization under certain circumstances that involve a comparison of cumulative accrual basis and cash basis amounts.

Gain or Loss Component — Deferred and Amortized. This component includes the difference between the actual return on plan
assets and the expected return on plan assets for the current year (defers the difference between the actual return and the expected return) and amortization of unrecognized net gain or loss from previous years.

Gains or losses would arise if experience differs from that assumed for return on plan assets or from the assumed accumulation of the postretirement benefit obligation, or from changes in assumptions. The proposed Statement would not require the recognition of gains or losses in the period that they arise. Rather, an unrecognized net gain or loss would be included as a component of net postretirement benefit cost for a year if, as of the beginning of the year, that unrecognized net gain or loss exceeded 10 percent of the greater of the accumulated postretirement benefit obligation or the market-related value of plan assets. If required, the minimum amortization would be the excess divided by the average remaining service period of active plan participants. Exceptions are provided for other systematic methods and immediate recognition.

Measurement of Cost and Obligation

The proposed Statement would require the use of explicit assumptions in the process of measuring the expected postretirement benefit obligation. Each assumption would have to represent the best estimate of a particular future event. A portion of that expected benefit would then be attributed to each period as service cost.

The accumulated postretirement benefit obligation would be the aggregation of the expected postretirement benefit obligation attributed to plan participants’ prior service periods associated with earning the postretirement benefits together with interest thereon, less benefit paid.

Principal Actuarial Assumptions

- **Discount rate** — reflects the interest rate inherent in the amount at which the postretirement benefit obligation could be effectively settled. The same rate would be used in determining the interest cost component of net periodic postretirement benefit cost.

- **Amount and timing of future benefit payments** — would consider past and present per-capita claims cost by age, health care cost
trend rates, medical reimbursement rates (Medicare), salary progressions (for pay-related plans) and probability of payment (turnover, retirement, dependency status, mortality, and the like).

• Expected long-term rate of return on plan assets — would reflect the average rate of earnings expected on the existing assets that qualify as plan assets. The expected rate of return on plan assets would be applied to the market-related value of plan assets to compute the expected return on plan assets. Most existing plans are unfunded and thus would not have to deal with this element.

Assumptions Unique to Health Care Benefits
The assumption that is unique to postretirement health care benefit measurement is the assumed per-capita claims cost by age, which is the future per-capita cost, after the measurement date, of providing the postretirement health care benefits at each age from the earliest ages at which plan participants could begin to receive benefits through their remaining life expectancy. Measurement requires consideration of many assumptions, critical among which are health care cost trend rates, Medicare reimbursement rates, and health care utilization or delivery patterns and medical technology.

Attribution Methods
Except for plans with benefit formulas that attribute benefits in a disproportionate way to later years, the expected postretirement benefit obligation for a plan participant would be attributed to periods of employee service to the full eligibility date, based on the plan’s benefit formula, if the formula states how the obligation should be attributed.

If the plan’s benefit formula does not specify the benefits earned for a specific period of service, an equal amount of the expected post-retirement benefit obligation would be attributed to each year of service in the attribution period (a benefit/years-of-service approach).

The beginning of the attribution period would be the date of hire, unless the plan’s formula grants credit only for service from a later date, in which case benefits would be attributed from the beginning of that credited service period.
Recognition of a Liability

The proposed Statement would require an employer to report a liability which is the greater of either of the following:

- The accrued postretirement benefit cost
- The accumulated postretirement benefit obligation for fully eligible plan participants in excess of the fair value of plan assets (minimum liability)

This requirement is designed to mitigate the effects of the delayed recognition principle.

Recognition of an Intangible Asset

The offset to any additional liability recognized under the above requirement would be the recognition of an intangible asset, provided that the asset recognized does not exceed the amount of any unrecognized prior service cost. If there is an excess, it would be reported as a separate component of equity, net of any tax benefits, as a temporary difference under SFAS 96. The additional liability would be unaffected by those tax considerations.

Plan Assets

The accounting for plan assets would follow SFAS 87 principles. At present few plans are funded.

Disclosure

The disclosures would follow the requirements of SFASs 87 and 88, but would also include disclosure of the effect of a one percentage point increase (or decrease) in the weighted average assumed health care cost trend rate on the net periodic cost and obligation.

Other Matters Covered

The proposed Statement also covers the following:
• Employers with more than one plan
• Insurance contracts
• Multiemployer plans
• Multiple-employer plans
• Non-U.S. plans
• Business combinations
• Accounting for settlements, curtailments, and termination benefits
• Disposal of a segment
• Defined contribution plans

As in the case of accounting for single-employer postretirement benefit plans, the proposed Statement continues to track SFASs 87 and 88 in other areas. For example, in the case of business combinations, the proposed Statement would require that the assignment of the purchase price to individual assets acquired and liabilities assumed should include a liability for the accumulated postretirement benefit obligation in excess of the fair value of plan assets or an asset for the fair value of plan assets in excess of the accumulated postretirement benefit obligation. If it is expected that the plan will be terminated or curtailed, the effects of those actions should be included in the allocation process. As a result of this procedure, any unrecognized items would be eliminated for the acquired employer's plan.

Proposed Effective Dates

The proposed Statement would be effective for fiscal years beginning after December 15, 1991. However, the effective date would be two years later (December 15, 1993) for (a) non-U.S. plans or (b) plans of employers that are nonpublic companies and that sponsor no plan with more than 100 plan participants.

For all plans, the requirement to provide for an additional minimum liability would be effective for fiscal years beginning after December 15, 1996. Earlier application would be encouraged. Restatement of previously issued annual financial statements is not permitted.
Transition

If at the transition date an employer has excluded assets in a post-retirement benefit fund from its balance sheet, and some or all of the assets do not qualify as plan assets, the employer would recognize in its balance sheet the fair value of the plan assets and an equal amount as an accrued postretirement benefit obligation.

Pronouncements to Be Superseded, Rescinded, or Amended

The proposed Statement would supersede SFAS 81, Disclosure of Postretirement Health Care and Life Insurance Benefits, which serves as a temporary measure to require certain disclosures.

The proposed Statement would also rescind FASB Technical Bulletin No. (TB) 87-1, Accounting for a Change in Method of Accounting for Certain Postretirement Benefits.

APB Opinion No. (APB) 12, Omnibus Opinion, which deals with deferred compensation contracts, would be amended to the extent that SFAS 87 and the proposed Statement apply to deferred compensation contracts with individual employees if those contracts, taken together, are equivalent to a postretirement income or health or welfare benefit plan. For other deferred compensation contracts accounted for on an individual basis, the accrual basis is required, and if the contract does not define the specific years of service, the amount expected to be paid should be accrued in accordance with the proposed Statement from the date the contract is entered into to the date the employee attains full eligibility for the benefits.

Paragraph 88 of APB 16, Business Combinations, which provides general guidelines for assigning amounts to the individual assets acquired and liabilities assumed in a purchase business combination, would be amended to incorporate the reference that paragraphs 82 and 83 of the proposed Statement should be applied to assets and liabilities related to postretirement benefits.

Immediate Rescission

Effective with issuance the proposed Statement would rescind TB 87-1, Accounting for a Change in Method of Accounting for Certain Post-retirement Benefits. If a change in method is adopted subsequent to the
issuance of the proposed Statement, the new method should comply with the provisions of the Statement.

DISCLOSURE OF INFORMATION ABOUT FINANCIAL INSTRUMENTS WITH OFF BALANCE-SHEET RISK AND FINANCIAL INSTRUMENTS WITH CONCENTRATIONS OF CREDIT RISK

In July 1989, the FASB issued a revised exposure draft of a proposed Statement on disclosure about financial instruments. As a result of comments received on the original exposure draft, the FASB decided to divide the disclosure phase of the project into two segments. The first segment, for which this exposure draft has been issued, focuses on information about the extent, nature, and terms of financial instruments with off balance-sheet risk, including related information about credit risk, and on information about concentrations of credit risk for all financial instruments. The second segment of the disclosure project, for which an exposure draft has not yet been issued, will focus on all financial instruments and disclosure of information about the credit, market, and liquidity risk of those instruments.

The major focus of the project, which will be considered in later stages, deals with issues of recognition and measurement of financial instruments.

Off Balance-Sheet Risk

The following are examples given in the revised exposure draft of financial instruments with off balance-sheet risk:

- Outstanding loan commitments written
- Standby and commercial letters of credit written
- Financial guarantees written
- Option written
- Interest rate caps and floors written
- Recourse obligations on receivables sold
• Futures contracts
• Interest rate and foreign currency swaps

Proposed Disclosure

The proposed Statement would require disclosure about the following for financial instruments with off balance-sheet risk:

• The face, contract, or notional principal amount and the amount recognized in the statement of financial position
• The nature and terms of the instruments and a discussion of the credit, market, and liquidity risk and related accounting policies
• The loss the entity would incur if any counterparty to the financial instrument failed to perform
• The entity’s policy for requiring collateral or other security on financial instruments it accepts and a description of collateral on instruments presently held

The proposed Statement also would require disclosure of information about significant concentrations of credit risk for all financial instruments.

Financial Instruments Not Covered

The proposed Statement would not apply to the following:

• Insurance contracts, other than financial guarantees and investment contracts
• Lease contracts as defined in SFAS 13
• Unconditional purchase obligations subject to disclosure requirement of SFAS 47
• Employers’ obligation for pension benefits and the like
• Financial instruments of a pension plan
• Extinguished debt subject to the disclosure requirements of SFAS 76
Effective Dates

The proposed Statement would be effective for fiscal years ending after December 15, 1989, except for disclosures on collateral and risk concentrations, which would be effective for fiscal years ending after June 15, 1990.
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CHAPTER 11

The FASB Emerging Issues Task Force

INTRODUCTION

In 1984, the Financial Accounting Standards Board (FASB) created the Emerging Issues Task Force (EITF) in response to a pressing need for more timely guidance on new accounting issues. The recent proliferation of innovative business transactions has triggered a number of complex accounting issues, many of which are narrow implementation issues or industry-specific. However, the FASB’s due process mechanism by nature limits the Board’s ability to deal promptly with these issues. What’s more, within the profession, there is a growing concern about a “standards overload,” that is, addressing narrow issues by issuing new pronouncements.

The EITF includes representatives from both accounting firms and industry. Presently, there are eleven accounting firms and four major corporations represented on the task force, which is chaired by the FASB director of research and technical activities. In addition, an SEC observer, ordinarily the chief accountant, actively participates in EITF meetings as does a representative of the AICPA accounting standards executive committee.

Through the cooperative efforts of practitioners, the FASB, and the SEC, the EITF addresses, and ultimately resolves, many of these narrow issues without formal due process procedures. In other words, the EITF shapes practice without setting standards. In Staff Accounting Bulletin No. 57, footnote 4, the SEC indicated that it will assist in identifying, and in some cases resolving, complex accounting issues. The commission stated—

the authoritative accounting literature cannot specifically address all the novel and complex business transactions into which registrants might enter. . . . The [SEC] staff intends to participate in the activities of [the task force] and believes the group’s efforts will be most effective
if preparers of financial statements and/or their independent accountants apprise the group of intended accounting for new business transactions.

While serving as SEC chief accountant, Clarence Sampson indicated that SEC registrants will be called on to justify accounting that differs from a consensus reached by the EITF.

**TASK FORCE OPERATING PROCEDURES**

Approximately every six weeks, EITF members hold a meeting to discuss issues that have been placed on the agenda. For each issue, members of either the task force or the FASB staff prepare an Issues Summary Package comprising an Issues Summary Form and other attachments. While most Issues Summary Packages attempt to present a neutral discussion of the issue, they sometimes advocate accounting positions. Views contained within an Issues Summary Package represent the views of the preparer prior to the task force’s discussion. Also attached to each Issues Summary Package are extracts from the minutes of each task force meeting at which the issue is discussed. An issue is summarized at the meeting by the EITF member who raised it or by a member of the FASB staff. Following the discussion, the chairman polls EITF members to ascertain whether there is a consensus on the issue. If fewer than three members object, the consensus is recorded in the minutes. In some situations, the discussion is inconclusive, and various aspects may be further discussed in subsequent meetings. Even if a consensus is not reached during a meeting, the FASB obtains insights about members’ views on particular transactions; areas where guidance is required on a timely basis; areas where guidance awaits work on an existing FASB project; and areas where further guidance is not required.

**NATURE OF ISSUES EXAMINED**

As of June 29, 1989, the EITF has discussed 200 accounting issues, which have been categorized in Appendix A. Of these 200 issues, 83 were related either to financial institutions or to financial instruments. Detailed listings of these accounting issues by group are available.
DISPOSITION OF ISSUES

Appendix B provides the disposition of the 200 accounting issues accepted for consideration by the EITF. Of that amount, 131 issues addressed by the EITF were resolved by consensus, while 24 issues were resolved by the FASB. Actions settling these issues include a number of Technical Bulletins and FASB Statements. Issue 84-3, Convertible Debt Sweeteners, was resolved by Statement of Financial Accounting Standards (SFAS) No. 84, Induced Conversions of Convertible Debt. Issue 85-4, Common Control Questions, was resolved by FASB Technical Bulletin (TB) 85-5, Issues Relating to Accounting for Business Combinations. Twenty-five issues have not been resolved under the EITF framework.

ACCESSING AND RESEARCHING ISSUES ADDRESSED BY THE EITF

The FASB offers a subscription plan for task force materials, which includes Issues Summary Packages and final minutes of meetings.

The FASB prepares an EITF Summary, which provides the following for each issue considered by the EITF:

- Description of issue
- Dates discussed/minute references
- Disposition, consensus reached, FASB/SEC document released, other

In addition, issues are grouped by type.

The professional researching an accounting issue can obtain from the FASB an EITF Summary and Analysis of Issues Grouped by Type to see if the task force might have already addressed a particular problem. Summary packets and minutes can be ordered individually from the FASB. The AICPA NAARS data base contains task force minutes and issues summaries, as well as the index to the issues and their dispositions. The FASB also publishes EITF Abstracts, which summarize the task force’s proceedings. A separate abstract is presented for each issue considered by the task force. A comprehensive topical index facilitates quick identification of relevant issues.
HOW TO USE EITF POSITIONS

Statement on Auditing Standards (SAS) No. 52, *Omnibus Statement on Auditing Standards—1987*, provides the following hierarchy of generally accepted accounting principles:

- The first level includes standards enforceable under Rule 203 of the AICPA's Code of Professional Conduct, such as Financial Accounting Standards Board Statements and Accounting Principles Board Opinions.

- If guidance is not found at the first level, the accountant will look to pronouncements that are not enforceable under Rule 203 but instead are the works of bodies of experts following a due process procedure. A significant due process effort includes the broad distribution of the proposed accounting principles for public comment, with the intent to establish accounting principles or describe existing practices that are generally accepted. Examples are FASB Technical Bulletins and AICPA Statements of Position.

- The next level includes practices or pronouncements that are widely recognized as generally accepted because they represent (1) prevalent practices in a particular industry or (2) the knowledgeable application to specific circumstances of pronouncements that are generally accepted.

- The last level, "other accounting literature," includes AICPA issues papers, EITF minutes, textbooks, and articles.

The EITF minutes would fall under the category of "other accounting literature." The SEC expects registrants to comply with the consensus of the EITF since it comprises members of the SEC and the FASB, as well as representatives from public accounting and industry. While an EITF consensus position is not enforceable under Rule 203, it does hold a place in the hierarchy of generally accepted accounting principles. Since consensus positions of the EITF represent the best thinking in areas in which there are no specific standards, the chief accountant of the SEC has indicated that registrants will be challenged if departing from these positions. Nonpublic companies should also heed this guidance, since the research efforts involved in resolving an issue are heavily reliant on analogies.
HOW TO CONFORM ACCOUNTING PRACTICE TO THAT IN AN EITF CONSENSUS

Since the EITF is not a standard-setting body, it doesn’t address, and ultimately specify, transition provisions. Under APB 20, this change in accounting, which is voluntarily adopted, would normally be reported as a cumulative catch-up adjustment in the year of the change.

Under SFAS 20, entitled *Reporting Accounting Changes Under AICPA Statements of Position*, the Board specified that transition provisions specified in a statement of position (SOP) would override APB 20. However, if unspecified in the SOP, then the cumulative catch-up adjustment would apply. Again, for EITF consensus rulings, APB 20 applies.

ANALYSIS OF SELECTED ISSUES

The following section reviews selected issues discussed by the EITF over the last two years that are of interest to nonpublic companies. The section is arranged by type of issue, including the following:

- Inventory/fixed assets/leases
- Income taxes
- Real estate
- Pensions/employee benefits
- Business combinations/new basis
- Other

Inventory/Fixed Assets/Leases

EITF 88-10—Costs Associated With Lease Modification or Termination

A company occupies a rental property accounted for as an operating lease. The company enters into a new lease for a new rental property with a different lessor. The company incurs costs on the new rental property and on its pre-existing lease.
The issues involved were these:

1. May costs incurred by a lessee in moving from one rental property to another be deferred and amortized over the new lease term?
2. What is the proper accounting for remaining costs under the pre-existing lease?
3. What is the treatment for capitalized costs associated with the pre-existing lease, such as leasehold improvements?

*Expense Moving Costs.* The Task Force could not reach a consensus on moving costs. However, predominant practice is to expense moving costs as incurred. The SEC Observer indicated that generally the SEC staff would object to deferral of moving costs.

*Expense Remaining Costs Related to Pre-Existing Leases.* Remaining costs for pre-existing leases, such as remaining rental payments and capitalized lease improvements, should be expensed when the lease property or improvements have no future use or benefit.

*Measuring Expenses on Pre-Existing Leases That Are Terminated.* On termination of the lease, costs should be charged to the period in which the pre-existing lease has no remaining operating value. The expense would equal the remaining costs reduced by actual or expected subrental income, and could be calculated on actual or discounted amounts.

**EITF 88-21 — Accounting for the Sale of Property Subject to the Seller’s Pre-Existing Lease**

A company owns property in which it is a lessee for all or part of the property. The company sells the property (that is, owner-lessee sells its interest in the property) to a third party, but continues to lease the property under the pre-existing lease.

The issues involved were these:

1. Should profit be deferred as in a sale and leaseback transaction?
2. How should profit be measured?

*Account for Transaction as Sale and Leaseback If Pre-Existing Lease Is Modified.* If the terms of the pre-existing lease are modified, except for minor changes, the transaction is to be accounted for as a sale and leaseback.
Acquisition of Ownership in Property and Consummation of Lease Occur at Same Time. The provisions for amortization into income of deferred profit specified under SFAS 28, Accounting for Sales With Leasebacks, should be applied if ownership interest in property is acquired at or near the same time that the lease is consummated, and there is no major change to the pre-existing lease. The deferred profit is the lesser of seller-lessee’s total remaining minimum lease payments or seller-lessee’s share of profit from sale. Percentage of prior ownership in property sold does not affect amount of profit that is deferred.

Transactions Involving Real Estate. Sales of real estate should meet requirements of SFAS 66, Accounting for Sales of Real Estate, and profit recognition should comply with SFAS 98, Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of Lease Term, and Initial Direct Costs of Direct Financing Leases. No guidance was provided when an ownership interest in the property is acquired and the lease is consummated at different times.

EITF 89-7—Exchange of Assets or Interest in a Subsidiary for a Noncontrolling Equity Interest in a New Entity

A company transfers a nonmonetary asset to a newly formed entity in exchange for a noncontrolling interest in the newly formed entity. In a second variation of the transaction, the company receives boot (that is, cash) plus a partial ownership interest.

The issues involved were these:

1. Should a gain be recognized at date of transfer?
2. How should a gain be measured?

At Most, Partial Gains Can Be Recognized. Full gain recognition is inappropriate. Most of the EITF felt no gain should be recognized in an exchange without boot of a nonmonetary asset for an ownership interest. To the extent there is cash consideration, most of the EITF agreed partial profit recognition is appropriate. Variations to the cases can alter solutions.

Determination of Gain Is Unaddressed. There was no consensus on how profit is to be determined.
Income Taxes

EITF 88-4—Classification of Payments Made to IRS to Retain Fiscal Year

Partnerships and S Corporations are permitted under the Revenue Act of 1987 to retain their fiscal years rather than adopting the calendar for tax purposes, as had been enacted under the Tax Reform Act of 1986. Each entity making that election must make an annual payment in a single installment approximating the income tax that would be paid on short period income if there had been a switch to a calendar year. The issue involved was How should the annual payment be reported?

Payment Is an Asset. Partnerships and S Corps should report the payment as a deposit (asset) that is adjusted annually. The payment is realized if the entity switches to a calendar year or liquidates.

Real Estate

EITF 88-12—Transfer of Ownership Interest as Part of Down Payment Under SFAS 66

An investor with a 75 percent interest in a parcel of real estate sells that interest to the investor owning the remaining 25 percent interest. Ten percent of the purchase price is paid in cash, and the remaining balance is a note. The note is secured by a pledge of 100 percent interest in the property.

The issues involved were these:

1. Should the pledged interest in the property be included as part of the buyer’s initial investment?

2. If other assets are included as collateral in lieu of the property itself, should those other assets be included in the initial investment?

SFAS 66, Accounting for Sales of Real Estate, requires the initial investment be adequate to demonstrate the buyer’s commitment to pay for the property. This transaction, under paragraph 54 of SFAS 66, requires an initial investment of 15 percent of the sales value as such evidence. Under SFAS 66, the transaction as currently structured would include only the cash payment of 10 percent as part of the initial investment.
Pledged Assets Not Included as Part of Initial Investment. The EITF indicated full accrual is inappropriate because purchased property or other pledged assets as security for a note are not part of the buyer’s initial investment.

EITF 88-24—Effects of Various Forms of Financing Under SFAS 66, Accounting for Sales of Real Estate

The accompanying Exhibit 1, page 484, assumes various forms of financing used in the acquisition of real estate requiring a hypothetical 20 percent initial investment. Under SFAS 66, full accrual of profit is required if collectibility of sales price is reasonably assured, the amount can be reasonably estimated, and the earnings process is virtually complete. Evidence that profit is determinable (that is, collectibility is reasonably assured) requires a substantial initial and continuing commitment by the buyer. Should that commitment not be present, profit is recognized using the installment, cost recovery, or reduced profit recognition methods, as appropriate.

The issue involved was How is profit to be recognized for situations as they are set forth in Exhibit 1?

EITF Consensus. The following financing possibilities are addressed and are referenced in Exhibit 1 as consensus paragraphs 1 through 3.

1. Full profit can be recognized under the accrual method and the initial and continuing investment requirement can be disregarded when (a) seller receives as full sales value cash without any seller-contingent liability on any debt relating to the real estate; (b) the buyer assumes seller’s nonrecourse debt on property; (c) seller is completely released from obligation on property with buyer assuming all recourse debt on property; (d) any combination of such cash and debt assumption. Essentially, the seller has received unconditionally all amounts to which it is entitled and is not at risk related to financing.

2. If the sale is financed with debt incurred by the buyer that is secured by the property (either directly through seller financing or through other parties or indirectly through assumption), full profit accrual is evidenced by the buyer’s own cash or other permissible form of investment. The buyer’s borrowing using the property as security does not satisfy such continuing commitment. Payments to seller from debt proceeds that are secured by property are not included in buyer’s initial investment.
Examples of the Application of the EITF Consensus on Issue 88-24

<table>
<thead>
<tr>
<th>Situation</th>
<th>Cash Received by Seller at Closing</th>
<th>Components of Cash Received by Seller at Closing</th>
<th>Assumption of Seller’s Nonrecourse Mortgage</th>
<th>Assumption of Seller’s Recourse Mortgage</th>
<th>Recognition Under Consensus Paragraph</th>
<th>Profit Recognized at Date of Sale³</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
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<tr>
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</tr>
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<td></td>
<td>#3</td>
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</tbody>
</table>

Assumptions for Situations 1-18: (a) Sales price = $100; (b) Seller’s basis in property sold = $70; (c) Initial investment requirement = 20%; (d) All mortgage obligations meet the continuing investment requirements of SFAS 66.

¹ First or second mortgage indicated in parentheses.
² Seller remains contingently liable.
³ The profit recognized under the reduced profit method is dependent on various interest rates and payment terms. An example is not presented due to the complexity of those factors and the belief that this method is not frequently used in practice. Under this method, the profit recognized at the consummation of the sale would be less than under the full accrual method, but normally more than the amount under the installment method.

3. When the installment, cost recovery or reduced profit recognition method is used, debt incurred by the seller that is secured by property (directly from seller or others, indirectly through assumption) is not part of the buyer’s cash payments. The seller may recognize excess income if profit deferred under any of the above methods exceeds the outstanding amount of seller financing and the outstanding amount of the buyer’s debt secured by property for which seller is contingently liable.

Pensions/Employee Benefits

EITF 88-1—Determination of Vested Benefit for a Defined Benefit Plan

This issue involves the measurement of vested benefits, that is, those benefits for which an employee’s right to receive a present or future benefit is no longer contingent on remaining in the employer’s service. Two alternative measurement approaches have been used in practice. Under one approach, the vested benefit obligation is the value of vested benefits if the employee separates immediately. Under the second approach, the vested benefit obligation is the expected value of benefits to which an employee is entitled if the employee separates at the expected date of separation or retirement (that is, assumes continued future service).

Under the first approach, vested benefit obligation can exceed the present value of accumulated benefit obligation and/or projected benefit obligation. Accordingly, the accumulated benefit obligation and/or projected benefit obligation would be increased to the amount of the vested benefit. This affects the amount of periodic pension costs, accrued/prepaid pension costs, and disclosure. An example cited in the issue is the Italian severance pay statute, under which the benefit an employee has accrued for service provided to date is payable immediately on termination or separation. Accordingly, the statute leads to a situation where benefits immediately payable exceed the discounted value of benefits at the projected retirement date.

The issue involved was whether vested benefit obligations are measured as (1) the actuarial present value of vested benefits to which an employee is entitled if the employee separates immediately or (2) the actuarial present value of vested benefits, based on the employee’s expected date of separation or retirement.
EITF Consensus. Either approach is acceptable for situations not specifically addressed in SFAS 87 and for those with facts and circumstances analogous to situations considered by the Task Force. Note that the SEC Observer called for disclosure of the method used.

Discussion of Issue 88-1. In applying SFAS 87, a difficulty arises regarding whether the amount of the vested benefit is determined assuming the employee actually separates immediately, or assuming the employee remains in service until the date of separation or retirement. Under the former approach, vested benefit obligation is the maximum amount to which the employee is currently entitled; under the latter, vested benefit is the present value of the maximum amount. Under SFAS 87, the projected benefit obligation is determined as the actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered prior to that date (incorporates future compensation levels). Accumulated benefit obligation is calculated in the same way as projected benefit obligation, without taking into account future compensation levels. Accumulated benefit obligation consists of vested and invested benefits. Projected benefit obligation is accumulated benefit plus the effects of future compensation levels. Accordingly, if vested benefits exceed accumulated benefit, this affects the measurement of the minimum amount of accumulated benefits. Vested benefits under the first approach can also exceed projected benefit obligation, and that amount then would be increased to the minimum affecting the provision for pension expense.

The FASB staff used the first approach to respond to inquiries. Those in favor of this approach argue that the vested benefit is a present benefit not requiring any discounting, and it is viewed as a liability if the plan is currently discontinued. Supporters of the second approach argue that vested benefits may be payable presently or at some future date. Accordingly, they would determine the vested benefit obligation by projecting the amount to which the employee is currently entitled to the expected date at which these amounts will be paid, and then by discounting.

The first method is inconsistent with paragraph 39 of SFAS 88, which requires that projected benefit obligation be increased by an event that causes employees to leave earlier than expected.
EITF 88-5—Recognition of Insurance Death Benefits

A company acquires a life insurance policy covering key employees. The company is the beneficiary and will use the net proceeds on death to fund obligations for deferred compensation, supplemental retirement, postretirement programs, pensions, and buyouts.

The issues involved were:

1. May income from death benefits be reported on an actuarially expected basis rather than at actual death of the insured?
2. May the policies be valued for accounting purposes at net loan value (maximum amount that can be borrowed against policy) if intent is to hold policy in force until death of insured and borrow against policy to meet the various deferred compensatory requirements?

Death Benefits Cannot Be Recognized on Actuarially Expected Basis. It is inappropriate for the purchaser to recognize death benefits on an actuarially expected basis. TB 85-4 requires the asset be recognized at the amount that could be realized as of the balance sheet date (that is, cash surrender value). Realization of death benefit prior to actual death is not permitted.

No Consensus on Second Issue. The second issue was discussed, but no consensus was reached.

EITF 88-23—Lump-Sum Payments Under Union Contracts

Instead of receiving all or part of an increase in a base wage rate, union employees agree to receive a lump-sum payment. The issue involved was Should the lump-sum payment or payments be charged to expense immediately or amortized over all or some portion of the contract period?

Lump-Sum Payments Benefiting Future Period Should Be Deferred. If a lump-sum payment will benefit future periods through a base wage rate lower than would have existed, the lump-sum payment can be deferred and amortized. Amortization period should not exceed the contract period. The SEC Observer noted deferral of lump-sum payment is appropriate only when that payment is not related to past services.
EITF 89-1—Accounting by a Pension Plan for Bank Investment Contracts and Guaranteed Investment Contracts

Pension plans may acquire from insurance companies guaranteed investment contracts (GIC), which provide guaranteed returns on principal over a specified period of time. Under SFAS 35, Accounting and Reporting by Defined Benefit Plans, contracts with insurance companies generally are presented in the financial statements at contract value, which might differ from fair value. Financial institutions other than insurance companies now offer similar financial instruments. These include bank investment contracts (BICs) and savings and loan investment contracts (SLICs). Except for GICs, SFAS 35 requires these contracts to be valued at fair value.

The issue involved was Can instruments similar to GICs from entities other than insurance companies be valued in financial statements of the plan at contract value?

FASB Staff Reiterates Only Insurance Contracts Qualify as Exception to Fair Value Presentation. The EITF did not reach a consensus. However, most members agreed the only exceptions to fair value presentation under SFAS 35 and under AICPA Audit and Accounting Guide, Audits of Employee Benefit Plans, are contracts with insurance companies.

EITF 89-10—Sponsor’s Recognition of Employee Stock Ownership Debt

A leveraged employee stock ownership plan (ESOP) is an arrangement where an ESOP borrows funds from a lender. Under some arrangements, the company either guarantees some or all of the debt or agrees to make sufficient contributions to the ESOP to meet debt service requirements.

SOP 76-3 requires that the company record the obligations of the ESOP as a liability if the company guarantees the ESOP’s obligations on the part of the company.

The issue involved was Under what circumstances should ESOP debt be recorded as a liability on company books?

Consensus. Debt should always be recorded on company books, except when the ESOP intends and has the ability to satisfy obliga-
tions by means other than dividends received from company stock, contributions from the company, or sale and exchange of company securities.

**Business Combinations/New Basis**

**EITF 88-26—Controlling Preferred Stock in a Pooling of Interests**

Two companies are approximately equal in size and have comparable capital structures. Venture capitalists hold 80 percent of voting shares of each company, which is in the form of convertible preferred stock. On a public offering, the preferred converts into common. The other 20 percent is common stock, which is held by management. All conditions required for pooling-of-interests accounting are met, except for the requirement of common stock with voting control.

The issues involved were these:

1. If one company issues shares of its voting preferred stock in exchange for the other company’s voting preferred, would this still qualify for pooling-of-interests accounting?

2. If each company creates a controlling class of common stock through the conversion of a sufficient number of preferred shares into common and then one company issues the common shares in exchange for the other company’s common, would this still qualify for pooling-of-interests accounting?

*Exchange of Convertible Preferred for Convertible Preferred Does Not Qualify as Pooling.* The first transaction precludes pooling, because the requirement that shares exchanged in the transaction must be substantially voting common stock is violated. Common stock is not being issued to obtain controlling interest in the combining company.

*Exchange by Issuing Company of Virtually All Voting Common and Preferred Stock for Substantially All Common and Preferred of Combining Company Qualifies as Pooling.* If the controlling class of common stock of the issuer is exchanged for at least 90 percent of the common stock of the combining company and the combined common and
preferred stock of the issuer is exchanged for at least 90 percent of the combined common and preferred stock of the combining company, the transaction still qualifies for pooling. Exhibit 2 provides examples of transactions under EITF 88-26.

**Exhibit 2**

*Examples of the Application of the EITF Consensus on Issue 88-26*

**General Assumptions:**
The following assumptions are applicable to all examples.

- Issuer and Combining Company have the following shares outstanding prior to any conversion or issuance of additional shares:

<table>
<thead>
<tr>
<th></th>
<th>Issuer</th>
<th></th>
<th>Combining Company</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Shares</td>
<td>Percent</td>
<td>Shares</td>
<td>Percent</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>8,500</td>
<td>85</td>
<td>8,000</td>
<td>88.8</td>
</tr>
<tr>
<td>Common stock</td>
<td>1,500</td>
<td>15</td>
<td>1,000</td>
<td>11.2</td>
</tr>
<tr>
<td></td>
<td>10,000</td>
<td>100%</td>
<td>9,000</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

- The preferred stock of Issuer and the preferred stock of Combining Company are voting, are convertible into common, and are otherwise similar securities.

- Issuer and Combining Company each convert 4,000 shares of preferred stock into common stock, resulting in the following:

<table>
<thead>
<tr>
<th></th>
<th>Issuer</th>
<th></th>
<th>Combining Company</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Shares</td>
<td>Percent</td>
<td>Shares</td>
<td>Percent</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>4,500</td>
<td>45</td>
<td>4,000</td>
<td>44.4</td>
</tr>
<tr>
<td>Common stock</td>
<td>5,500</td>
<td>55</td>
<td>5,000</td>
<td>55.6</td>
</tr>
<tr>
<td></td>
<td>10,000</td>
<td>100%</td>
<td>9,000</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

**Example 1**
Issuer exchanges 5,000 shares of common stock and 4,000 shares of preferred stock for an equal number of common and preferred shares of Combining Company.

*Accounting for Example 1:*

1. A controlling class of common stock is created.
2. 100 percent of the common stock of Combining Company is exchanged.
Exhibit 2 (continued)

3. 100 percent of the combined common and preferred stock of Combining Company is exchanged.

The transaction meets the criteria in the consensus and should be accounted for using the pooling-of-interests method of accounting.

Example 2
Issuer exchanges 4,500 shares of common stock and 3,500 shares of preferred stock for an equal number of common and preferred shares of Combining Company.

Accounting for Example 2:

1. A controlling class of common stock is created.
2. 90 percent of the common stock of Combining Company is exchanged.
3. 88.8 percent of the combined common and preferred stock of Combining Company is exchanged.

The transaction does not meet the criteria in the consensus because less than 90 percent of the combined common and preferred shares were exchanged. Thus, the transaction may not be accounted for as a pooling of interests.

Example 3
Issuer exchanges 4,100 shares of common stock and 4,000 shares of preferred stock for an equal number of common and preferred shares of Combining Company.

Accounting for Example 3:

1. A controlling class of common stock is created.
2. 82 percent of the common stock of Combining Company is exchanged.
3. 90 percent of the combined common and preferred stock of Combining Company is exchanged.

The transaction does not meet the criteria in the consensus because less than 90 percent of the common shares were exchanged, even though 90 percent of the combined common and preferred shares were exchanged. Thus, the transaction may not be accounted for as a pooling of interests.

EITF 88-27—Effect of Unallocated Shares in an ESOP on Accounting for Business Combinations

Unallocated shares of common stock of the sponsoring company ESOPs may be held by an ESOP. Ultimately, these shares may not remain with either the ESOP or plan participants. To the extent there is a pension plan termination resulting in the ESOP acquiring unallocated shares, EITF 86-26, Measurement of Excess Contributions to a Defined Contribution Plan or Employee Stock Ownership Plan, requires the unallocated shares be treated as treasury shares.

The issue involved was, Are unallocated shares of the sponsoring company held by an ESOP tainted treasury shares in establishing whether pooling-of-interests accounting can be used in a business combination?

Pooling-of-Interests Accounting Is Not Precluded. Pooling is not precluded unless (1) there is more than a remote possibility that shares can revert back to the company; (2) there is an agreement or intent that the company will reacquire shares from an ESOP or receive them in a distribution (unless to maintain, under law, plan liquidity to plan participants); or (3) the intent in reacquiring shares was circumvention of requirements for pooling of interests.

Other

EITF 88-3—Rental Concessions Provided by Landlord

A landlord may provide a tenant with incentives or concessions, including moving allowances or assumption of tenant commitment on pre-existing leases.

The following issues were addressed to provide FASB staff with input on their deliberations in preparation of a Technical Bulletin on the subject:

- What constitutes concessions?
- How should the lessee account for such concessions?

Definition of Incentives. TB 88-1, Issues Relating to Accounting for Leases, indicates that payments made to or for a lessee are incentives. Losses incurred by the lessor as a result of assuming a lessee’s pre-existing lease with a third party are considered an incentive by both lessee and lessor.
Accounting for Incentives. These incentives are to be accounted for as reductions of rental expense by the lessee and reductions of rental revenue by the lessor over the lease term. Incentives are to be recognized on a straight-line basis over the term of the new lease in accordance with SFAS 13, Accounting for Leases, as amended.

Measurement of Loss. The new lessee and lessor should independently estimate any loss (gain to lessee) attributable to assumption of a pre-existing lease with a third party.

Accounting for Moving Expenses and Abandonments of Leasehold Improvements. The lessee's immediate recognition of expenses or losses such as moving expenses, losses on subleases, and losses from abandonment of leasehold improvements is unaffected by the new Technical Bulletin.

EITF 88-18—Sale of Future Revenues
An investor provides cash to a company in exchange for a specified amount or a percentage of revenue or income of a product line, business segment, trademark, patent, or contractual right over a defined length of time. Income might be measured using gross margin, operating income or pretax income. The transaction is such that immediate income recognition is inappropriate.

The following issues were addressed in EITF 88-18:

- Should the company classify the proceeds as debt or deferred income?
- How should debt or deferred income be amortized?
- How should foreign currency effects, if applicable, be recognized?

Factors Leading to Rebuttable Presumption of Classification of Proceeds as Debt. Any of the following factors leads to classification of the cash proceeds as debt:

- The transaction is not purported to be a sale.
- There is continuing involvement by the company in generating cash flows to be paid to investor.
- Either the company or the investor can cancel the transaction through a lump-sum payment or transfer of assets to the investor.
The transaction caps the potential rate of return to the investor.

The investor’s rate of return is largely unaffected by variations in the company’s revenue or income.

The investor is given some form of recourse to the company or collateral.

The following criteria for immediate revenue recognition were not addressed by the EITF.

**Method for Amortizing Debt.** Amounts recorded as debt are to be amortized under the interest method.

**Method for Amortizing Deferred Income.** Deferred income should be amortized using the units-of-revenue method. The portion of the deferred amount recognized as revenue is based on the ratio of each period’s payment to the investor to total payments expected to be made over the period of the agreement multiplied by the proceeds initially received from the investor.

**Recognition of Foreign Currency Effects, If Any.** Deferred income results in a nonmonetary liability that is not subject to foreign exchange gains and losses under SFAS 52, *Foreign Currency Translation*. The following conditions are required when classifying proceeds as debt to avoid recognition of foreign exchange gains and losses:

- The debt must be contractually required to be repaid only if there is related future revenue.
- There is no recourse to the investor related to payments due the investor.
- The transaction is noncancellable by either the company or the investor.

Under these conditions, translation gains and losses on debt are deferred and included with the measurement of future revenues. If these conditions are not met, the translation gains and losses are treated as foreign currency transactions for which translation gains and losses are recognized in accordance with SFAS 52.
EITF 88-15—Classification of Subsidiary’s Loan Payable in Consolidated Balance Sheet When Subsidiary’s and Parent’s Fiscal Year Differ

A consolidated balance sheet is prepared as of February 28, 1988, for a company having a parent company with a fiscal year-end of February 29, 1988, and a subsidiary with a year-end of December 31, 1987. According to Accounting Research Bulletin (ARB) 51, consolidation of parent and subsidiary with different year-ends is permissible as long as the difference is not more than three months. The subsidiary has a significant amount of debt becoming due on January 31, 1989.

The issue involved is Should the subsidiary’s loan payable be classified as current or noncurrent? The EITF couldn’t reach a consensus on this question, but it indicated there should be disclosure of intervening events that materially affect the balance sheet or the income statement. The SEC Observer indicated the SEC would expect classification of debt as current to prevent material misstatement.

EITF 89-2—Maximum Maturity Guarantees on Transfers of Receivables With Recourse

A company owning receivables or certificates representing pools of receivables transfers the receivables, with recourse in a transaction to be accounted for under SFAS 77, Reporting by Transferors for Transfers of Receivables With Recourse. The purchaser has the right to sell (put) the remaining receivables back to the seller, or the seller is permitted to repurchase (call) the receivables at some specified date when the remaining receivable balances are considered minor, based on the seller’s estimate of prepayments. Under SFAS 77, a transfer of receivables with recourse is accounted for as a sale even if the seller is permitted or required to repurchase the remaining outstanding receivable balance when the remaining outstanding amount has become minor (clean-up call/put). Some in practice have interpreted minor to mean 10 percent or less of the original amount transferred.

The accounting issue was Can the transaction be accounted for as a sale if the receivable balance that the purchaser sells back is minor based on seller’s estimate of expected prepayments but not minor based on contractual payment terms?
Conditions for Treating Transfers as Sales. The transfer may be accounted for as a sale if the put or call can be exercised at some future date when the outstanding remaining receivable balances are expected to be minor based on the contractual payment schedule. Sales accounting is not appropriate if the put or call can be exercised at some later date when the remaining outstanding balances are expected to be minor based on seller’s estimate of prepayments but not minor based on contractual payment terms.

Minor Is Not Quantified. The EITF did not address what constitutes minor.
APPENDIX A
EITF Issues Grouped by Type
(June 29, 1989)

<table>
<thead>
<tr>
<th>Type</th>
<th>Number of Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Taxes</td>
<td>22</td>
</tr>
<tr>
<td>Financial Institutions</td>
<td>33</td>
</tr>
<tr>
<td>Financial Instruments</td>
<td>50</td>
</tr>
<tr>
<td>Off-Balance-Sheet Financing</td>
<td>12</td>
</tr>
<tr>
<td>Pensions/Employee Benefits</td>
<td>18</td>
</tr>
<tr>
<td>Business Combinations</td>
<td>22</td>
</tr>
<tr>
<td>Inventory/Fixed Assets/Leases</td>
<td>14</td>
</tr>
<tr>
<td>Real Estate</td>
<td>8</td>
</tr>
<tr>
<td>Other</td>
<td>21</td>
</tr>
<tr>
<td>Total</td>
<td>200</td>
</tr>
<tr>
<td>Disposition</td>
<td>Number of Issues</td>
</tr>
<tr>
<td>----------------------------------------------------------------</td>
<td>-----------------</td>
</tr>
<tr>
<td>Consensus Was Reached</td>
<td>131</td>
</tr>
<tr>
<td>Resolved by FASB</td>
<td>24</td>
</tr>
<tr>
<td>Resolved by SEC</td>
<td>4</td>
</tr>
<tr>
<td>Resolved by AICPA</td>
<td>2</td>
</tr>
<tr>
<td>FASB Staff Work In Progress</td>
<td>2</td>
</tr>
<tr>
<td>AICPA Committee Work In Progress</td>
<td>1</td>
</tr>
<tr>
<td>Issues To Be Addressed in an FASB Major Project</td>
<td>6</td>
</tr>
<tr>
<td>No Resolution</td>
<td>25</td>
</tr>
<tr>
<td>Further Discussion by Task Force Pending</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>200</strong></td>
</tr>
</tbody>
</table>
Following is an article reproduced from the *Journal of Accountancy*, August 1989 that represents an excellent discussion of the current EITF consensus regarding when to apply carryover basis for all leveraged buyout (LBO) transactions.

**LBO Accounting: Consensus at Last!**

by Jerry Gorman, CPA

Accounting for leveraged buyouts has been somewhat of a free-for-all over the past several years—especially for LBOs featuring a decline in the previous owners’ interest. (See *Journal of Accountancy*, October 1988, page 71.) Although the Financial Accounting Standards Board’s emerging issues task force tackled the problem, its original guidance wasn’t comprehensive and raised many questions as to its application. That changed in May 1989 when the EITF finally reached a consensus that resolves the issue of when to apply carryover basis for all LBO transactions.

LBO transactions typically feature the establishment of a holding company with no substantive operations (Newco). This company purchases all the outstanding voting equity of an operating entity (Oldco) in a highly leveraged acquisition. The two companies then merge to form a Consolidated Newco. The big LBO accounting question: What basis should be used to record Oldco’s assets in Consolidated Newco’s financial statements? Fair value? Or predecessor (carryover) basis? Predecessor basis normally is measured as a shareholder’s original cost plus earnings, less dividends and any payment received for Oldco stock.

Authoritative literature and guidelines were established by EITF Issue No. 86-16. However, that consensus focused primarily on LBOs featuring an increase in owners’ interest. The EITF
returned to the LBO question at its meetings in July and August 1988 and established a new working group to try to resolve some of the broad inconsistencies between accounting for LBOs featuring increasing and decreasing owners' interests.

Finally, consensus on Issue 88-16, *Basis in Leveraged Buyout Transactions*, was reached at the EITF's May 1989 meeting. It supersedes Issue 86-16 and otherwise consolidates all LBO accounting rules. (See Exhibit 1.) Though finally settling the LBO accounting controversy, it has left CPAs with a very complicated set of rules to follow. The purpose of this article is to review the consensus and illustrate its application.

**Examining an LBO**

To account for an LBO transaction properly, CPAs must gain a complete understanding of the ownership and capitalization of Oldco and Newco. The LBO should be effected in a single, highly leveraged transaction or a series of related transactions that result in the acquisition by Newco of all previously outstanding Oldco voting equity interests.

CPAs must be ready to answer the following questions:

- Does the LBO result in a change in control that's genuine, substantive and not temporary?
- Who are the members of Newco's control group?
- Based on these factors and the extent of monetary and nonmonetary consideration paid by Newco for Oldco, how much of Newco's investment in Oldco should be recorded at fair value?

**Change in Control . . . It's Not an LBO Without It**

Without a change in control that's genuine, substantive and not temporary, there can be no change in the carrying basis of Oldco's net assets. If no change occurs, the funds disbursed to the selling shareholders are accounted for as charges to equity. This probably will result in a deficit in Consolidated Newco's opening equity.

For a change in control to occur, the consensus says one of the following three events must happen:
Exhibit 1  A Guide to the New Consensus’s Decision Making

Is the LBO a single, highly leveraged transaction, or a series of transactions that result in the acquisition by Newco of all previous outstanding voting equity interests of Oldco?

No  Consensus does not apply.

Yes

Is there a change in control?

No  No change in accounting basis permitted.

Yes

Determine each continuing shareholder’s residual interest.

Determine whether each continuing shareholder is a bull, a bear or management.¹

Bulls¹  Management  Bears¹

Fair valuation for that portion of Newco investment.²

No

Does the bull have greater than or equal to 5% residual interest?

Yes

Perform voting-interest test. Greater than or equal to the 20% level?

Yes

Perform capital-at-risk test. Greater than or equal to the 20% level?

No

No

Part of the Newco control group.

Apply predecessor basis to the extent of the lessor of the continuing shareholder’s residual interest in Newco or Oldco.³

Yes

Does the bear (or bears) have greater than or equal to 5% residual interest in Newco and greater than or equal to 20% residual interest in the aggregate?

No  Fair valuation for that portion of Newco investment.⁴

¹There’s a rebuttable presumption that management is a member of the control group. If the presumption is overcome, management would be considered either a bull or a bear.

²Bulls are shareholders with a greater residual interest in Newco than Oldco.

³Bears are shareholders with a greater residual interest in Oldco than Newco.

⁴Fair valuation is subject to the monetary test.

⁵Application should be made for each member of management separately.

501
1. A single shareholder, who may be an individual member of management, obtains unilateral control of Newco, and that shareholder did not have unilateral control of Oldco. This condition is met when either an individual member of management or management as a group obtains unilateral control of Newco and did not have unilateral control of Oldco.

2. A group of new shareholders, which may include management, that meets the definition for inclusion in the Newco control group (described below), obtains unilateral control of Newco. For purposes of this test, there’s a rebuttable presumption that management as a group is considered a single shareholder.

3. The Newco control group that obtains unilateral control of Newco has no subset that had unilateral control of Oldco.

Dilutive securities of Newco (other than options and warrants) that are substantially equivalent to voting interests of Newco and issued to or held by investors that aren’t members of the controlling shareholder group should be considered when analyzing whether control has changed. This is key to valuing the net assets of the LBO. If a change in control hasn’t occurred, the transaction should be accounted for as a recapitalization—that is, a change in accounting basis is not appropriate.

The new controlling shareholder must have the ability to implement major operating and financial policies, such as selling and acquiring assets and refinancing debt. If the terms of other nonvoting securities substantially limit the new controlling group’s ability to exercise such control, a change in control hasn’t occurred. Similarly, if dilutive or convertible securities allow shareholders to regain control, the change in control cannot be considered substantive.

The SEC’s Position. The consensus becomes part of the accounting literature that makes up generally accepted accounting principles. Notwithstanding the consensus, public entities and those considering going public during the next several years should be aware that the Securities and Exchange Commission is likely to review further the facts and circumstances independently to determine whether a change in control has occurred. It will consider three factors:

1. The amount of Newco’s capital the selling shareholder will provide after the LBO.
2. Related party agreements, employment contracts, guarantees and other financial arrangements between the selling shareholders and the Newco investors.

3. Certain criteria set forth in topic 5E of the SEC Staff Accounting Bulletins, *Accounting for Divestitures of a Subsidiary or Other Business Operation*, must be present for the seller to account for a sale as a divestiture.

The Newco Control Group: Membership Has Its Consequences

The previous EITF consensus described a control group as “two or more parties . . . to the extent that (1) they mutually promote the transaction, (2) their continuing economic interests are sufficiently compatible and (3) the available evidence supports the position that the members of the control group will continue to collaborate to exert voting control over Newco after the transaction.” The criteria in the new consensus are more quantitative and leave less to judgment. Determining who’s included in the Newco control group is important because it’s a key element in determining the proportion of the Newco investment (Oldco’s net assets) that are recorded at fair value or predecessor basis.

The new consensus introduces the concept of residual interest—that is, a shareholder’s proportional interest, including the effect of dilutive securities, in the net assets of an entity, net of satisfaction, liquidation or redemption provisions of other equity securities. In computing a shareholder’s residual interest, the total shareholder’s equity interest appearing in the denominator should include the dilutive effect of those convertible securities, warrants and options included in the numerator and other such securities exercisable and convertible at no less favorable terms. The computation, however, ignores a shareholder’s rights to acquire additional Newco common stock at fair value when the right is exercised, if the right can’t be exercised until Newco has been in operation for a substantial period of time. See Exhibit 2 for an example of how to calculate residual interest.

The consensus says the procedures to determine the accounting for a shareholder’s investment in Newco should be different if the shareholder’s residual interest increases or decreases as a result of an LBO. (See Exhibits 3 and 4.) The consensus focused on residual interest as a means of measuring economic involvement and included
this provision because of the recent popularity of nonvoting and preferred equity securities (and options) that are being issued to Oldco shareholders as part of an LBO. When such securities are included in Newco’s capital, it’s often difficult to ascertain whether an Oldco shareholder’s investment actually increased or decreased and what such shareholder’s residual interest is after the LBO.

The consensus divides Newco shareholders into three groups and sets forth the following rules:

- There’s a rebuttable presumption that management is part of the Newco control group. That presumption may be overcome if management did not participate in promoting the LBO. Management is defined as Oldco employees or management that hold management positions and a residual interest in Newco. The consensus points to SEC regulation S-K section 401 for guidance on who’s considered management.

- Those who hold a greater residual share in Newco than they held in Oldco (bulls) and who hold a 5 percent or more residual interest in Newco are considered part of the Newco control group.

- Those with the same or lesser residual share in Newco than held in Oldco (bears) will be considered part of the Newco control group—unless they fall below the 20 percent level in the voting-interest test and all cumulative levels in the capital-at-risk test described below.

The 5 percent thresholds were included in the consensus to prevent public shareholders from being considered part of the Newco control group. In addition, related parties as defined in SFAS 57, Related Party Disclosures, whose related party status stems from something other than being Oldco shareholders, are considered a single individual shareholder.

**Exhibit 2 Calculating Residual Interest**

Residual interest is a shareholder’s proportional interest in the net assets of an entity, after satisfaction, liquidation or redemption provisions of other equity securities. Assume Newco features the following equity breakdown:
Exhibit 2 (continued)

<table>
<thead>
<tr>
<th>Shareholders' Equity</th>
<th>Outstanding Shares</th>
<th>Book Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred stock:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Class A,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>no liquidation or redemption features</td>
<td>300</td>
<td>$1,600</td>
</tr>
<tr>
<td>Class B,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>liquidating value $10 per share</td>
<td>400</td>
<td>4,000</td>
</tr>
<tr>
<td>Class C,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>redemption value $12 per share</td>
<td>100</td>
<td>1,200</td>
</tr>
<tr>
<td>Common stock:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Voting</td>
<td>800</td>
<td>$9,200</td>
</tr>
<tr>
<td>Nonvoting</td>
<td>500</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>2,100</td>
<td>$21,000</td>
</tr>
</tbody>
</table>

Assume Brett owns 10 shares of class A preferred stock, 20 shares of class B preferred stock, 30 shares of class C preferred stock, 70 shares of voting common stock and 20 shares of nonvoting common stock. His residual interest is 6.25 percent ($100 \div 1,600) computed as follows:

<table>
<thead>
<tr>
<th>Class of Stock</th>
<th>Total Equity Securities Outstanding</th>
<th>Number of Shares Outstanding</th>
<th>Owned by Brett</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class A preferred</td>
<td>300</td>
<td>300</td>
<td>10</td>
</tr>
<tr>
<td>Class B preferred</td>
<td>400</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Class C preferred</td>
<td>100</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Voting common</td>
<td>800</td>
<td>800</td>
<td>70</td>
</tr>
<tr>
<td>Nonvoting common</td>
<td>500</td>
<td>500</td>
<td>20</td>
</tr>
</tbody>
</table>

1,600 100

Where there are convertible securities or options, the numerator should be calculated on a fully diluted basis. The denominator should include those convertible securities, warrants and options included in the numerator and other such securities exercisable and convertible at terms no less favorable than the terms of such securities included in the numerator.
Voting-Interest Test. The voting-interest test computes the bear’s proportional voting interest in Newco. A fraction is determined: The numerator is the bear’s voting shares in Newco and the denominator is the total number of outstanding Newco voting shares. The numerator should be calculated on a fully diluted basis; the denominator should include those convertible securities, warrants and options included in the numerator and other such securities exercisable and convertible at terms no less favorable than the terms of such securities included in the numerator. Convertible securities, options and so forth need not be included in the numerator or denominator, however, if a substantive period of time must elapse before they can be exercised.

However, the effect of including the dilutive securities held by individuals other than a continuing shareholder may not reduce the continuing shareholder’s percentage of voting interest below its percentage of outstanding voting interest.

Capital-At-Risk Test. This test determines whether a bear with an insignificant voting interest in Newco nevertheless has a significant economic stake in the enterprise. A bear’s capital at risk is the sum total of his or her investment in Newco’s debt and equity securities.

The test starts with consideration of the bear’s proportional share of Newco’s most risky security—typically common stock—and continues, cumulatively, to secured debt. Guarantees and the bear’s commitments to advance additional funds under specified circumstances also are considered for test purposes. (The voting-interest and capital-at-risk tests are illustrated in Exhibit 4.)

Exhibit 3 Increasing Residual Interest: Going Private

Using the EITF’s new consensus, here’s an example of an LBO featuring an increasing shareholder’s interest.

Brittany Manufacturing Co. is an established publicly traded corporation. Its book value is $2,400, with management owning 50 shares or 5 percent of the 1,000 outstanding shares at June 30, 1989. Assume the shares are trading at $20 per share and the fair market value of Brittany’s fixed assets is $12,000. Management also has a 5 percent residual interest in the company.

A private investor and a bank approach management about a leveraged buy-out. On June 30, 1989, Newco is formed and capitalized with $18,000 of bank debt and $1,000 contributed by the private investor who receives 100 shares (50 percent voting interest) of Newco. Management exchanges its 50
Exhibit 3 (continued)

shares of Brittany, worth $1,000, for 100 shares (50 percent voting interest) of Newco. The $19,000 raised from the bank and the private investor is used to acquire the 950 shares in public hands. Immediately after the tender offer, Newco and Brittany merge. Management emerges with a 50 percent residual interest in the merged company.

Management and the private investor will act in concert and exert voting control over the merged entity (and form the Newco control group).

In establishing an opening balance sheet for Newco, a change of accounting basis for Brittany’s net assets is permitted under the new consensus because there’s been a change in control. But only a partial step-up in basis is permitted.

Let’s assume that management’s predecessor basis is equal to its share of the book value. The book value of its recorded net assets equals its fair value—except for fixed assets. Under such circumstances, there would be a $16,720 step-up in the carrying value of Brittany Manufacturing Co.’s net assets and an opening shareholders’ equity of $1,120. The amounts are derived as shown below:

<table>
<thead>
<tr>
<th></th>
<th>Brittany Manufacturing Co.</th>
<th>Newco Investment and Initial Capitalization</th>
<th>Consolidation Entries</th>
<th>Consolidated Newco</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 300</td>
<td>$20,000</td>
<td>$(2,400)</td>
<td>$3,250</td>
</tr>
<tr>
<td>Receivables</td>
<td>250</td>
<td>$20,000</td>
<td>(20,000)</td>
<td>$250</td>
</tr>
<tr>
<td>Inventory</td>
<td>700</td>
<td></td>
<td>7,600</td>
<td>700</td>
</tr>
<tr>
<td>Fixed assets Investment in Brittany</td>
<td>1,250</td>
<td></td>
<td>$10,000</td>
<td>1,250</td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td></td>
<td>(380)</td>
<td>7,220</td>
</tr>
<tr>
<td></td>
<td>$3,250</td>
<td>$20,000</td>
<td>$(880)</td>
<td>$19,970</td>
</tr>
<tr>
<td>Payables</td>
<td>$ 850</td>
<td></td>
<td>$ 850</td>
<td></td>
</tr>
<tr>
<td>Payable to Bank</td>
<td></td>
<td></td>
<td>$18,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Equity</td>
<td>2,400</td>
<td>2,000</td>
<td>$ 2,400</td>
<td>$1,120</td>
</tr>
<tr>
<td></td>
<td>$3,250</td>
<td>$20,000</td>
<td>$ 880</td>
<td>$19,970</td>
</tr>
</tbody>
</table>

(1) This entry eliminates Newco’s investment in Brittany Manufacturing Co. and Brittany Manufacturing Co.’s equity. It also steps up the value of Brittany Manufacturing Co.’s net assets to their fair market value of $12,000 for fixed assets and $7,600 for goodwill—the excess of the purchase price over the fair value of assets acquired.

(2) Since management in this example is a member of the Newco control group, predecessor basis amounting to its 5 percent residual interest (the lesser of its residual interest in Brittany Manufacturing Co. and Newco) must be considered in determining Consolidated Newco’s equity. This entry charges the disallowed portion of the step-up in basis to Newco’s equity.
Exhibit 3 (continued)

Newco’s equity can be determined as follows:

| Stock issued to private investor for cash: | $1,000 |
| Stock issued to management valued at book value (assumed to be predecessor basis) | 120 |
| **Total** | **$1,120** |

The determination of the permitted step-up in basis under the consensus is as follows:

| Fair value of Brittany Manufacturing Co. | $20,000 |
| Book value of Brittany Manufacturing Co. | 2,400 |
| **Difference (step-up permitted without consideration of carryover basis)** | **$17,600** |
| Percentage of carryover basis required by consensus: | 5% |
| Reduction of step-up required to reflect carryover basis | 880 |
| **Permitted step-up in basis** | **$16,720** |

The step-up in basis is allocated to fixed assets, $9,500, and goodwill, $7,220. Both amounts are 95 percent of the amounts that would have been recorded but for the 5 percent carryover basis adjustment.

The computation of the step-up in basis allowed also may be used as a method to calculate Newco equity and serve as a proof to the accounting:

| Nominal capital of Newco: |
| Received by management (in exchange for 20 shares of Brittany Manufacturing Co.) | $1,000 |
| Purchased by private investor | 1,000 |
| **Reduction of step-up required to reflect carryover basis** | **880** |
| **Fair value of Newco equity** | **$1,120** |

Another method of computing Newco equity, which may be useful as a further proof, is as follows:

| Investment in Brittany: |
| 95 percent fair value | $19,000 |
| 5 percent predecessor basis | 120 |
| **Total** | **$19,120** |
| Cash paid to Brittany’s shareholders | (19,000) |
| Cash proceeds from sale of Newco stock | 1,000 |
| **Total** | **$1,120** |
Exhibit 3 (continued)

The opening parent company balance sheet of Newco should appear as follows:

Newco Parent Company
Balance Sheet
June 30, 1989

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Brittany Manu</td>
<td>$19,120</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and shareholders’ equity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Payable to bank</td>
<td>$18,000</td>
</tr>
<tr>
<td>Shareholders’ equity:</td>
<td></td>
</tr>
<tr>
<td>Management</td>
<td>120</td>
</tr>
<tr>
<td>Private investor</td>
<td>1,000</td>
</tr>
<tr>
<td>Total</td>
<td>1,120</td>
</tr>
</tbody>
</table>

$19,120

Disclosure

Disclosure of the LBO transaction may be made as follows:

"Newco (the “company”), a Delaware corporation, was formed on June 30, 1989, for purposes of acquiring 100 percent of the outstanding common stock of Brittany Manufacturing Co. (the “subsidiary”) in a leveraged buy-out purchase transaction. The company adopted a fiscal year end of June 30. In establishing the company, a private investor acquired 50 percent of the company’s stock for $1,000 and management of the subsidiary acquired 50 percent of the company’s stock in exchange for 50 shares of the subsidiary. The remaining 950 outstanding subsidiary shares were acquired from shareholders for $20 per share in cash. Financing for this purpose was obtained from the funds provided by the private investor and through an $18,000 bank borrowing by Newco as described in note X. Immediately after the acquisition, the company and subsidiary merged.

“The company has allocated the purchase price of the subsidiary among its assets and liabilities, based on their respective fair values in accordance with APB Opinion No. 16, Business Combinations. The excess of the cost of acquired assets over their fair values was recorded as goodwill. This will be amortized over 40 years. According to EITF Issue 88-16, Basis in Leveraged Buyout Transactions, in allocating the purchase price of the subsidiary among its net assets, the difference between the fair values and the subsidiary’s recorded values of the net assets acquired has been proportionately
Exhibit 3 (continued)

reduced by $880—with such amount being charged against Newco’s shareholders’ equity. Such amount represents the difference between the fair value of common stock acquired from management and management’s predecessor basis in such stock.”

Exhibit 4  
Decreasing Residual Interest:  
Mr. Bonham Retires

The Joy Co. is an established service company that was incorporated many years ago by Mr. Bonham, who owns 100 percent of The Joy Co.’s common stock. Joy employs a president and two managers in its business. Neither of them has any equity ownership in the company.

The fair market value of The Joy Co. is $80,000. Bonham’s basis in the company equals $12,000.

Bonham is considering retirement and selling the business. Management, with the aid of an LBO firm, approaches Bonham about an LBO. A deal is made and a Newco is established. The LBO firm invests $3,000 for a 30 percent interest (3,000 shares) in Newco. Bonham purchases a 15 percent voting interest in Newco by buying 1,500 shares for $1,500. Management purchases 5,500 shares of Newco for $5,500.

As part of the negotiations, management grants Bonham options to purchase 500 additional shares at $5 per share, 400 of which are nonvoting shares. Management receives options to purchase 500 additional shares at $4 per share, 100 of which are nonvoting shares. The LBO firm is granted options to purchase 1,000 voting shares at $6 per share and 1,500 nonvoting shares at $4 per share. Assume the options have no fair value but are all currently exercisable.

On March 31, 1989, the LBO is completed. Newco borrows $70,000 from a bank. This combined with $8,500 received from the LBO firm and management are paid to Bonham, who also receives 1,500 shares of Newco stock, valued at $1,500, in exchange for this 100 percent ownership of The Joy Co. He will become a passive investor in Newco and not part of management.

In establishing the Newco opening consolidated balance sheet, there is a step-up in basis of the net assets of The Joy Co. because there has been a change in control.

To determine the extent of carryover basis, it’s necessary to determine who’s part of the Newco control group:
Exhibit 4 (continued)

- Management promoted the LBO and as such is considered part of the group.
- The LBO firm is a bull with a 5 percent or greater residual interest, so it's part of the control group, too.
- Bonham is a bear. His residual interest in Oldco is greater than his residual interest in Newco, which amounts to 16 percent, calculated as follows:

<table>
<thead>
<tr>
<th>Common Stock</th>
<th>Outstanding Shares*</th>
<th>Adjusted Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Voting</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonham</td>
<td>1,500</td>
<td>100</td>
</tr>
<tr>
<td>Management</td>
<td>5,500</td>
<td>400</td>
</tr>
<tr>
<td>LBO firm</td>
<td>3,000</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>10,000</td>
<td>500</td>
</tr>
<tr>
<td>Nonvoting</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonham</td>
<td>—</td>
<td>400</td>
</tr>
<tr>
<td>Management</td>
<td>—</td>
<td>100</td>
</tr>
<tr>
<td>LBO firm</td>
<td>—</td>
<td>1,500</td>
</tr>
<tr>
<td></td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10,000</td>
<td>2,500</td>
</tr>
</tbody>
</table>

*Assumed to be outstanding reflecting the exercise of Bonham's options and all others' at no less favorable prices.

Bonham's residual interest is equal to \( (1,600 + 400) \div 12,500 \), or 16 percent. Options with an exercise price greater than the highest price of Bonham's options ($5 per share) are excluded from the computation.

Because he is a bear, two tests must be performed to determine whether Bonham is a member of the Newco control group. If he reaches or exceeds the voting-interest test or the capital-at-risk test at the 20 percent level, he would be considered part of the Newco control group and 16 percent of his predecessor basis in The Joy Co. would be carried over to Newco. If he had a residual interest greater or equal to 20 percent in Newco, predecessor basis at that level would be required whether or not he's a member of the Newco control group.

Voting-Interest Test

Bonham's voting interest in Newco falls short of the 20 percent threshold:
Exhibit 4 (continued)

Numerator: Bonham’s voting shares, as adjusted 1,600
Denominator: Total voting shares 10,500
Voting-interest test percentage 15.238%

To illustrate the voting test further, consider the following scenario:

If the bank had loaned Newco only $59,500 to buy out Bonham and the remainder was paid to him by issuing a $10,500 Newco convertible bond, convertible at $21 per share into 500 shares, then the voting-interest test would put Bonham’s voting-interest percentage at the 17.5 percent level (2,100 ÷ 12,000 = 17.5 percent):

<table>
<thead>
<tr>
<th>Common Stock</th>
<th>Adjusted</th>
<th>Additional Options¹</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Voting</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonham</td>
<td>1,600</td>
<td>500</td>
<td>2,100</td>
</tr>
<tr>
<td>Management</td>
<td>5,900</td>
<td>—</td>
<td>5,900</td>
</tr>
<tr>
<td>LBO firm</td>
<td>3,000</td>
<td>1,000</td>
<td>4,000</td>
</tr>
<tr>
<td></td>
<td>10,500</td>
<td>1,500</td>
<td>12,000</td>
</tr>
<tr>
<td>Nonvoting</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonham</td>
<td>400</td>
<td>—</td>
<td>400</td>
</tr>
<tr>
<td>Management</td>
<td>100</td>
<td>—</td>
<td>100</td>
</tr>
<tr>
<td>LBO firm</td>
<td>1,500</td>
<td>—</td>
<td>1,500</td>
</tr>
<tr>
<td></td>
<td>2,000</td>
<td>—</td>
<td>2,000</td>
</tr>
<tr>
<td>Total</td>
<td>12,500</td>
<td>1,500</td>
<td>14,000</td>
</tr>
</tbody>
</table>

¹The LBO firm’s $6 options are now considered exercised because the convertible bonds issued to Bonham are convertible at $21 per share.

Capital-at-Risk Test

Because the voting-interest test is below 20 percent, the capital-at-risk test should be performed:

<table>
<thead>
<tr>
<th>Newco Capitalization</th>
<th>Applicable to Bonham</th>
<th>Total Outstanding</th>
<th>Percentage</th>
<th>Cumulative Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonvoting common stock</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Voting common stock</td>
<td>$1,500</td>
<td>$10,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Exhibit 4 (continued)

<table>
<thead>
<tr>
<th>Newco Capitalisation</th>
<th>Applicable to Bonham</th>
<th>Total Outstanding</th>
<th>Percentage</th>
<th>Cumulative Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total common stock</td>
<td>$1,500</td>
<td>$10,000</td>
<td>15</td>
<td>15(^1)</td>
</tr>
<tr>
<td>Debt to bank</td>
<td>—</td>
<td>$70,000</td>
<td>—</td>
<td>1.875</td>
</tr>
</tbody>
</table>

\(^1\)The capital-at-risk percentage is 15 percent at the common stock level and 1.875 percent \(\frac{1,500 \div (10,000 + 70,000)}{}\) cumulatively through the debt capitalization.

Options are not included in the capital-at-risk computation because the underlying common shares are not outstanding and the option price is less than that paid for the common shares as part of the LBO.

To illustrate the capital-at-risk test further, consider this scenario:

If The Joy Co.'s land and building secured $55,000 of the $70,000 loan and Bonham's personal guarantee was required for the remainder, and if $400 of nonvoting common stock and $400 of nonconvertible, nonredeemable preferred stock were sold to each of the three groups of shareholders to raise additional funds for working capital purposes, then Bonham's capital-at-risk percentage would hit the 21 percent mark:

<table>
<thead>
<tr>
<th>Applicable to Bonham</th>
<th>Total Outstanding</th>
<th>Percentage</th>
<th>Cumulative Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonvoting common stock</td>
<td>$ 400</td>
<td>$ 1,200</td>
<td>16.96</td>
</tr>
<tr>
<td>Voting common stock</td>
<td>1,500</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Total common stock</td>
<td>$ 1,900</td>
<td>$11,200</td>
<td>16.96(^1)</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>$ 400</td>
<td>$ 1,200</td>
<td>33.33</td>
</tr>
<tr>
<td>Debt to bank</td>
<td>$15,000(^4)</td>
<td>$70,000</td>
<td>21.43</td>
</tr>
</tbody>
</table>

\(^1\)16.96 percent = $1,900 ÷ $11,200.

\(^2\)18.55 percent = (1,900 + 400) ÷ (11,200 + 1,200).

\(^3\)21.00 percent = (1,900 + 400 + 15,000) ÷ (11,200 + 1,200 + 70,000).

\(^4\)Reflects guarantee of Bonham.

If this were the case, Bonham would be considered part of the Newco control group and carryover basis would be required to the extent of his residual interest—subject to the monetary test. It should be noted that if the 20 percent mark is reached cumulatively through any risk level, the shareholder would be included in the Newco control group.
Monetary Test

A monetary test ascertains if enough objectively determinable consideration was paid to support the fair valuation assigned to Newco’s investment in The Joy Co.

The test is:

Total monetary consideration  
paid to Bonham to acquire The Joy Co. $78,500
Total consideration paid $80,000 = 98.125 percent

As long as the monetary consideration paid is at least 80 percent of the total consideration, carryover basis would be required to the extent determined by the above tests. For LBO transactions in which consideration paid is less than the 80 percent threshold, the percentage of Newco’s investment in Oldco that can be valued at fair value is limited to the percentage of monetary consideration paid.

The Bottom Line

Because Bonham is below the 20 percent level in both the voting-interest test and the capital-at-risk test, he’s excluded from the Newco control group. Also, because his residual interest in Newco is below 20 percent, all of Newco’s investment in The Joy Co. may be valued at fair value—that is, there’s no consideration of carryover basis.

If Bonham were considered part of the Newco control group, then carryover basis would have to be considered to the extent of his residual interest in Newco. The opening Newco balance sheet would be prepared in a manner similar to the one in Exhibit 3—with the carryover percentage equal to Bonham’s residual interest in Newco.

Fair Value Versus Predecessor Basis

A shareholder’s predecessor basis is his or her original cost plus his or her share of earnings or losses less dividends and other distributions received. A shareholder’s proportionate equity in an entity’s book value may be substituted when it’s impracticable to recompute predecessor basis.

Assuming there’s been a change in control, the consensus sets forth the following provisions for valuing Newco’s investment in Oldco:

- For Newco control group members: The lesser of the continuing shareholder’s residual interest in Oldco or Newco is carried over at predecessor basis.
• For Newco noncontrol group members: The residual interest of bears that have a 5 percent or more residual interest in Newco, and that in the aggregate have a 20 percent or more residual interest in Newco, is carried over at predecessor basis.

• The remainder of Newco’s investment in Oldco is valued at fair value, subject to the monetary test described below.

For these determinations, each member of management is considered an individual shareholder; related parties are considered one single shareholder.

**Monetary Test**

The consensus requires that a test be performed to determine whether enough objectively determinable consideration is being paid to support the fair values being assigned to all or part of Newco’s investment in Oldco (Oldco’s net assets). Accordingly, the consensus requires the performance of a global test on monetary consideration.

Unlike the monetary test in Issue 86-16, which addressed consideration paid to noncontrolling shareholders only, the new consensus tests consideration paid to all Oldco shareholders in an LBO. As long as the total consideration paid to all Oldco shareholders consists of at least 80 percent monetary consideration, the Newco investment can be valued as described above. Monetary consideration includes cash, debt and debt-type instruments—such as mandatorily redeemable preferred stock.

The consensus requires, however, that if the ratio of monetary consideration to total consideration falls below 80 percent, the amount of fair valuation that may be assigned to the Newco investment is limited to whatever that percentage may be.

**If at First You Don’t Succeed . . .**

CPAs following the LBO issue are pleased the new EITF consensus eliminates most of the inconsistencies that had existed between accounting for LBOs featuring increasing and decreasing ownership. Also, they’re pleased it doesn’t depart significantly from most of the conclusions of Issue 86-16. However, debates are still likely to arise in some LBOs about whether a bear is part of management and whether the rebuttable presumption that management is part of the control group can be overcome.
The SEC appears satisfied with the new consensus and believes it’s generally consistent with what it has been requiring in financial statements of public companies.

Is this new consensus the final word in LBO accounting? Already some observers have complained that the new rules are just too complex. Why not have either all full valuation or all predecessor basis depending on whether there’s been a genuine change in control? Or why not allow fair valuation just to the extent of new shareholders?

Some observers argue major inconsistencies still exist in LBO accounting. Some LBOs are structured without any formation of a Newco. If the results and economics of these transactions are identical to those of the classic LBO, why should the accounting be different? Guidance also is needed on what the accounting should be if Newco acquires substantially all the outstanding operating assets of Oldco and not the outstanding equity. Most believe the accounting should be the same.

Many accounting theoreticians aren’t satisfied either. The new consensus still has characteristics of part-purchase/part-pooling accounting, which was eliminated by APB 16, Business Combinations, 20 years ago.

Those satisfied with the consensus point to the fact that LBO transactions are very complex, with no two LBOs alike. The consensus looks at the economic substance of the LBO to determine its accounting. Though the tests required are complex, performing them should not be overly burdensome to the practitioner—especially since they need only be performed when preparing the opening balance sheet of Newco and not on a recurring basis.
# Overview of AICPA Technical Inquiries, Accounting Statements of Position, and Practice Bulletins

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CHAPTER 12
Overview of AICPA Technical Inquiries, Accounting Statements of Position, and Practice Bulletins

INTRODUCTION

Accounting guidance is also available through the AICPA in the form of Technical Practice Aids, Accounting Standards Division Statements of Position, and Accounting Standards Executive Committee (AcSEC) Practice Bulletins.

AICPA Technical Practice Aids, Volume 1, summarizes the most troublesome and frequently encountered questions and problems submitted to the AICPA's Technical Information Service. Each inquiry includes a statement of problem, recommendations made by the AICPA staff and references to relevant standards and other authoritative literature. Inquiries are organized by subject and indexed.

The Accounting Standards Division of the AICPA issues Statements of Position with the stated purpose to influence the development of accounting standards in directions the division believes are in the public interest and, in certain circumstances, to propose revisions or clarifications to recommendations on accounting standards contained in industry oriented Audit Guides and Accounting Guides published by the American Institute of Certified Public Accountants.

In November 1987, the AICPA issued Practice Bulletin 1, which announced that the Accounting Standards Executive Committee (AcSEC) will, when necessary, publish AcSEC Practice Bulletins. Such bulletins provide practitioners and preparers with guidance on narrow financial accounting and reporting issues. (Previously, AcSEC released its views on such issues through the CPA Letter and the Journal of Accountancy.) The issues are limited to those that the Financial Accounting Standards Board and the Governmental Accounting Standards Board have not or will not address.
Drafts of Practice Bulletins are neither exposed for public comment nor are they the subject of public hearings. However, they are discussed at open meetings of AcSEC and are included with agenda papers for such meetings. For publication, a Practice Bulletin requires approval by two-thirds of AcSEC members. Before publication, the FASB and GASB are given the opportunity to review the Practice Bulletin, and then inform AcSEC that they have no intention of considering the issue. Practice Bulletins are numbered to facilitate reference and retrievability, and, on issuance, are distributed to practice units and other interested parties.

Amendments of Practice Bulletins require the same procedures as those for issuing a new Practice Bulletin.

Technical Practice Aids, AcSEC Statements of Position and AcSEC Practice Bulletins are not covered by rule 203 of the AICPA Code of Professional Conduct. Their places in the hierarchy of generally accepted accounting principles are established through Statement on Auditing Standards No. 5, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor’s Report*, as amended by Statement on Auditing Standards No. 43, *Omnibus Statement on Auditing Standards*. AICPA Accounting Statements of Position are specifically mentioned as belonging at the second level within the hierarchy, which is works of experts following a due process procedure. Technical Inquiries and Practice Bulletins fall within the lowest level of the hierarchy, which is other accounting literature.

In September 1979, SFAS 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters*, as amended, specifies that specialized accounting and reporting principles and practices in designated AICPA Statements of Position are preferable accounting principles for applying APB Opinion 20, *Accounting Changes*. Under SFAS 20, *Reporting Accounting Changes Under AICPA Statements of Position*, the FASB specified that transition provisions in a Statement of Position override APB 20. However, if a transition is unspecified in the Statement of Position, then the cumulative catch-up adjustment would apply.

If the FASB, GASB, or predecessor bodies have not ruled on a given transaction, privately held companies and, of course, publicly held companies, should look to and would clearly do well to look to Technical Practice Aids, Accounting Statements of Position, and
AcSEC PracticeBulletins as sources of GAAP. This chapter concentrates on Technical Practice Aids, Accounting Statements of Position, and AcSEC Practice Bulletins recently published that have general applicability.

**AICPA TECHNICAL PRACTICE AIDS—SELECTED QUESTIONS**

The following inquiries and replies on selected practice problems are directly excerpted from AICPA, *Technical Practice Aids*, Vol. 1, TIS Sections 1,000–5,000, 7,000 (New York: AICPA, 1988, 1989).

**Financial Statement Presentation**

**Statement of Financial Position**

*Need for comparative financial statements*

*Inquiry.* Are both a balance sheet and income statement (and, therefore, also the statement of cash flows) required for all annual reports, and must all such statements be in comparative form for at least two years?

Is either statement alone a fair presentation? There are certain specific circumstances where this question can be specifically raised, for example, does a balance sheet alone (especially if not in comparative form) “fairly present” financial position if the client incurred a material operating loss during the current year?

*Reply.* ARB No. 43, chapter 2A, *Comparative Financial Statements*, paragraph 2, recommends, but does not require, presentation of comparative financial statements. However, by its Securities and Exchange Act of 1934 Release No. 9000, the SEC requires comparative financial statements for the last two fiscal years, both in financial statements submitted to it and, under its proxy regulations, in annual reports of such companies to the public.

SAS No. 58, *Reports on Audited Financial Statements*, paragraph 5, states:
Reference in the fourth reporting standard to the financial statements "taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement (for example, to a balance sheet) for one or more periods presented. The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances warrant.

SAS No. 58, paragraph 47, states:

The auditor may be asked to report on one basic financial statement and not on the others. For example, he may be asked to report on the balance sheet and not on the statements of income, retained earnings or cash flows. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if he applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.

Therefore, it appears a separate statement of financial position may fairly present financial position, and a separate statement of income may fairly present results of operations for a period. Such statements are useful for certain purposes, such as in statements furnished to indicate compliance with bond indentures and reports on operations for an interim period. The fact that many users of financial statements will require a statement of financial position, a statement of income, a statement of changes in stockholders' equity, and a statement of cash flows to properly evaluate a company does not indicate that a single statement may not fairly present the information it purports to present.

A statement of financial position, as the term is generally used, refers to a "picture" of an entity at one point in time. Losses from operations should be appropriately reflected in the retained earnings account of the entity. If the losses are so great that the "going concern" premise is in question, proper treatment of this matter is necessary for the statement to reflect "financial position," whether or not an accompanying statement of income is presented.

Each statement should stand on its own when presented in conjunction with the other, and therefore should be able to stand on its own when presented separately. The fact that neither statement by itself is adequate for full evaluation of the company should not pre-
clude issuance of such statements, as they may serve other purposes. [Amended]

Income Statement

**Presentation of reimbursed payroll expense**

_Inquiry._ One company of a controlled group, in addition to its own operations, acts as a "paymaster" for the entire group. This company records the entire payroll of all members in the group on its general ledger to facilitate reconciliation with state and federal payroll tax returns. Each member of the group reimburses the "paymaster" for its share of payroll and payroll taxes and records management fee expense while the paymaster records it as management fee income.

Should the reimbursement be classified as other income in the separate income statement of the "paymaster" company?

_Reply._ No. The reimbursement should be allocated as a reduction of payroll and payroll tax expense because this approach would more accurately present the "paymaster" company’s expenses for its own operations.

Statement of Cash Flows

**Comparative statements of cash flows**

_Inquiry._ Is it necessary to provide a statement of cash flows for both the current and prior periods if comparative income statements are presented, but only the current balance sheet is presented?

_Reply._ FASB Statement No. 95, _Statement of Cash Flows_, paragraph 3, requires a business enterprise that reports both financial position and results of operations to provide a statement of cash flows for each period for which results of operations are provided.

Therefore, if a balance sheet is presented, a statement of cash flows should be presented for both current and prior periods if income statements are presented for such periods. [Amended]
Statement of cash flows for annual report with balance sheet only

Inquiry. When only a statement of financial position is presented, is it necessary that the auditor's opinion be qualified relative to the omission of the statement of cash flows?

Reply. FASB Statement No. 95, Statement of Cash Flows, paragraph 3, states:

A business enterprise that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided.

Therefore, when a statement of financial position is not accompanied by a statement of operations, there is no need for presentation of a statement of cash flows, and no comment on the absence of such a statement is necessary. [Amended]

Statements of cash flows for nonprofit organizations

Inquiry. FASB Statement No. 95, Statement of Cash Flows, paragraph 3, specifies that the statement of cash flows should be presented as a basic financial statement when a balance sheet and a statement of income are issued by a profit-oriented business entity. May this requirement be properly interpreted to mean that the statement of cash flows is not a requirement when reporting on financial position and operating results of a nonprofit organization?

Reply. The AICPA industry audit guides applicable to colleges and universities, voluntary health and welfare organizations, and funds (other than enterprise funds) of state and local governmental units state that those entities need not present a statement of changes in financial position because the essential information is presented in the other financial statements. The applicable audit guides and statement of position (SOP) No. 78-10, Accounting Principles and Reporting Practices for Certain Nonprofit Organizations, state that financial statements intending to present both the financial position and results of operations of hospitals, enterprise funds of local and state governmental units, and other nonprofit organizations should include a statement of changes in financial position.
The guidance in the aforementioned audit guides and SOP regarding statements of changes in financial position should be applied to statements of cash flows, as required by FASB Statement No. 95. [Amended]

**Effect of change in depreciation method on statement of cash flows**

*Inquiry.* A company which formerly depreciated its equipment on an accelerated basis has changed to the straight-line method. The cumulative effect of this change, net of tax, was a $100,000 increase in income for the current year. How should this change be shown on the statement of cash flows?

*Reply.* The cumulative effect should be shown on the statement of cash flows under cash flows from operating activities as a reconciling item between net income and net cash provided by operating activities, if the indirect method is used. If the direct method is used, the cumulative effect should be shown as a reconciling item on the reconciliation of net income to net cash provided by operating activities. [Amended]

**Presentation of property sold in statement of cash flows**

*Inquiry.* What is the correct method of presenting property sold in a statement of cash flows?

*Reply.* FASB Statement No. 95, *Statement of Cash Flows*, paragraph 16, states that receipts from sales of property, plant, and equipment and other productive assets are cash inflows from investing activities. The gain or loss arising from the sale should appear as a reconciling item between net income and net cash provided by operating activities. The total proceeds received from the sale should appear under cash flows from investing activities. [Amended]

**Comprehensive basis of accounting other than generally accepted accounting principles**

*Inquiry.* When an entity prepares its financial statements on a comprehensive basis of accounting other than generally accepted accounting principles (GAAP), is a statement of cash flows required?
Reply. FASB Statement No. 95, Statement of Cash Flows, paragraph 3, states:

A business enterprise that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided.

SAS No. 14, Special Reports, paragraph 7, states in part:

Terms such as “balance sheet,” “statement of financial position,” “statement of income,” “statement of operations,” “statement of changes in financial position,” or similar unmodified titles are generally understood to be applicable only to financial statements that are intended to present financial position, results of operations, or changes in financial position in conformity with generally accepted accounting principles.

Accordingly, an entity presenting financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles is not required to include a statement of cash flows, since these statements do not purport to present both financial position and results of operations in accordance with GAAP. [Amended] [SAS No. 14 is now superseded by SAS No. 62.]

The effect of a prior period adjustment on the statement of cash flows when single period statements are presented

Inquiry. How would a prior period adjustment be presented in the statement of cash flows if single period statements are presented?

Reply. FASB Statement No. 16, Prior Period Adjustments, paragraph 16a, states that “prior period adjustments shall, in single period statements, be reflected as adjustments of the opening balance of retained earnings.” A corresponding prior period adjustment will normally result in a change in the beginning balance of an asset or liability account. FASB Statement No. 95, Statement of Cash Flows, paragraph 32, states in part:

Information about all investing and financing activities of an enterprise during a period that affected recognized assets or liabilities but that did not result in cash receipts or cash payments in the period shall be reported in related disclosures.
Therefore, the difference in an account between the current balance sheet and that same account in the restated beginning balance sheet (even if not presented) that resulted from the prior period adjustment should be reflected in the related footnote disclosures and clearly referenced to the statement of cash flows. [Amended]

**Statement of cash flows for initial year of operations**

*Inquiry.* Is a statement of cash flows required for a company's first year of operations?

*Reply.* Yes. FASB Statement No. 95, *Statement of Cash Flows*, paragraph 3, states that a business enterprise that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided.

**Consolidated Financial Statements**

*Presentation of investment in partnership*  

*Inquiry.* A company has an investment in a limited partnership engaged in the construction of an office building. In order to obtain outside investors for the office building partnership, the company has agreed that profits or losses for the first nine years of operation shall be allocated 70% to the outside investors and 30% to the company. At the expiration of the nine years, the distribution of earnings or losses shall revert 70% to the company and 30% to the outside investors. However, since the company is contributing 70% of the value to the office building partnership, it was agreed that upon sale of the office building, at any time, the company will receive 70% of the profit and the outside investors 30%.

Should the financial statements of the limited partnership be combined with those of the company or would the equity method of accounting have to be used?

*Reply.* Since the company “owns” 70% of the limited partnership, the financial statements of the limited partnership should be combined with those of the company on a line by line basis even though during the first nine years there would be a minority interest in earnings of 70%. [Amended]
Consolidation of indirect subsidiaries

Inquiry. Corporation A owns one hundred percent of the stock of corporation B. B owns ninety percent of Company C and one hundred percent of Company D.

Would companies C and D be considered subsidiaries of A or B? Should B show the investments in C and D according to the equity method when filing financial statements?

Reply. Companies C and D would be considered indirect subsidiaries of A, and direct subsidiaries of B. APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, paragraph 14, as amended by FASB Statement No. 94, Consolidation of All Majority-Owned Subsidiaries, states in part, “The equity method is not a valid substitute for consolidation. Moreover, since ARB No. 51, Consolidated Financial Statements, as amended, requires the general-purpose financial statements of companies having one or more majority-owned subsidiaries to be consolidated statements, parent-company statements are not a valid substitute for consolidated financial statements.”

Unless the financial statements of corporation B are being prepared for a special purpose for which consolidation of its subsidiaries is not appropriate, failure to consolidate its interests in corporations C and D should be considered a departure from generally accepted accounting principles. [Amended]

Loss of control of subsidiary

Inquiry. Company A owns 55% of the voting stock of Company B. However 10% of the stock has been assigned to a voting trust for a period of two years. The trustee of the voting trust is a representative of the minority interest, giving the minority interest voting control for a period of two years.

Should Company A consolidate Company B or account for its investments by the equity method?

Reply. ARB No. 51, Consolidated Financial Statements, paragraph 2, as amended by FASB Statement No. 94, Consolidation of All Majority-Owned Subsidiaries, in a discussion of consolidation policy states:
The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over 50% of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. A majority-owned subsidiary shall not be consolidated if control is likely to be temporary or if it does not rest with the majority owner (as, for instance, if the subsidiary is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary).

Control does not rest with Company A (the majority owner) because Company A assigned 10% of the shares to a voting trust. Therefore, Company A should not consolidate Company B. APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, paragraph 14, footnote 4, as amended by FASB Statement No. 94, states that the limitations in ARB No. 51, paragraphs 2 and 3 (as amended by FASB Statement No. 94), should also be applied as limitations to the use of the equity method. Therefore, Company A should account for its investment in Company B by the cost method. [Amended]

**Issuance of parent company only financial statements**

**Inquiry.** FASB Statement No. 94, Consolidation of All Majority-Owned Subsidiaries, paragraph 15, precludes preparation of parent company financial statements for issuance to stockholders as the financial statements of the primary reporting entity. Are there any circumstances under which parent company financial statements may still be prepared?

**Reply.** Yes. ARB No. 51, Consolidated Financial Statements, paragraph 24, states: "In some cases parent company statements may be needed, in addition to consolidated statements, to indicate adequately the position of bondholders, other creditors, or preferred stockholders of the parent. Consolidated statements, in which one column is used for the parent company and other columns for particular subsidiaries or groups of subsidiaries often are an effective means of presenting the pertinent information."
Inventories

**Disclosure of LIFO reserve**

*Inquiry.* Should a company using the last-in, first-out (LIFO) method of inventory valuation be required to disclose the LIFO reserve in its financial statements or in the accompanying footnotes?

*Reply.* Yes. The Accounting Standards Division Issues Paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories*, addresses this matter in section 2, paragraphs 24 through 28. Paragraph 28 indicates that the task force voted (9 yes, 0 no) that either the LIFO reserve or replacement cost and its basis for determination should be disclosed. Paragraph 26 states that the Securities and Exchange Commission (SEC) requires companies whose securities trade publicly to disclose this information [Regulation S-X, section 210.5-02.6(c)] and that many nonpublic companies also disclose this information.

SAS No. 43, *Omnibus Statement on Auditing Standards*, paragraph 7, states that in the absence of a pronouncement covered by Rule 203 of the Rules of Conduct of the AICPA Code of Professional Conduct or another source of established accounting principles, the auditor may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example, APB Statements, AICPA Issues Papers, FASB Statements of Financial Accounting Concepts, pronouncements of other professional associations or regulatory agencies, and accounting textbooks and articles.

**Airplanes chartered while held for sale**

*Inquiry.* A company purchases airplanes for sale to others. However, until they are sold, the company charters and services the planes. What would be the proper way to report these airplanes in the company's financial statements?

*Reply.* The primary use of the airplanes should determine their treatment on the balance sheet. Since the airplanes are held primarily for sale, and chartering is only a temporary use, the airplanes should
be classified as current assets. However, depreciation would not be appropriate if the planes are considered inventory. ARB No. 43, Chapter 4, *Inventory Pricing*, states in part that the term inventory "excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified."

If the use period were to exceed one year, reclassification to fixed assets and recognition of depreciation expense would be appropriate under generally accepted accounting principles (GAAP). [Amended]

**Uniform capitalization rules for inventory**

*Inquiry.* The Tax Reform Act of 1986 established uniform capitalization rules requiring the capitalization of direct costs and a portion of indirect costs that benefit inventory produced or acquired for resale. May the costs that are required to be inventoried under the Tax Reform Act of 1986 be inventoried under generally accepted accounting principles (GAAP)?

*Reply.* The FASB Emerging Issues Task Force (EITF) reached a consensus on this issue, which was addressed in EITF Issues Summary No. 86-46, "Uniform Capitalization Rules for Inventory Under the Tax Reform Act of 1986." The fact that a cost is inventoried for tax purposes does not, in itself, indicate that it is preferable, or even appropriate, to inventory that cost for financial reporting purposes.

However, task force members indicated that certain costs required to be inventoried for tax purposes may also be inventoried for financial reporting purposes, depending on such factors as the nature of the enterprise's operations and industry practices.

**Fixed Assets**

**Cost of ski slopes and lifts**

*Inquiry.* A company has developed a piece of land into a ski resort. The company has cut trees and graded land and hills, and constructed ski lifts and pulls. Should the tree-cutting, land-clearing and grading of slopes be capitalized to land? If so, are these costs amortizable? Should the clearing and grading costs connected with construction be capitalized to the equipment and depreciated?
Reply. All expenditures incurred which are made for the purpose of making the land suitable for its intended use or purpose (whether that use be construction of a ski lodge, lifts, pulls, slopes, or other facilities) are properly capitalizable as land costs, and land is not subject to depreciation. During the course of clearing the land to make it useful for the purpose acquired, salable timber may be recovered, and since the clearing costs are capital items, amounts realized from the sale of the timber may properly be credited to the land account. Recurring maintenance of right-of-way (i.e., the slope and ski-lift areas) would be properly treated as a period cost. [Amended]

Capitalization of interest costs incurred by subsidiary

Inquiry. A subsidiary with an asset qualifying for interest capitalization under FASB Statement No. 34, Capitalization of Interest Cost, incurs its entire interest cost from a loan from its parent.

What is the extent of interest that may be appropriately capitalized?

Reply. FASB Statement No. 34, Capitalization of Interest Cost, paragraph 13, states in part that the amount capitalized in an accounting period shall be determined by applying an interest rate to the average amount of accumulated expenditures for the asset during the period. FASB Statement No. 34, paragraph 15, further states that in separately issued financial statements of a parent company, consolidated subsidiary, or unconsolidated subsidiary, the amount of interest cost that may be capitalized is limited to the total amount of interest cost (including interest on intercompany debt) incurred by the separate entity.

Such financial statements should disclose related party transactions as required by FASB Statement No. 57, Related Party Disclosures.

Appraisal value for mailing lists

Inquiry. A client distributes various advertising materials by mail, and has developed mailing lists over a number of years. The costs of preparing and maintaining the lists have been expensed through last year. Although the company will continue to expense
the costs of maintaining and updating such lists, it has capitalized an amount equal to what it considers a current estimated replacement cost of the mailing lists and credited “Appraisal Surplus.” There is no way of reconstructing the actual costs incurred in prior years to prepare the mailing list.

The amount capitalized represents 25% of the client’s total assets, and the client does not intend to amortize the capitalized amount because in its opinion, these lists have an unlimited useful life.

Is this the proper accounting treatment for these mailing lists?

Reply. The recording of the mailing lists at their estimated replacement cost would not be in accordance with generally accepted accounting principles. If the client is adamant about recording the mailing list as described, “Appraisal Surplus” would be the appropriate account to credit under the circumstances, but the auditor should issue a qualified or adverse opinion in accordance with SAS No. 58, Reports on Audited Financial Statements. [Amended]

Capitalization of debt service cost for a constructed asset

Inquiry. A corporation floated a bond issue to finance construction of an asset which qualifies for interest capitalization. The bond indenture provides that the corporation reimburse the trustee for administrative costs incurred in servicing the debt. The reimbursement is stated as a fixed annual amount to be paid over the term of the bond issue. May this cost be capitalized as a component of the asset cost?

Reply. The historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. Since the financing was directly related to the construction, related financing costs may be capitalized during the construction period.

Equity method for investee following completed contract method

Inquiry. A client, a contractor who follows the percentage of completion method for income recognition, has entered into a joint
venture. The joint venture follows the completed contract method in its financial statements. The client accounts for his investment in the joint venture on the equity basis. May the client recognize his share of the venture's income (determined on the percentage of completion method) even though the venture will not recognize income until the contract is completed?

Reply. APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, paragraph 3f, states:

"Earnings or losses of an investee" and "financial position of an investee" refer to net income (or net loss) and financial position of an investee determined in accordance with accounting principles generally accepted in the United States.

Both the completed contract method and the percentage of completion method are generally accepted, and the investor should not change the investee's method of accounting from completed contract to percentage of completion in applying the equity method. If the investee's financial statements are prepared on a comprehensive basis of accounting other than GAAP, the investor should eliminate material variances from GAAP in applying the equity method, in accordance with SOP No. 78-9, Accounting for Investments in Real Estate Ventures, paragraph 24. [Amended]

Intangible Assets

Accounting treatment of agreements not to compete

Inquiry. A company enters into an agreement with an outgoing officer whereby the company will make future periodic payments to the officer in return for the officer's agreement not to compete with the company for the period coinciding with the payments.

Would it be appropriate for the company to record a liability for the total future payments to the former officer and a corresponding intangible asset for the covenant?

Reply. The authoritative literature does not provide specific guidance for the treatment of executory contracts, which require future consideration upon the occurrence of certain events.
FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 36, specifies that a characteristic of a liability is that "the transaction or other event obligating the entity has already happened." Since the event that gives rise to the company's obligation is the former officer's forbearance from competition, many accountants believe that the transaction should be recorded prospectively, as the payments are "earned" by the former officer. They would disclose the contractual obligation as a commitment in the company's notes to its financial statements.

Concepts No. 6, paragraph 26, provides that a characteristic of an asset is that "it embodies a probable future benefit. . . ." Accordingly, the company would only record an intangible asset if the payment to the former officer preceded the period of forbearance.

**Write-off of goodwill on date of purchase**

*Inquiry.* An investor purchased a significant interest in an equity investee and at the same time guaranteed its obligations. The subsequent share of the investee's losses plus advances exceeded the carrying amount of the investment. The investor purchased the remaining interest and assumed responsibility for the obligations of the investee. The purchase price of the remaining interest was in excess of the sum of the fair values of the identifiable assets acquired less liabilities assumed, which implied goodwill. If the parent determines that the goodwill has no value can it immediately be written off?

*Reply.* No. Goodwill is defined as the excess of the purchase price over the fair value of the identifiable assets acquired. APB Opinion No. 17, *Intangible Assets*, requires goodwill to be capitalized and amortized over its useful life. To reduce the carrying amount of goodwill, it is usually necessary to establish that the economic conditions and factors which gave rise to the goodwill no longer exist, or that the period benefited by such factors and conditions has expired. Since sufficient time has not elapsed to demonstrate either of these conditions, it would be improper to write off the goodwill.
Liabilities and Deferred Credit

Current Liabilities

*Accounting for teachers’ salaries over a 12-month period*

*Inquiry.* Teachers in a public school district teach from September 1 through June 30, a 10-month period. The school district pays these teachers over a 12-month period for the 10 months of service. The school district’s fiscal year ends June 30. What is the appropriate financial statement presentation for the 2 months of teachers’ salaries that have been earned but not yet paid by the school district at the end of the fiscal year? Does the guidance for compensated absences apply?

*Reply.* The salaries of teachers who complete their services prior to the end of the fiscal year but are paid after the end of the fiscal year are a current liability of the governmental fund. The AICPA Audit and Accounting Guide, *Audits of State and Local Governmental Units*, pages 75—76 (chapter 10, paragraph 4), states that if the government has received the service and has become liable for payment, then it should record an expenditure for the liability—teachers’ salaries, in this case—in the year in which the service was received.

Therefore, the teachers’ salaries for the months of July and August should be considered current liabilities.

While the rules related to compensated absences are not applicable in this case, they are similar and result in a similar response. National Council on Governmental Accounting (NCGA) Statement No. 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, paragraphs 25 and 26 (GASB Codification, section C60.108.109), discusses accounting for compensated absences in governmental funds. According to NCGA Statement No. 4, paragraph 25, if all the conditions of FASB Statement No. 43, *Accounting for Compensated Absences*, paragraph 6, are met, then the amount of compensated absences recorded as expenditures in governmental funds should be the amount accrued during the year that would normally be liquidated with expendable available financial resources. The phrase “normally would be paid with expendable available resources” is generally interpreted to mean payments within 60 days after the end of the fiscal year. In this case,
even if the rules regarding compensated absences were applicable, the teachers' salaries would still be considered current liabilities. [Amended]

**Long-Term Debt**

*Effect of sales taxes on the determination of present value of minimum lease payments*

**Inquiry.** A company leases a machine for $14,000 a month for 72 months. The monthly invoice received from the lessor includes the stipulated monthly rent plus a charge for state sales taxes. The lease does not meet the 90 percent criterion of a capital lease (i.e., the present value of the minimum lease payments excluding executory costs equals or exceeds 90 percent of the fair value of the leased property) if sales taxes are excluded from minimum lease payments. The criterion is met if both the rent and sales taxes are included as minimum lease payments.

Should the minimum lease payments include sales taxes?

**Reply.** Practice in this area varies. FASB Statement No. 13, *Accounting for Leases*, paragraph 5(j)(i), defines, in part, minimum lease payments as the payments that the lessee is obligated to make or can be required to make in connection with the leased property. However, "... the lessee's obligation to pay (apart from rental payments) executory costs such as insurance, maintenance, and taxes in connection with leased property shall be excluded." Many accountants interpret this to mean that all taxes, including sales taxes, levied on lease payments are considered executory costs since the lessor is merely acting as a collection agent for the taxing authority.

Other accountants believe that only taxes other than sales taxes (such as property taxes) should be excluded from the minimum lease payments because sales taxes are often capitalized as part of the cost of purchased assets. FASB Statement No. 13, paragraph 60, states that the provisions of this Statement derive from the view that a lease that transfers substantially all of the benefits and risks incident to ownership should be accounted for as the acquisition of an asset and the incurrence of an obligation.

Because the authoritative pronouncements do not specifically address whether sales taxes should be included as part of minimum
lease payments, practice varies and should be determined by the company’s general policy for accounting for sales taxes on purchased assets.

Regardless of which approach is used, in order to properly apply the 90 percent test referred to in FASB Statement No. 13, paragraph 7(d), the components of the numerator and denominator should be the same. For example, if the sales taxes are included as part of the minimum lease payments (the numerator) then the sales taxes should be included in the fair value of the leased asset (the denominator).

Capital

Issuance of Capital Stock

Costs incurred to acquire treasury stock

Inquiry. A company has incurred legal and accounting costs arising from the acquisition of treasury stock. How should the costs be classified in the company’s financial statements?

Reply. There is no authoritative literature on this particular subject. Some accountants believe that costs associated with the acquisition of treasury stock should be treated in a manner similar to stock issue costs. Stock issue costs are usually accounted for as a deduction from the gross proceeds of the sale of stock. Costs associated with the acquisition of treasury stock may be added to the cost of the treasury stock.

Balance sheet presentation of mandatory redeemable preferred stock

Inquiry. Should mandatory redeemable preferred stock be reflected in the equity section of the balance sheet?

Reply. The Securities and Exchange Commission has addressed this question in Regulation S-X, section no. 210.5-02.28. This regulation states that mandatory redeemable preferred stock is not to be included in amounts reported as stockholders’ equity.

Although nonpublic companies are not required to follow Regulation S-X, it would be appropriate for them to do so in most cases. However, practice varies.

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FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 62, states all classes of equity depend to some extent on enterprise profitability for distribution of enterprise assets, and no class of equity carries an unconditional right to receive future transfers of assets from the enterprise except in liquidation, and then only after liabilities have been satisfied.

This characteristic of equity is generally not found in mandatory redeemable preferred stock. If the stock is redeemable at a specific date or at the option of the holder, debt classification as suggested by Regulation S-X seems most appropriate. Some financial statements present mandatory redeemable preferred stock in a category between liabilities and equity. However, facts and circumstances in nonpublic entities (e.g., certain stock issued for estate planning purposes) may justify equity classification of certain mandatory redeemable preferred stock. [Amended]

**Revenue and Expense**

**Revenue Recognition**

*Rights to broadcast time received for services*

*Inquiry.* An advertising agency creates and sells jingles and station identifications to radio and television stations. The agency receives broadcast time credit as part payment. This broadcast time is then resold by the agency to its clients. Should this broadcast time be recognized by the advertising agency:

1. when the agency bills the radio or television station, or
2. when it is subsequently sold to advertisers?

*Reply.* The broadcast time credit should be recognized as income when the services are billed to the station. It may be necessary to estimate the value of the credits. A corresponding asset account should be charged. This asset would be relieved as the broadcast time is sold by the advertising agency. [Amended]

**Accounting for patronage distributions**

*Inquiry.* A manufacturer purchases power from an electrical cooperative. The cooperative grants patronage dividends to the man-
ufacturer, but these dividends are not remitted for several years. What is the appropriate accounting for such dividends by the manufacturer?

Reply. Patronage dividends, sometimes referred to as patronage allocations, are distributions by cooperatives to its members and customers; ordinarily these are rebates on purchases which should be treated as a reduction of the cost of purchases.

Statement of Position No. 85-3, Accounting by Agricultural Producers and Agricultural Cooperatives, paragraph 104, discusses the appropriate accounting for patronage refunds. SOP No. 85-3 concludes that such refunds should be recognized either—

(a) When the related patronage occurs if it is then probable that (1) a patronage refund applicable to the period will be declared, (2) one or more future events confirming the receipt of a patronage refund are expected to occur, (3) the amount of the refund can be reasonably estimated, and (4) the accrual can be consistently made from year to year, or

(b) On notification by the distributing cooperative.

The accrual should be based on the latest available information and should be adjusted on notification of allocation.

Operating lease with rental payments rebated against purchase price

Inquiry. A lessor corporation leases construction equipment for periods of six to eighteen months under short-term cancellable leases. The leases provide that during the first six months, 100 percent of the rentals paid may be applied toward the purchase price of the equipment if the lessee decides to purchase the equipment; during the next three months the percentage drops to 80 percent, and after nine months 60 percent may be applied toward the purchase price. The leases do not qualify as capital leases. How should the lessor account for the leases and the respective rebates?

Reply. The authoritative literature does not address this matter. The lessor should record rental income until the lessee decides to purchase the equipment. The lessor should then record the sale of
the equipment net of the applicable rebate. The amount recorded as rental income should not be reclassified as sales proceeds.

Cost Allocation

**Cost of computer software purchased for internal use**

*Inquiry.* How should the cost of computer software purchased for internal use be accounted for?

*Reply.* FASB Interpretation No. 6, *Applicability of FASB Statement No. 2 to Computer Software*, paragraph 5, states that costs incurred to purchase or lease computer software developed by others for use in research and development activities shall be charged to expense as incurred unless the software has alternative future uses (in research and development or otherwise) in which case it should be capitalized and depreciated over its estimated useful life.

The cost of computer software developed by others purchased for use in activities other than research and development should be capitalized and depreciated over its estimated useful life in accordance with ARB No. 43, chapter 9, *Depreciation*, paragraph 11.

**Computer software development costs**

*Inquiry.* Should a company capitalize or expense costs incurred in developing computer software for a general management information system to be used within the company?

*Reply.* Practice varies in accounting for the costs to develop computer software for general management information systems. Most companies expense the costs as incurred, but some companies capitalize the costs and amortize them over the expected future period to be benefited.

APB Opinion No. 22, *Disclosure of Accounting Policies*, discusses disclosure policies with respect to amortizing intangibles. Companies should consider disclosing the amount of capitalized software cost and related amortization expense, the method of amortization, and the amortization period.

Costs of software for a general management information system are excluded from research and development costs as indicated in
FASB Interpretation No. 6, *Applicability of FASB Statement No. 2 to Computer Software*, paragraph 4. [Amended]

**Depreciation and Depletion**

*Additional first year depreciation*

**Inquiry.** A corporation reports depreciation expense on its financial statements at the same amount that it claims on its income tax return. If that amount included the maximum $10,000 deduction for additional first year depreciation (election to expense recovery property) allowed for tax purposes, whereas, normal depreciation was $18,000, would the financial statements be in conformity with generally accepted accounting principles?

**Reply.** ARB No. 43, chapter 9C, *Depreciation*, paragraph 5, states, in part: "... depreciation accounting, a system which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit ... in a systematic and rational manner. ..." Accordingly, if an arbitrary additional first year depreciation amount is included in the financial statements and it is material, it would be a departure from generally accepted accounting principles. Refer to SAS No. 58, *Reports on Audited Financial Statements*, paragraph 50, and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, paragraph 6, for guidance on materiality. [Amended]

**Specialized Organizational Problems**

**Partnerships**

*Income allocation of limited partnership*

**Inquiry.** A real estate limited partnership allocates the depreciation deduction entirely to the limited partners in accordance with the provisions of the partnership agreement. This is done in order to induce investment in the venture by the limited partners. Would such an allocation in the financial statements conform with generally accepted accounting principles (GAAP)?
Reply. Yes. Allocation of partnership income is determined by the partnership agreement. Therefore, in computing the income allocable to the limited and general partners, the depreciation deduction may be allocated entirely to the limited partners, in financial statements prepared in conformity with GAAP.

Not-For-Profit Organizations

Applicability of single audit act to nonprofit organizations

Inquiry. Are nonprofits or other nongovernmental entities which receive federal funding required to comply with the Single Audit Act of 1984?

Reply. Nonprofits and other nongovernmental entities do not fall within the scope of the Single Audit Act of 1984. However, they may be subject to its requirements by contract with the grantor agency. Furthermore, they are probably subject to the General Accounting Office's Standards for Audit of Governmental Organizations, Programs, Activities, and Functions and the Office of Management & Budget's Circular A-110, Uniform Requirements for Grants to Institutions of Higher Education, Hospitals and Other Nonprofit Organizations.

Business Combinations—General

Transfer to entities under common control

Inquiry. How should a capital contribution from an individual to a 100% owned corporation be recorded?

Reply. The transfer should be accounted for at the historical cost to the individual since the transfer lacks economic substance. AICPA Interpretation No. 39 of APB Opinion No. 16, Transfers and Exchanges Between Companies Under Common Control, provides support for this view. Even though the transaction does not involve a business combination, the analogy is made that because the owner owns 100% of the company, the assets and liabilities so transferred would be accounted for at historical cost.
However, practice regarding this matter varies and some accountants believe this type of transfer may also be recorded at fair value. Those holding this view cite APB Opinion No. 29, Accounting for Non-Monetary Transactions, paragraph 18. Holders of this view also cite FASB Statement No. 57, Related Party Disclosures, paragraph 3, which states that transactions with related parties should not imply that the terms of the transactions are the same as prevail in arm's-length transactions unless such a view can be substantiated. This statement implies that a transfer to a corporation from its sole shareholder can be recorded at fair market value if the value can be objectively supported. [Amended]

Specialized Organizational Problems

Purchase Method

*Accumulated depreciation in a purchase business combination*

*Inquiry.* In a purchase business combination, a used market did not exist for certain plant and equipment to be used, therefore, it was valued at replacement cost new less estimated accumulated depreciation in accordance with APB Opinion No. 16, Business Combinations, paragraph 88, footnote 11. Should the estimated accumulated depreciation be recorded by the acquirer as a contra account to the plant and equipment, which would be shown at replacement cost new?

*Reply.* No. Replacement cost new less estimated accumulated depreciation is a method used to approximate the current fair value of a used asset. Only the net amount should be shown on the balance sheet.

S Corporations

*Accounting for income taxes after termination of an S corporation election*

*Inquiry.* Company A, a nontaxable S corporation, terminated its S corporation election and became a taxable corporation. What
are the consequences in Company A's GAAP financial statements at the date of its change in tax status? How should Company A account for those consequences?

Reply. FASB Statement No. 96, Accounting for Income Taxes, paragraph 21, states, in part, that: “An enterprise’s tax status may change from nontaxable to taxable . . . . Temporary differences may be created or eliminated at the date that a nontaxable enterprise becomes a taxable enterprise. A deferred tax liability shall be recognized for temporary differences in accordance with the requirements of this Statement at the date that a nontaxable enterprise becomes a taxable enterprise. . . . The effect of recognizing . . . the deferred tax liability . . . shall be included in income from continuing operations.” [Amended]

Reversal of deferred income tax liabilities after election of S corporation status

Inquiry. A taxable corporation with substantial deferred income tax liabilities reported in its GAAP financial statements has elected to become a nontaxable S corporation effective in its next year. How should the deferred income tax liabilities be accounted for in the year of the change? What information should the company disclose in the current year?

Reply. FASB Statement No. 96, Accounting for Income Taxes, paragraph 21, states, in part, that: “A deferred tax liability or asset shall be eliminated at the date an enterprise ceases to be a taxable enterprise. That effect of . . . eliminating the deferred tax liability or asset shall be included in income from continuing operations.”

The current year’s financial statements should include a footnote disclosure notifying the user that the tax status of the corporation will change in the subsequent period and that the deferred income tax liability will be eliminated in the subsequent period. [Amended]
ACCOUNTING STANDARDS EXECUTIVE COMMITTEE PRACTICE BULLETINS

Elimination of Profits Resulting From Intercompany Transfers of LIFO Inventories—Practice Bulletin 2

Definition of LIFO Liquidation

LIFO liquidations occur when the number of units in a LIFO pool at the end of the year is below that at the beginning of the year, causing prior years' costs to be charged against current year's income. If dollar value LIFO is being used, the liquidation occurs when total base year cost at the end of the year is below that at the beginning of the year (that is, a decrement or erosion of previously created layers).

LIFO Liquidations Occurring Upon Inventory Transfer Within Entity

During any year there may be inventory transfers between or from LIFO pools within a company to subsidiaries or divisions of the company that result in LIFO liquidations.

Accounting for such LIFO liquidations becomes difficult when there are intercompany transfers of inventory. When reporting the results of operations and financial position for a parent and its subsidiaries, the purpose of the consolidated report is to present the statements as if the group were a single company with one or more branches. (See Accounting Research Bulletin (ARB) 51, Consolidated Financial Statements.) To accomplish this requires elimination of intercompany profits that remain with any members of the group. Intercompany profit to be eliminated on consolidation could be affected by inventory transfer between LIFO pools that resulted in LIFO liquidations.

Deferral of Inventory Profit From Intercompany Transfers

Entities should develop an approach for deferring such inventory profits emerging from intercompany transfers of inventory. Companies can use different methods to eliminate such intercompany profits from LIFO liquidations created through inventory transfers within a reporting entity. An approach should be adopted that con-
sistently defers these inventory profits until they are realized by the reporting entity through disposition to an outside party.

ACCOUNTING STANDARDS DIVISION
STATEMENTS OF POSITION

Accounting for Joint Costs of Information Materials and Activities of Not-For-Profit Organizations That Include a Fund-Raising Appeal—Statement of Position 87-2

This statement of position provides guidance on accounting for joint costs of informational materials and activities that include a fund-raising appeal. Not-for-profit organizations that solicit financial support may incur joint costs relating to several functions including program activities, fund raising, and other support services. Relating these joint costs to each function is often difficult.


Diversity in Current Practice

Some not-for-profit organizations choose not to allocate joint costs of informational materials and activities that include a fund-raising appeal. Such organizations charge all joint costs to the fund-raising activities, and trace to other functions only the incremental costs of the separate educational or informational material or activity. For instance, joint costs such as postage are charged to fund-raising, while the direct costs of educational pamphlets are charged to the other functions. Other not-for-profits allocate the joint costs primarily to the educational program function, reasoning that content of materials distributed and activities conducted clearly demonstrate this to be the intent of efforts expended. Other not-for-profits allocate joint costs to program expenses, fund-raising expenses, or management and general expenses as determined through content, motivation for distribution, and audience.
Conclusions

_Bona Fide Program or Management and General Function Must Be Demonstrated._ All joint costs of informational materials or activities including fund-raising are reported as fund-raising expense if it cannot be demonstrated that program or management and general function has been conducted together with the appeal. If it can be demonstrated that a genuine program or management and general function has been conducted along with fund-raising, joint costs are then allocated between fund-raising and the appropriate program or management and general function.

_Circumstances and Factors That Should Be Considered in Making Allocation of Joint Cost Decision._ Indicators of bona fide program or management and general function include:

- Content of non-fund-raising activity
- Targeted audience
- Actions requested of recipients
- Written directions to external parties who produce the activity
- Documentation in minutes of the organization's board of directors

Unless an appeal is directed to an action other than acquiring financial support, all costs of appeal should be charged to fund-raising.

Organizations that seek public involvement and instruct the public on how to accomplish a goal should allocate joint costs to program activities if informational materials or activities further those program goals.

If an audience is selected based on need or interest in educational information and not on capacity to provide support to the not-for-profit, fund-raising is incidental, and joint costs of educational activities need not be allocated to fund-raising. If an audience is selected based on ability to provide financial support, all joint costs should be allocated to fund-raising.

**Required Disclosure**

Not-for-profit organizations incurring joint costs of information materials and activities that include fund-raising efforts should disclose through a note in the financial statements that costs have been
allocated to each functional expense category, and should indicate the total amount allocated during the period and the portion of costs allocated to each functional expense category.

Effective Date and Transition

SOP 87-2 is effective for financial statements beginning after December 31, 1987 with earlier application encouraged. In the year of the change, the financial statements should disclose the fact of change and the effect on the financial statements. Prior periods may, but need not, be restated.
CHAPTER 13
SEC Staff Accounting Bulletins

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APPLICABILITY OF GUIDANCE

The United States Securities and Exchange Commission Division of Corporation Finance and the Office of the Chief Accountant publish Staff Accounting Bulletins (SABs). The guidance in the bulletins is not SEC rules or interpretations thereof, nor are they published as bearing the commission's official approval; they represent interpretations and practices followed by the division and the chief accountant in administering the disclosure requirements of the federal securities laws. Registrants may be called on to justify departures from SABs. The SEC sets forth its views and interpretations of financial reporting practices in Financial Reporting Releases (initially published as Accounting Series Releases). The Financial Reporting Releases do not supplant the rules set forth in Regulation S-X, "Form and Content of Financial Statements," and Regulation S-K, "Integrated Disclosure Rules," but only supplement those regulations. These publications prescribe the rules covering the filing of financial statements with the SEC. Thus, they apply to publicly held companies. Nevertheless, privately held companies may find some guidance in those publications useful.

The SEC itself has relied on the Financial Accounting Standards Board (FASB) and its predecessors to develop generally accepted accounting principles and has limited itself largely to matters of disclosure and other compliance matters. Nevertheless, on occasion the SEC or its staff finds it necessary to issue pronouncements on accounting issues on which the FASB or its predecessors have not yet acted. These pronouncements are considered part of the overall body of authoritative accounting literature on generally accepted accounting principles (GAAP). Thus, where the FASB or its predecessor bodies have not ruled on a given transaction, pri-
vately held companies might wish to, and publicly held companies must, look to SEC pronouncements on the subject as a source of GAAP.

This chapter concentrates on SABs published during the past two years that may have general applicability.

**INCREASING-RATE PREFERRED STOCK — SAB 68**

SAB 68, published in May 1987, expresses the staff’s views regarding accounting for increasing-rate preferred stock. Essentially, increasing-rate preferred stock is cumulative preferred and carries either a zero dividend rate in the early years after issuance or a low dividend rate, which increases over time to a higher “permanent” rate. The higher dividend rate is usually a market rate for dividend yield given the preferred’s characteristics, other than scheduled cash dividend entitlements (voting rights, liquidation preference, and the like), as well as the registrant’s financial condition and future prospects. Therefore, the issue price is well below the amount that could be expected, based on the future permanent dividend.

*Balance Sheet Treatment.* The staff’s view is that the increasing-rate preferred stock should be recorded initially at its fair value at the date of issuance. Thereafter, the carrying amount should be increased periodically.

*Amortize Discount.* It is unacceptable to recognize the dividend costs according to their stated schedules. Any discount due to the absence of dividends, or gradually increasing dividends, for an initial period represents prepaid, unstated dividend cost. The discount is based on the price the stock would have sold for had the permanent dividend been in effect from the date of issuance. The discount should be amortized over the periods preceding commencement of the perpetual dividend by charging imputed dividend cost against retained earnings and increasing the carrying amount of the preferred stock by a corresponding amount.

*Computation of Discount and Amortization.* The discount at the time of issuance should be computed as the present value of the dif-
ference between (1) any dividends that will be payable in the periods preceding commencement of the perpetual dividend and (2) the perpetual dividend amount for a corresponding number of periods, discounted at a market rate for dividend yield on preferred stocks that are comparable (other than with respect to dividend payment schedules) from an investment standpoint.

The amortization in each period should be the amount which, together with any stated dividend for the period, results in a constant rate of effective cost relative to the carrying amount of the preferred stock (the market rate that was used to compute the discount). The staff believes that this approach is consistent with Accounting Principles Board Opinion No. (APB) 21, Interest on Receivables and Payables.

The imputed dividends would be considered an adjustment of net income in the computation of earnings per common share during the amortization period.

If stated dividends on an increasing-rate preferred stock are variable, computations of the initial discount and subsequent amortization should be based on the value of the applicable index at the date of issuance and should not be affected by subsequent changes in the index.

NONRECOVERY DEBT COLLATERALIZED BY LEASE RECEIVABLES OR THE RELATED LEASED ASSETS—SAB 70

SAB 70, published in June 1987, expresses the staff's views regarding the accounting and balance sheet presentation for nonrecourse debt collateralized by lease receivables or the related leased assets, or both.

Transaction as a Borrowing. The SEC staff believes that under existing generally accepted accounting principles this type of transaction should be accounted for as a borrowing, and the debt should be reflected in the balance sheet.

Direct Interest vs. Security Interest. In reaching its conclusions, the staff differentiates between an assignment that represents the
transfer from one party to another of a direct interest in a contractual right or property and a security interest in a right or property. Non-recourse borrowing arrangements that involve the assignment of a security interest do not result in recognition "as if" a sale had occurred.

Sale of Interest in Residual Value. In a variation of this transaction, some leasing companies borrow nonrecourse by collateralizing the lease receivable or leased asset, or both, and also sell a portion of the interest in the residual value of the leased asset to third-party investors. The sale to an investor group may be accompanied by the leasing company's retaining a portion of the residual interest. The staff's view is that in a transaction in which the leasing company retains a future benefit in the leased assets and is not relieved of its (nonrecourse) debt obligation, the company's status with respect to the lessee or the lender under the nonrecourse note is not altered. A sale should not be recognized in such a case.

Offset. Nonrecourse debt and lease receivable or the related leased assets may not be offset in the balance sheet. Setoff is not supported by authoritative literature unless there is a legal right of setoff. (FASB Technical Bulletin No. (TB) 86-2, Accounting for an Interest in the Residual Value of a Leased Asset.)

FASB Technical Bulletin No. 88-2, Definition of a Right of Setoff, states that a right of setoff exists when each of the two parties owes the other determinable amounts, the reporting party has the right to set off the amount owed with the amount owed by the other party, the reporting party intends to set off, and the right of setoff is enforceable at law.

"PUSHING DOWN" PARENT COMPANY DEBT IN AN ACQUISITION—SAB 73

SAB 73, published in December 1987, expresses the staff's views regarding recording (or "pushing down") parent company debt in the separate financial statements of the subsidiary when such debt is incurred in connection with or is related to the acquisition of the subsidiary in a business combination accounted for by the purchase method.
Debt Included in Subsidiary’s Separate Statements. If a company incurs debt to acquire substantially all of another company’s common stock, and the new subsidiary issues its own financial statements in connection with a public offering of its stock or debt, the parent company’s incurred debt, related interest expense, and allocable debt issue costs should be reflected in the subsidiary’s financial statements under the following conditions:

- The subsidiary is to assume the parent company’s debt, either presently or in a planned transaction in the future.
- The proceeds of the subsidiary’s debt or equity offering will be used to retire all or part of the parent’s debt.
- The subsidiary guarantees or pledges its assets as collateral for the parent’s debt.

Debt Not Included in Subsidiary’s Separate Statements. Other relationships may exist, such as the parent’s pledge of the subsidiary’s stock as collateral for the parent’s debt. Although this may mean that the subsidiary’s cash flow will service all or part of the parent’s debt, the staff does not insist that the debt be reflected in the subsidiary’s financial statements, provided the relationship is disclosed.

Disclosure in Subsidiary’s Financial Statements. Regardless of whether the debt is reflected in the subsidiary’s financial statements, the notes to its financial statements should at least generally disclose the following:

- The relationship between the parent and subsidiary
- A description of any arrangements that result in the subsidiary’s guarantee, pledge of assets or stock, and the like that provides security for the parent’s debt
- The extent (in the aggregate and for each of the five years subsequent to the date of the latest balance sheet presented) to which the parent is dependent on the subsidiary’s cash flows to service its debt and the method by which this will occur
- The impact of such cash flows on the subsidiary’s ability to pay dividends or other amounts to holders of its securities
DISCLOSURES WHEN ACCOUNTING STANDARD IS ISSUED BUT NOT YET ADOPTED—SAB 74

SAB 74, published in December 1987, expresses the staff’s views concerning disclosures that generally should be provided by a company when an accounting standard has been issued but not yet adopted.

Disclosure Recommended. The staff recommends that relevant disclosures should be made in financial statements issued after a new standard has been issued even if the standard does not require adoption until some future period.

The objectives of the disclosure should be (1) to notify the reader of the disclosure documents that a standard has been issued that the company will be required to adopt in the future and (2) to assist the reader in assessing the significance of the impact that the standard will have on the company’s financial statements when adopted.

The following disclosures generally should be considered:

- A brief description of the new standard, the date that adoption is required, and the date that the company plans to adopt, if earlier
- A discussion of the methods of adoption allowed by the standard and the method expected to be used by the company, if determined
- A discussion of the impact that adoption of the standard is expected to have on the company’s financial statements, unless not known or reasonably estimable (In such a case, a statement to that effect may be made.)
- A discussion of the potential impact of other significant matters that the company believes might result from adopting the standard (such as technical violations of debt-covenant agreements, planned or intended changes in business practices, and the like)

ALLOCATION OF DEBT-ISSUE COSTS IN A BUSINESS COMBINATION—SAB 77

SAB 77, published in March 1988, expresses the staff’s views regarding the allocation of debt issue costs in a business combination accounted for by the purchase method.
Fees Paid to Underwriter. Fees are frequently paid to underwriters in connection with an acquisition for advisory services, "bridge financing," and the underwriting of permanent financing. As a result, the following questions have arisen:

- Are all fees paid to investment bankers considered a direct cost of the acquisition and, as such, accounted for as an element of the purchase price of the acquired business?
- May the debt issue costs of the interim bridge financing be amortized over the anticipated combined life of the bridge and permanent financing?

Cost of Purchase. The staff believes that fees paid to an investment banker for advisory services, including financing services, must be allocated between direct costs of the acquisition and debt issue costs. This position is consistent with APB 16, Business Combinations, paragraph 76, which states that debt issue costs are an element of the effective interest cost of the debt, and neither the source of the debt financing nor the use of the debt proceeds changes the nature of such costs. Accordingly, they are not a direct cost of the acquisition.

Allocation of Costs. The staff believes that the allocation of costs between direct costs and debt issue costs should be representative of the actual services provided. This allocation would apply irrespective of whether the services were billed as a single amount or separately. Tests to determine whether the allocation made by the company or the investment banker are reasonable should consider such factors as the fees charged by investment bankers in connection with other recent bridge financings and fees charged for advisory services when obtained separately. These fees should normally be considered to determine the relative fair values of the two services. Whether these or other factors are considered, the allocation normally should result in an effective debt service cost and interest and amortization of debt issue costs that is comparable to the effective cost of other recent debt issues of similar investment risk and maturity.

Amortization of Bridge-Financing Costs. The bridge-financing costs should be amortized over the estimated interim period preceding the placement of the permanent financing with any unamortized amounts charged to expense if the bridge loan is repaid prior to the expiration of the estimated interim period.
ACCOUNTING CHANGES IN A QUASI-REORGANIZATION—SAB 78

SAB 78, published in August 1988, expresses the staff’s views with regard to certain matters relating to quasi-reorganizations, including deficit eliminations. The questions that arise here are these:

- May a company reclassify its capital accounts to eliminate a deficit and shortly thereafter adopt an anticipated discretionary accounting change that will be recorded as a cumulative-effect type of accounting change that will result in increasing the company’s retained earnings?
- May there be a write-up of net assets in connection with a quasi-reorganization?

Quasi-Reorganization. The staff believes that a deficit reclassification of any nature is a quasi-reorganization and should fully meet the tests of that procedure. (Accounting Standards Release No. 25, Accounting Research Bulletin No. 43, chapter 7A.)

Regarding discretionary accounting changes, the company must adopt such changes before or as an integral part of the quasi-reorganization. This conclusion is consistent with the “fresh start” concept of a quasi-reorganization, which requires that the company’s accounting principles in place at the time of the quasi-reorganization be those planned to be used following the reorganization to avoid a misstatement of earnings and retained earnings after the reorganization. This concept also applies to mandated accounting changes (that is, issued by rule-making bodies) that do not require adoption until some future date. If the company intends to or is required to adopt those standards within 12 months following the quasi-reorganization, the company should adopt those standards before or as an integral part of the quasi-reorganization.

Net Write-Up of Assets. The staff believes that it is acceptable to increase the recorded values of specific assets (or reductions in liabilities) to fair value. The amounts of such increases are limited to offsetting decreases in other assets (or increases in liabilities). However, a quasi-reorganization should not result in a net write-up of a company’s net assets.
TRANSACTION BY PRINCIPAL STOCKHOLDER FOR CORPORATION’S BENEFIT—SAB 79

SAB 79, published in September 1988, expresses the staff’s views regarding the accounting for transactions undertaken by a company’s principal stockholder(s) for the benefit of the company.

Accounting for Expenses or Liabilities Paid by the Principal Stockholder(s). In this particular situation a principal stockholder* transfers a portion of his shares to the plaintiff to settle litigation against the company. The staff believes that the value of the shares transferred should be reflected as an expense in the company’s financial statements with a corresponding credit to contributed capital.

The SEC staff believes that such a transaction is similar to those described in Interpretation No. 1 to APB 25, in which a principal stockholder establishes or finances a stock option, or the like, for one or more employees of the company. The staff agrees that the benefits to a principal stockholder and to the corporation are generally impossible to separate. This transaction can be generalized to apply to others where a principal stockholder pays an expense for the company.

Disclosure in such cases is not an adequate substitute for measurement and recognition. The staff believes that such cases are unlike related-party transactions covered by SFAS 57, in which there is no arm’s-length transaction and for which a faithful measurement may not be determinable.

GAIN RECOGNITION ON SALE TO HIGHLY LEVERAGED ENTITY—SAB 81

SAB 81, published in April 1989, expresses the staff’s views regarding the appropriateness of gain recognition on the sale of a business or operating assets to a highly leveraged entity.

*SFAS 57, paragraph 24e, defines principal owners as “owners of record or known beneficial owners of more than 10 percent of the voting interests of the enterprise.”
**Sale of Subsidiary, Division, or Operating Assets.** In this case, a company has sold a subsidiary, division, or operating assets to a newly formed, thinly capitalized, highly leveraged entity for cash or a combination of cash and securities. In some of these cases, the seller may guarantee debt or enter into other agreements (make-well agreements) that may require the seller to infuse cash into the new company. The securities received are usually not actively traded and are subordinated to substantially all of the new company’s other debt.

**Uncertainties of Profit Realization.** The staff believes that in such circumstances there is often uncertainty about the seller’s ability to realize the noncash proceeds received in the transaction, particularly when the buyer’s assets consist principally of those purchased from the seller. Factors that would lead the staff to question immediate gain recognition would include—

- Situations in which the assets or operations sold have historically not produced cash flows from operations that will be sufficient to fund future debt-service and full-dividend requirements on a current basis. Often the servicing of debt and preferred-dividend requirements depends on future events that cannot be assured, such as sales of assets or improvements in earnings.
- The lack of any substantial amount of equity capital in the buyer company other than that provided by the seller.
- The existence of contingent liabilities of the registrant, such as debt guarantees or agreements that require the seller to infuse cash into the buyer under certain circumstances.

At times there may even be a question whether a divestiture has in fact occurred. To determine if a divestiture has occurred the following factors should be considered:

- Continuing involvement by the seller in the business
- Absence of significant financial investment in the business by the buyer
- Repayment of debt (which constitutes the principal consideration in the transaction) depends on future successful operations
- Continued necessity for debt or contract performance guarantees on behalf of the business by the seller
Deferral of Gain. If immediate recognition of the gain is not appropriate, the gain should not be recognized until such time as cash flows from operating activities are sufficient to fund debt service and dividend requirements on a full accrual basis, or until the seller’s investment in the buyer has been or could readily be converted into cash, and the seller has no further obligation under any debt guarantees and the like.

Classification of Deferred Gain. The deferred gain should be reported in the balance sheet as a deduction from the related asset account (that is, investment in the buyer), with adequate footnote disclosures of the transaction.
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