4-22-1993

Accounting Standards Update

American Institute of Certified Public Accountants. Accounting Standards Division

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

ACCOUNTING STANDARDS UPDATE

Developed by the
Accounting Standards Division
American Institute of Certified Public Accountants

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Revised as of April 22, 1993

Accounting Standards Executive Committee
(1992-1993)

AICPA Staff

AGENDA

Projects of the Accounting Standards Executive Committee:

- **Foreclosed Assets** arleen
- **Employee Stock Ownership Plans** arleen
- **Advertising** Joel
- **Not-for-Profit Projects** Joel
    - **Joint costs**
    - **Application of the requirements of certain pronouncements**
    - **Related entities**
- **Risks and Uncertainties** Fred
- **Real Estate Projects** Cliff
    - **Joint ventures**
    - **Current value reporting**
- **Environmental Liabilities Accounting Guide** Fred

ACCOUNTING FOR
FORECLOSED ASSETS

I. Summary of SOP 92-3, *ACCOUNTING FOR FORECLOSED ASSETS*

1. Issues on April 28, 1992

2. Should be applied to foreclosed assets in annual financial statements for periods ending after December 14, 1992.

3. Deals with the measurement of foreclosed assets in the balance sheet *after* foreclosure.

II. Scope

The SOP should be applied to all assets obtained through foreclosure or in-substance foreclosure, with the certain exceptions.

III. Requirements

A. Accounting at the point of foreclosure

B. Held-for-sale presumption

Under SOP 92-3, there is a rebuttable presumption that foreclosed assets are held for sale. The presumption may be rebutted by a preponderance of the evidence, but because financial institutions or other lenders are often prohibited y regulations from investing in or holding real estate assets, many foreclosed assets would be considered as held for sale.

C. Measurement of foreclosed assets held for sale

After foreclosure foreclosed assets held for sale should be carried at the lower of (1) fair value minus estimated costs to sell or (2) cost.

IV. Transition

1. On initial application, enterprises should compare the carrying amount (cost net of valuation allowance) of each foreclosed asset held for sale to the fair value minus estimated costs to sell of the asset.

2. To the extent that the fair value minus estimated costs to sell is less than the carrying amount, the carrying amount of the asset should be adjusted downward and income from continuing operations should be charged in the period of adoption.

3. To the extent that the fair value minus estimated costs to sell is greater than the carrying amount, the carrying amount of the asset may be adjusted upward to the extent of any existing valuation allowance.

V. Related Projects

A. Proposed SOP, *Accounting for the Results of Operations of Foreclosed Assets*

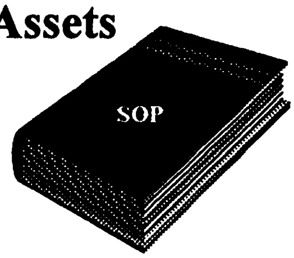
1. Issued November 10, 1992

2. Provides guidance on accounting for results of operations, including depreciation of foreclosed assets held for sale.

3. Project delayed pending completion of the FASB project on long-lived assets.

SOP 92-3

Accounting for Foreclosed Assets



SCOPE

- Applies to assets obtained through foreclosure
- Except for:
  - Broker-dealers, investment companies
  - Marketable equity securities
  - Foreclosed real estate previously owned

AT FORECLOSURE

- FASB Statement No. 15 –

Assets received in satisfaction of the receivable be accounted for at fair value

Example

FACTS:

■ P& I owed	$ 270,000
■ Fair value	180,000
■ Loan balance	250,000
■ Allowance for loan	50,000
■ Carry amount	200,000
■ Estimated selling cost	20,000

June 30, 1993

EXAMPLE

Foreclosed asset	**180,000**	
Loss on foreclosure	**20,000**	
Allowance for loan loss	**50,000**	
Loan receivable		**250,000**

(To record foreclosure of small office building on June 30, 1993)

MEASUREMENT

After foreclosure -- lower of:

- **fair value minus estimated costs to sell, or**
- **cost**

FAIR VALUE

FASB Statement No. 15...

the amount that the creditor could reasonable expect to receive in a current sale between a willing buyer and willing seller, that is, other than a forced or liquidation sale. If no market price exists for the asset, the selling prices of similar assets in the market may be used in estimating the fair value.

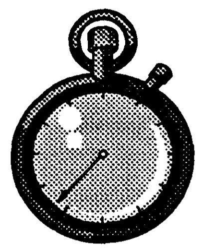
COST

Fair value of the asset at the time of foreclosure; expenditures for capital additions and improvements would increase cost and depreciation and direct writedowns would decrease cost

EXAMPLE

Loss on holding foreclosed asset	20,000	
Valuation allowance		20,000

(To record estimating selling cost)



EXAMPLE

Foreclosed asset	30,000	
Cash		30,000

(To record capital expenditures on small office building)

October 30, 1993

EXAMPLE

FACTS:

■ Fair value	$ 170,000	
■ Estimated selling cost	20,000	
■ Fair value, net	150,000	
■ Cost of property	210,000	
■ Valuation Allowance		20,000

December 31, 1993

EXAMPLE

Loss on holding foreclosed asset	40,000	
Valuation allowance		40,000

(To record valuation allowance on small office building as of December 31, 1993)

EXAMPLE

	1994	1993
FACTS:		
■ Fair value	$ 190,000	170,000
■ Estimated selling cost	20,000	20,000
■ Fair value, net	170,000	150,000
■ Cost of property	210,000	210,000
■ Valuation Allowance		60,000

December 31, 1994

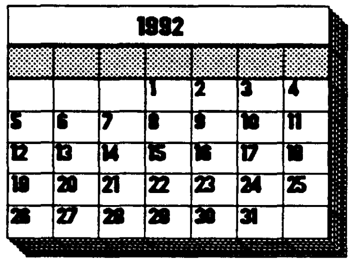
EXAMPLE

Valuation allowance	20,000	
Gain on holding of foreclosed asset		20,000

(To record decrease in valuation allowance on small office building as of December 31, 1994)

EFFECTIVE DATE

Financial statements for periods ending after December 14, 1992



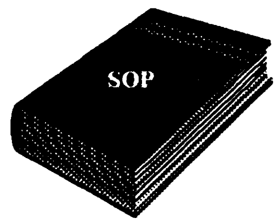
TRANSITION

On initial adoption

- **Compare fair value, net to carrying amount, net**
- **FV less than carrying amount**
  - adjust asset downward through income
- **FV greater than carrying amount**
  - adjust asset upward to the extent of any existing valuation allowance

PROPOSED SOP

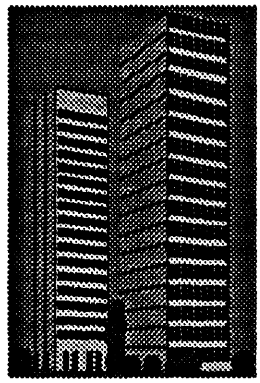
Accounting for the Results of Operations of Foreclosed Assets Held for Sale



PROPOSED REQUIREMENTS

- **Depreciate foreclosed assets, commencing no later than one year**
- **Systematic and rational manner**
- **Basis: cost of asset at the time depreciation commences**
- **Net revenues and expenses to income**
- **Disclosed in the notes to financial statements**

WHAT NEXT?



DRAFT

July 12, 1993

Mr. J. T. Ball
Financial Accounting Standards Board
401 Merritt 7
P. O. Box 5116
Norwalk, CT 06856-5116

File 2700

Dear Mr. Ball:

Enclosed are the comment letter received in response to the November 10, 1992 exposure draft of a proposed statement of position "Accounting for the Results of Operations of Foreclosed Assets Held for Sale," and an analysis of the comment letters. The comment letters indicate that a large majority of respondents disagreed with the requirement in the exposure draft to depreciate foreclosed assets held for sale. After reviewing and discussing the letters at its last two meetings, AcSEC voted (eight to seven) that the depreciation requirement should be deleted from the exposure draft. However, AcSEC's operating policies require ten votes for the issuance of an SOP.

Further, AcSEC is aware that the FASB has expanded its project on impairment of long-lived assets to include assets to be disposed of. AcSEC also understands that the Board expects to continue to actively discuss this project in the second half of 1993. It has therefore become apparent to AcSEC that the issues in the AcSEC exposure draft will also be key issue that the FASB will confront in its expanded project. AcSEC believes the FASB should address as part of its impairment of long-lived assets project (1) whether depreciation should be recognized subsequent to the application of measurement as a held-for-disposal asset and (2) how to report cash flows from operating those assets.

Accordingly, at its June 15, 1993 meeting, AcSEC decided to delay further consideration of its exposure draft. AcSEC will resume its consideration of its exposure draft after the Board reaches conclusions on the issues that will be considered in the impairment of long-lived assets project.

Sincerely,

Norman Strauss, CPA
Chairman, Accounting Standards
Executive Committee

Edward Trott, CPA
Chairman, Foreclosed Assets

Enclosures

ACCOUNTING FOR EMPLOYEE STOCK OWNERSHIP PLANS

I. Current practice

A. SOP 76-3

1. ESOPs debt is recorded as a liability in the financial statements of the employer, with the offsetting debit as a contra-equity account.
2. The debt and the contra-equity account are reduced simultaneously as the ESOP makes payments on the debt.
3. Contributions to the ESOP are charged to interest expense and compensation expense.
4. Dividends on ESOP shares are charged to retained earnings.
5. All shares held by an ESOP are considered outstanding.

B. EITF CONSENSUS No. 89-8

II. What is wrong with employers' current accounting for employee stock ownership plans (ESOPs)?

A. Measurement of compensation cost is inconsistent.

B. Dividends on unallocated shares.

III. What led AcSEC to take on this project?

A. Changes in laws and regulations.

B. Leveraged ESOPs have become more complex and innovative.

IV. Objectives of AICPA project

A. To reconsider SOP 76-3

B. To consider current ESOP issues that are not addressed in that SOP

C. To provide guidance that improves employers' reporting of ESOPs, that is enhance the relevance and representational faithfulness of financial statements of employers that sponsor ESOPs

V. Scope

The proposed SOP would apply to all ESOPs--leveraged, nonleveraged, pension reversion.

VI. Threshold decision

Employers' accounting for ESOP debt (financing element, if an outside loan is involved) should be separate from their accounting for the ESOP shares (compensatory element). Though the financing and compensatory elements are related, each should be analyzed and reported separately.

VII. Summary

A. Accounting for establishment of an ESOP

1. Issuance of new shares.

2. Recording of debt.

B. Accounting for contributions

Contributions would be reported as a reduction of debt and of accrued interest payable.

C. Accounting for dividends

1. Employers would charge dividends on allocated ESOP shares to retained earnings, and credit dividends payable. Employers would report dividends on unallocated shares as a reduction of debt and of accrued interest or as compensation cost, depending on whether the dividends are used for debt service or paid to participants.

2. If dividends on allocated shares are paid to participants accounts, such payment would reduce dividends payable. However, if ESOP shares are used to replace dividends on allocated shares, see point E.3.

D. Reporting employee compensation established independent of the ESOP.

E. Accounting for release of shares

1. ESOP shares are released for different purposes.

   a. Direct compensation -- recognize compensation cost equal to the fair value of the shares committed to be released.

   b. Settlement or fund liabilities for other employee benefits -- report satisfaction of the liabilities when the shares are committed to be released to settle the liabilities.

c. Replacement of dividends on allocated shares used for debt service -- employers would report satisfaction of the liability to pay dividends when the shares are committed to be released for that purpose.

2. Employers would reduce unearned compensation as the shares are committed to be released based on the cost of the shares to the ESOP; difference would be charged or credited to additional paid-in-capital.

F. Earnings per share

1. Primary and fully diluted earnings per share (EPS), ESOP shares that have been committed to be released should be considered outstanding; not been committed to be released should not be considered outstanding.

2. Convertible preferred shares held by ESOPs are usually considered common stock equivalents, regardless of yield test.

VIII. Transition

1. The SOP would be effective for fiscal years ending after December 15, 1994 as of the beginning of the fiscal year in which the SOP is adopted.

2. Application of the guidance in the SOP **is required** for shares acquired by ESOPs after December 31, 1992 (new ESOP shares).

3. Employers with ESOPs that elect to not adopt the SOP for shares held by ESOPs at December 31, 1992 should still make all of the applicable

disclosures required in the SOP, in addition to the disclosures required by existing pronouncements.

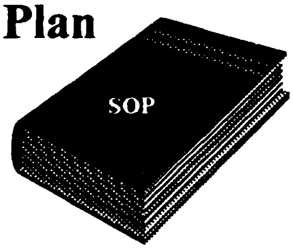
4. If the SOP is adopted in other than the first interim period of an employer's fiscal year, previous interim periods of that year should be restated.

IX. Disclosures

1. All employers with ESOPs must make the disclosures in the proposed SOP, regardless of whether they adopt the accounting provisions.
2. On adoption, companies should disclose the number of shares considered outstanding in prior periods that were not considered outstanding in the current period.

PROPOSED SOP

Employer's Accounting for Employee Stock Ownership Plan



CURRENT PRACTICE

- **Employer reports ESOP's debt with offset in equity**
- **Debt and contra-equity reduced simultaneously as ESOP repays debt**
- **Contributions charged to expense**
- **Dividends charged to retained earnings**
- **Difference between expense and contribution debited or credited to contra-equity**
- **All ESOP shares outstanding**
- **Shares allocated method required**

What is wrong with employer's current accounting for ESOPs?

COMPENSATION

FACTS:

- **ESOPs shares used to fund 401(k) match**
- **Period 1 - Employees contribute $10,000**
  Employers match $5,000
- **Market value per share (release date) is $6.25**
- **800 shares are released ($5,000 divided by $6.25)**
- **Cost per share was $5 -- 800 shares is $4,000**

COMPENSATION

	Current Practice	Proposed SOP
■ Compensation expense	$4,000	5,000
■ Unearned compensation	4,000	4,000
■ Paid-in capital	-	1,000

DIVIDENDS

FACTS:

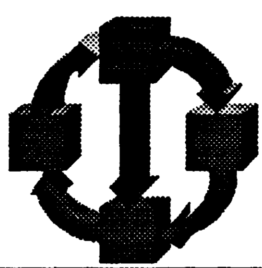
- ESOPs uses dividends on unallocated shares to pay debt to bank
- Debt service is $5,000
  - $2,000 in dividends on ESOP shares
  - $3,000 in contributions
- No shares have been allocated in year 1
- Cost of shares to the ESOP and the FV are the same

DIVIDENDS

	Current Practice	Proposed SOP
■ Compensation expense	$2,000	4,000
■ Interest expense	1,000	1,000
■ Dividends	2,000	0

WHAT'S THE MOTIVATION?

- Changes in laws and regulations
- More complex and innovative ESOPs
- Increased use of ESOPs to fund other benefits
- Current accounting inadequate and deficient



OBJECTIVES

- Reconsider current guidance
- Consider issues not addressed in current guidance
- Enhance relevance and representational faithfulness of reporting of ESOP transactions

SCOPE

Proposed SOP applies to:

- Leveraged ESOPs
- Nonleveraged ESOPs
- Pension reversion ESOPs

This presentation covers leveraged ESOPs

THRESHOLD DECISIONS

- Leveraged ESOPs may have two elements
  - Financing
  - Compensatory
- The elements are related
  - Analyzed
  - Reported

ESTABLISHMENT

FACTS:

- Company "A" borrows $1,000,000 to establish an ESOP
- Company buys 100,000 shares for $10 per share

Cash	1,000,000	
Debt		1,000,000
Unearned compensation	1,000,000	
Common stock/APIC		1,000,000

CONTRIBUTIONS

- Company "A" contributes cash and dividends for debt service
- Principal ($163,800) and interest ($100,000)
- 20,000 shares released and allocated

Debt	163,800	
Interest Expense	100,000	
Cash		263,800
Retained earnings	10,000	
Dividends payable		10,000

WITHOUT THE ESOP

FACT:

- Company "A" obligated to match 401(k) for $200,000

Compensation expense	200,000	
401(k) liability		200,000

RELEASE OF SHARES

FACTS:

- **Company "A" uses:**
  - **The ESOP to fund the 401(k)**
  - **ESOPs shares to replace dividends on allocated shares used for debt service**
- **20,000 shares released and allocated**
  - **952 ($10,000 dividends divided by $10.5) used to replace dividends**
  - **19,048 used for compensation (20,000 less 952)**
- **The average market value per share is $10.50**

RELEASE OF SHARES

401 (k) liability	**200,000**	
Dividends payable	**10,000**	
Unearned compensation		**200,000**
Additional paid in capital		**10,000**

(To record release of shares)

EARNINGS PER SHARE

- ESOP shares that have been committed to be released:
  - should be considered outstanding
- Shares that have not been committed to be released:
  - should not be considered out outstanding
- Convertible preferred shares are usually considered in common stock equivalents

TRANSITION

- Effective for fiscal years ending after December 15, 1993
- Applicable to shares acquired after December 31, 1992

DISCLOSURES

- Must disclose regardless of adoption
- No. of shares considered outstanding in previous years

MINORITY VIEW

- Type I - Compensation vehicles
- Type II - Fund employee benefits

ACCOUNTING FOR ADVERTISING

I. Status

The FASB did not object to final issuance of the SOP, subject to certain revisions. The SOP is expected to be issued in the third quarter of 1993.

II. Summary

A. The SOP would require the following:

1. Reporting the costs of all advertising as expenses in the periods in which those costs are incurred or the first time the advertising takes place except for certain direct response advertising that results in probable future economic benefits (future benefits).

2. Direct-response advertising that is eligible for capitalization under this SOP is advertising whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising.

   a. Documentation required:

      - Files indicating the customer and the related direct response advertisement
      - A coded order form included with an advertisement
      - A log of a phone call to a number appearing in an advertisement
      - A response card that includes a description or indication of the advertisement
      - A coded coupon used as a product order form and turned in by a customer

   b. Costs to capitalize - The costs of the future benefits of direct response advertising should be reported as assets.

c. Components

   1. Production
   2. Communications

d. Amortization

e. NRV Test

f. Disclosure

   - A description of the direct-response advertising and the amortization period
   - The amount of direct-response advertising capitalized for each period that an income statement is presented
   - The unamortized costs of direct-response advertising included in each balance sheet presented
   - The total amount charged to expense in each income statement presented for amortization of direct-response advertising and for amounts written down to net realizable value

III. Effects on Other Pronouncements

SOP amends other AICPA statements of position that include industry specific guidance on accounting for advertising. (SOP 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications*, paragraph 22; SOP 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services*, paragraph 55; and SOP 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities*, paragraph 15)

IV. Effective Date and Transition

This SOP would be effective for financial statements for years beginning after December 15, 1994. Costs incurred before initial application of this SOP, regardless of whether they are reported as assets, should not be adjusted to the amounts that would have been reported as assets had this SOP been in effect when those costs were incurred. However, the concepts included in the SOP concerning amortization, net-realizable-value test, and disclosures should be applied to any unamortized costs reported as assets before initial application of this SOP that continue to be reported as assets after the effective date.

V. Timing

The SOP is expected to be issued in the third quarter of 1993.

VI. Related Projects

AcSEC has on its agenda a multi-phase project on reporting the costs of activities undertaken to create future benefits through the development of intangible assets by advertising, preopening, start-up, training, other customer acquisition, and similar activities. The project is expected to result in broad standards that would aid in resolving issues concerning financial reporting on the costs of such activities. Accounting for advertising costs is the first phase of the project. The second phase, preopening costs, will begin when the advertising SOP is issued.

Group Exercises
Advertising

Exercise 1

Facts: SureFire Soft Drink company hires Johnny Pop to act in a major ad campaign that will first be shown during the Super Bowl on the Accountants Sports Network (ASN), and subsequently on several other networks throughout the year. Surefire incurs $10 million of production costs in November and December of 19X1, including $2 million paid to Mr. Pop. In addition, Surefire buys 2 minutes of ad time from ASN for $1 million. Surefire's year end is December 31.

Question: How should Surefire account for the ad campaign?

Group Exercises
Advertising

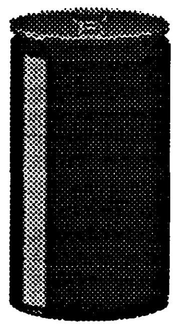
Exercise 2

Facts: Envelope Stuffers Inc. conducts a June 1, 19X1 direct mail ad campaign for its highly successful product, glow in the dark sunglasses. Envelope mails 1 million solicitations at a cost of $400,000 (40 cents per solicitation). Envelope's records show that historically, 2 percent of all mailings result in the sale of one pair of glasses, at a sales price of $60 and a gross profit of $52. 90 percent of all the sales occur before June 30 and 10 percent occur after June 30. Envelope's year end is June.

Question: How should Envelope account for the transaction.

PROPOSED SOP

Reporting on Advertising Costs



STATUS

- FASB approved - June, 1993
- Expected final pronouncement - 3rd quarter 1993

REQUIREMENTS

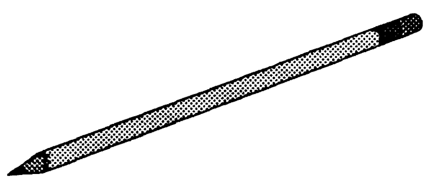
Cost of advertising:

- **Expensed as incurred or first showing**
- **Except for certain direct response advertising**

* Direct Response Advertising—

DOCUMENTATION

- **Written documentation**
- **Coded order form**
- **Phone call long**
- **Response card**
- **Coded coupon**



& Past experience

DIRECT RESPONSE

The cost of future benefits of direct response advertising should be reported as assets.

- Incremental direct 3rd party cost
- Payroll and payroll related costs

DIRECT RESPONSE

- Component Costs
  - Production - idea development
  - Communications - air time

AMORTIZATION

Current period revenue stream

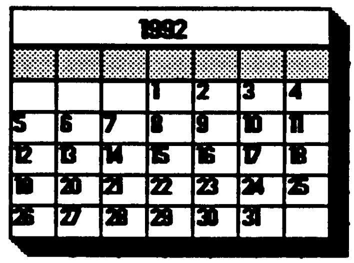
Current and future period revenue stream

DISCLOSURES

- **Description**
- **Amounts capitalized for each income statement presented**
- **Unamortized costs for each balance sheet presents**
- **Total advertising expense**

EFFECTIVE DATE

Financial statements for periods ending after December 15, 1994



ACCOUNTING FOR JOINT COSTS

I. Status

The FASB and GASB did not object to exposure of proposed SOP for comment, subject certain revisions. An exposure draft is expected to be released in the third quarter of 1993.

II. Scope

A. Supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal.*

 1. What is a joint activity

 2. Specific concerns

 3. Perceived abuse

B. All NPOs and state and local governments, such as colleges and universities, that report expenses by function

III. Summary

A. The proposed SOP would require the following:

 1. Reporting the costs of all materials and activities that include a fund-raising appeal as fund-raising expenses, *including costs that are otherwise clearly identifiable with program or management and general functions*, unless a bona-fide program or management and general function has been conducted in conjunction with the appeal for funds. The proposed SOP sets forth the criteria of purpose, audience, and content and requires that all three be met in order to conclude that a bona-fide program or management and general function has been conducted.

 2. Conditions:

  a. Purpose

  The conditions for determining whether the purpose criteria have been met are as follows:

(1) If substantially all compensation or fees for performing the activity are based on amounts raised, the criterion is not met and allocation is prohibited

(2) If the program or management and general component is conducted on a similar scale using the same medium without the fund-raising appeal, the criterion is met.

However, not meeting (2) does not necessarily lead to the conclusions that the criterion is not met. It may still be met based on an evaluation of other indicators, which are discussed in the proposed SOP.

b. Audience

The conditions for determining whether the audience criterion has been met are as follows:

(1) If the audience is selected principally on its ability or likelihood to contribute, the audience criterion is not met and all costs of the joint activity should be charged to fund-raising.

(2) If the audience is not selected principally on its ability or likelihood to contribute, but rather is selected because it can assist the NPO in meeting its program goals other than by financial support provided to the NPO, the audience criterion is met.

c. Content

The conditions for determining whether the content criterion has been met are as follows:

The materials or activity must either:

(1) motivate the audience to action in support of program goals or

(2) inform the public regarding the NPO's stewardship function (For example, annual reports may inform the public regarding the NPO's stewardship function.)

3. Allocation

If a bona-fide program or management and general function has been conducted in conjunction with an appeal for funds, the joint costs of those activities should be allocated. ("Joint costs" are costs that are related to more than one activity without being clearly identifiable with either activity, such as postage or a letter that includes messages concerning more than one activity.) Costs that are clearly identifiable with fund-raising, program, or management and general functions should be charged to that cost objective.

a. Illustrates but does not prescribe or prohibit

IV. Disclosure

A. The proposed SOP requires the following disclosures if joint costs are allocated:

1. The types of materials and activities for which joint costs have been incurred

2. A statement that such costs have been allocated

3. The allocation method

4. The total amount allocated during the period

5. The portion allocated to each functional expense category

V. Effective Date

The proposed SOP is expected to be effective for financial statements for years beginning on or after its issuance date.

Group Exercises
Joint Activities

Exercise 1

Facts: NPO A's mission is to prevent drug abuse. NPO A's annual report states that of one NPO A's objectives in fulfilling that mission is to assist parents in preventing their children from abusing drugs.

NPO A mails informational materials to the parents of all students in junior high schools to help and encourage parents to counsel children about the dangers of drug abuse and to detect drug abuse, and includes an appeal for funds. NPO A conducts other activities that inform the public about the dangers of drug abuse but that do not include appeals for funds.

Exercise 2

Facts: NPO B's mission is to reduce the incidence of illness from XYZ disease, which afflicts a broad segment of the population. One of NPO B's objectives in fulfilling that mission is to inform the public about the early warning signs of the disease and specific action that should be taken to prevent the disease.

NPO B maintains a list of its prior contributors and sends them donor renewal mailings. The mailings include a separate piece of paper containing messages about the early warning signs of the disease and specific action that should be taken to prevent it. The information on that separate piece of paper is also sent to a similar size audience, but without the fundraising appeal. Prior donors are deleted from the mailing list if they have not contributed to NPO B during the last three years.

Appendix B

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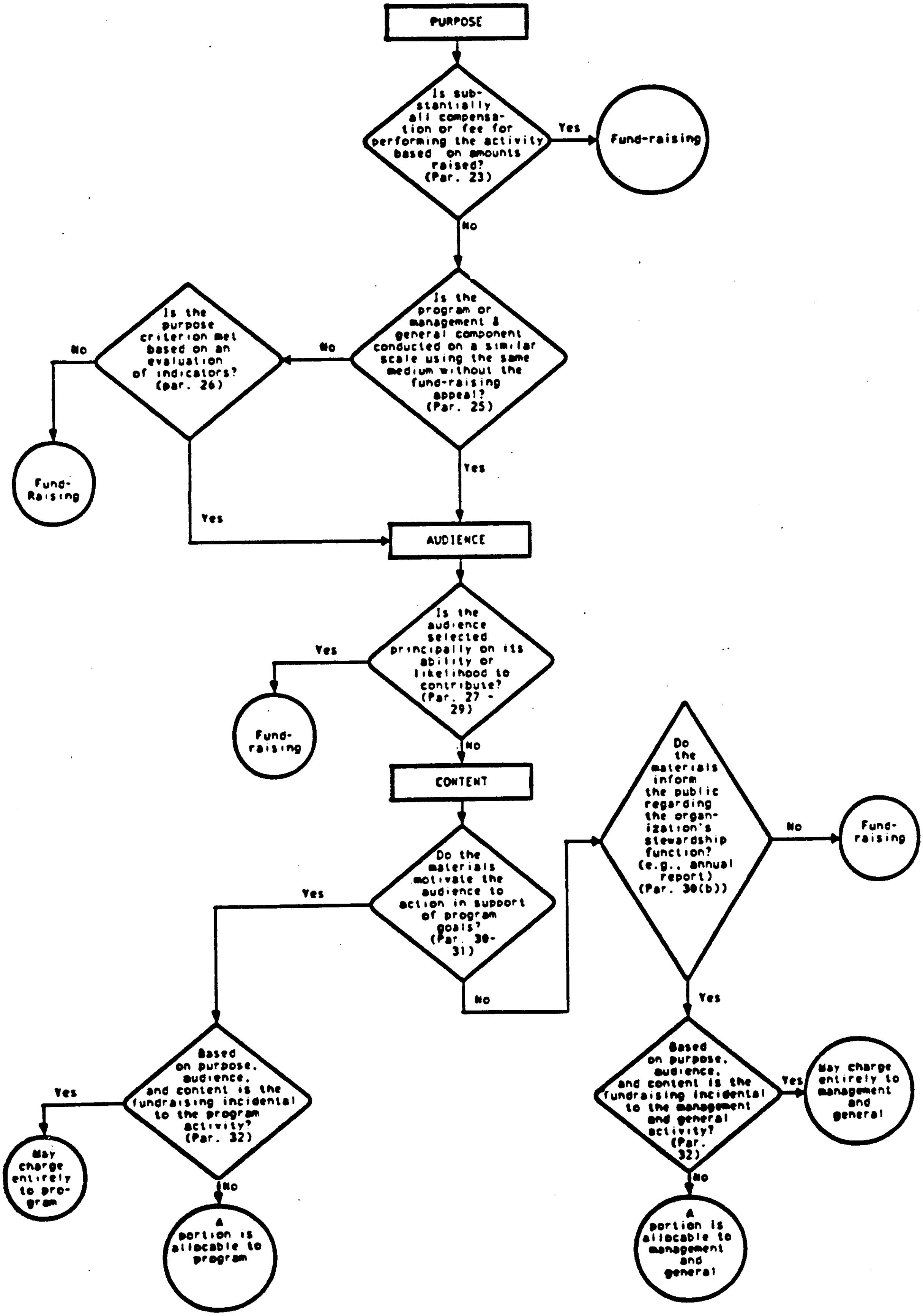
6/23/93

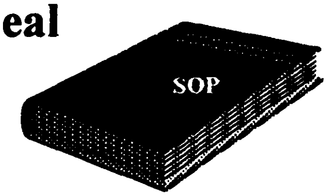
ACCOUNTING FOR JOINT ACTIVITIES*



* Note - This flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.

PROPOSED SOP

Accounting for Costs of Materials and Activities of Not-for-Profit Organizations That Include Fund-Raising Appeal



SCOPE

- Proposed SOP - Applies to all NPOs and state and local governments that report expense by function
- SOP 87-2 - Applies to all NPOs that follow the audit guides

FOCUS

- Qualitative
  - When to charge or allocate costs of program or management and general

- Quantitative
  - Not how to allocate

REQUIREMENTS

- Fund-raising expense; unless
- Bona-fide program has been conducted
- All three criteria
  - Purpose
  - Audience
  - Content

PURPOSE

- Compensation
  - criterion not met
  - charge to fund-raising
- Held the event regardless
  - criterion is met
  - allocation appropriate

AUDIENCE

- Selected on ability or likelihood to contribute
  - criterion not met
  - charge to fund-raising

- Selected on ability to assist the npo
  - criterion is met
  - allocation appropriate

CONTENT

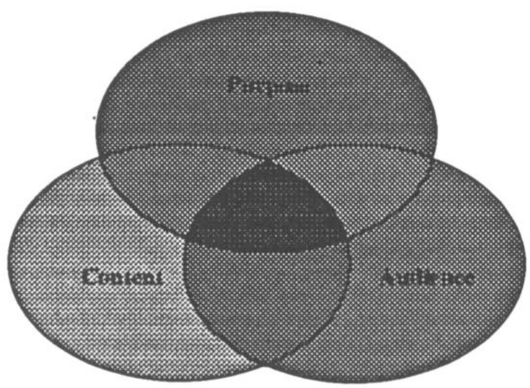
If the materials:

- Motivate the audience to action, or

- Inform the public

Content criteria is met

BONA-FIDE PROGRAM



JOINT COSTS

Costs that are related to more than one activity without being clearly identifiable with either activity.

ALLOCATION METHODS

- **Physical units**
- **Relative direct costs**
- **Stand alone joint cost**

DISCLOSURES

- Types of materials and activities
- Statement that costs have been allocated
- Allocation method
- Total amount allocated
- Portion allocated to each functional expense category

SUMMARY

- Applies to all NPOs and state and local governments that report expenses by function
  - Applies to entities that follow the guides
- Covers all joint costs
  - Covers only joint costs of joint activities
- Criteria of purpose, audience, and content
  - Unclear whether criteria must be met

SUMMARY

- **Illustrates allocation methods**
  - **No illustrations**
- **Requires extensive note disclosures**
  - **Requires less extensive note disclosures**

The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements, and Interpretations, of the Financial Accounting Standards Board to Not-for-Profit Organizations

I. Status

A May 19, 1993 exposure draft of a proposed Statement of Position was released.

II. Summary

A. Some believe the applicability of Accounting Research Bulletins (ARBs), Opinions of the Accounting Principles Board (APB), and Statements and Interpretations of the Financial Accounting Standards Board (FASB) to NPOs is unclear.

B. The proposed SOP provides that NPOs should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations except for specific pronouncements that explicitly exempt NPOs. Also, it includes interpretive comments concerning the application of certain pronouncements.

C. NPOs are permitted to follow the guidance in effective provisions of APB Opinions and FASB Statements which specifically exempt NPOs from their application, unless the guidance has been superseded or unless *Audits of Voluntary Health and Welfare Organizations, Audits of Colleges and Universities, Audits of Certain Nonprofit Organizations*, Statement of Position (SOP) 78-10, and *Audits of Providers of Health Care Services* provide different guidance. (However, the guidance included in the effective provisions of pronouncements that specifically exempt NPOs does apply to all for-profit entities owned by NPOs.)

III. Effective Date

The proposed SOP would be effective for fiscal years beginning on or after its issuance date.

PROPOSED SOP

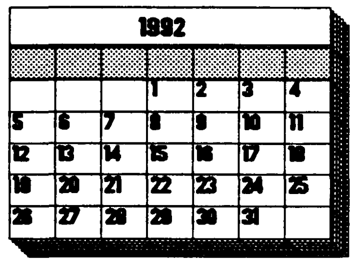
The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements, and Interpretations, of the Financial Accounting Standards Board to Not-for-Profit Organizations

APPLICABILITY

- **Accounting Research Bulletins (ARBs)**
- **Opinions of the Accounting Principles Board (APB)**
- **Statements and Interpretations of the Financial Accounting Standards Board (FASB)**

EFFECTIVE DATE

Effective for fiscal years beginning on or after its issuance.



Reporting of Related Entities by NPOs

I. Status

A May 19, 1993 exposure draft of a proposed statement of position was released.

II. Summary

A. This proposed statement of position (SOP) would amend the following AICPA audit and accounting guides and SOP:

1. *Audits of Voluntary Health and Welfare Organizations*

2. *Audits of Colleges and Universities*

3. SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

4. *Audits of Certain Nonprofit Organizations*

B. The proposed SOP focuses on:

(1) NPO's investments in for-profit entities and

(2) financially interrelated NPOs.

III. Investments in For-Profit Entities

A. An NPO should consolidate a for-profit entity in which it has a majority ownership interest if the guidance in ARB No. 51, as amended by FASB Statement No. 94, would require consolidation.

B. Except as specified below, an NPO should use the equity method in conformity with APB Opinion No. 18 to report an investment in a for-profit entity in whose voting common stock it has a 50 percent or less voting interest if the guidance in that Opinion would require the use of the equity method.

IV. Financially Interrelated NPOs

A. An NPO should consolidate another NPO if the reporting NPO has both control of the other NPO, as evidenced by either majority ownership or a majority voting interest in the board of the other NPO, and an economic beneficial interest in the other NPO. However, there are exceptions to this general rule. Another NPO should not be consolidated if control is likely to be temporary or if it does not rest with the majority owner, as discussed in paragraph 13 of FASB Statement No. 94.

B. A NPO may exercise control of a separate NPO in which it has an economic beneficial interest by means other than majority ownership or a majority voting interest in the board of the other NPO. In such circumstances, the NPO is permitted but not required to consolidate the financial statements of the other NPO, subject to the exception in the last sentence of the previous bullet (control is temporary or does not rest with the majority owner). If consolidated financial statements are not presented, the NPO should make the following 7@3 financial statement disclosures:

1. Identification of the other NPO and the nature of its relationship with the reporting NPO resulting in control

2. Summarized financial data of the other NPO including

   a. Total assets, liabilities, net assets, revenue, and expenses

   b. Resources held for the benefit of the reporting organization or under its control

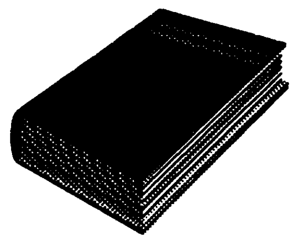
3. A description and quantification of any transactions between the other NPO and the reporting NPO

V. Effective Date

The proposed SOP would be effective for financial statements for fiscal years beginning on or after its date of issuance, with earlier application encouraged. Comparative financial statements for earlier periods included with those for the period in which the SOP is adopted should be restated.

PROPOSED SOP

**Reporting of Related Entities by
Not-for-Profit Organizations**



FOCUS

- **NPO's investment in for-profit entities**
- **Financially interrelated NPOs**

REQUIREMENTS

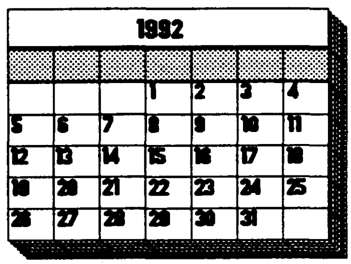
- **Investments in for profit entities**
  - **Consolidate if required by statement No. 94**
  - **Equity method under APB Opinion No. 18**

FINANCIALLY INTERRELATED

- **Control**
  - **Majority ownership**
  - **Majority voting interest**
  - **Economic beneficial interest**

EFFECTIVE DATE

Effective for fiscal years beginning on or after its issuance



DISCLOSURE OF CERTAIN SIGNIFICANT RISKS AND UNCERTAINTIES AND FINANCIAL FLEXIBILITY

I. Introduction

II. Scope

A. Applies to all entities that prepare financial statements in conformity with GAAP (including business enterprises, not-for-profit organizations, and state and local governments). and OCBOA.

B. Applies only to the financial statements for the most recent fiscal period presented.

C. Does not encompass--

1. risks and uncertainties that might be associated with management or key personnel,

2. proposed changes in government regulations, proposed changes in accounting principles,

3. deficiencies in the internal control structure over financial reporting, or

4. acts of God, war, sudden catastrophes, or losses from uninsured risks that are caused by damages occurring after the date of the financial statements.

III. Relationship to other pronouncements

The disclosure requirements of this SOP in many circumstances are similar to or overlap the disclosure requirements in certain FASB and GASB pronouncements, such as

- FASB Statement No. 5, *Accounting for Contingencies*,
- FASB Statement No. 105, *Disclosures about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*,
- GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*,

- GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*,

- for public business enterprises, FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*, and
- SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.*

This SOP **does not alter the requirements of any other pronouncement**. Rather, **it supplements them**. In many cases, the disclosure requirements in this SOP, particularly those relating to certain significant estimates and current vulnerability due to concentrations with respect to credit risk of financial instruments, will be met or partly met by compliance with such other pronouncements.

IV. REQUIRED DISCLOSURES

This SOP would require all reporting entities to make disclosures about--

1. The nature of their operations.

2. Use of estimates in the preparation of financial statements.

In addition, if specified disclosure criteria are met, it would require them to make disclosures about--

3. Certain significant estimates.

4. Current vulnerability due to concentrations.

5. Financial flexibility.

V. Disclosures that would always be made

A. Nature of Operations

   1. Describe the entity's major products or services and its principal markets, including the locations of those markets.

   2. Describe relative importance

3. Current Requirements:

   SFAS 5, SFAS 14, GASB Cod. Sec. 2500

4. Reasons for the Disclosure

B. Use of Estimates in the Preparation of Financial Statements

1. An explanation that the preparation of financial statements in conformity with GAAP requires the use of management's estimates.

2. Current Requirements:

   SAS No. 58

3. Reasons for the Disclosure

VI. DISCLOSURES THAT WOULD BE MADE ONLY IF CERTAIN CRITERIA ARE MET

A. Certain Significant Estimates

1. Discuss the potential near-term effects on the financial statements of the risks and uncertainties associated with estimates used in the determination of the carrying amounts of assets or liabilities or disclosure of gain or loss contingencies.

2. Criteria. *Both* of the following criteria must be met:

   - It is at least reasonably possible that the estimate will change in the near term.

   - The effect of the change would be material to the financial statements.

3. Examples of assets, liabilities, and related revenues and expenses (expenditures) or disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances, may be based on estimates that are particularly sensitive to change in the near term include:

- Inventory subject to rapid technological obsolescence
- Specialized equipment subject to technological obsolescence
- Goodwill and other intangible assets
- Deferred tax assets based on significant future income, reported pursuant to FASB Statement No. 109, *Accounting for Income Taxes*
- Long-term investments
- Capitalized motion picture film production costs
- Environmental-related liabilities
- Litigation-related liabilities
- Contingent liabilities for debt of other entities
- Provisions for commercial and real estate loan losses
- Provisions for restructurings
- Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on the disposition of a business or assets
- Amounts reported for long-term contracts

3. Current Requirements:

   SFAS 5, GASB Cod. Sec. C50

4. Reasons for the Disclosure

B. Current Vulnerability Due to Concentrations

1. Disclose any concentration (including group concentrations) existing at the date of the financial statements that makes the enterprise vulnerable to the

risk of a near-term severe impact.

2. *Severe impact* is defined as a significant financially disruptive effect on the normal functioning of the entity or, for governmental entities, on the functioning of the essential services of government. Severe impact is a higher threshold than materiality.

3. Criterion. When it is at least reasonably possible that the events that could cause the near-term severe impact will occur.

4. Examples of areas in which current concentrations might make an entity vulnerable to a risk that would be disclosed include:

   - Products or other revenue sources (such as a particular type of tax)
   - Inputs (suppliers, raw materials, labor)
   - Customers, taxpayers, grantors, or contributors
   - Investments, interest rate or foreign exchange rate exposure
   - Dependence on patent protection
   - Assets subject to expropriation

5. Current requirements:

   SFAS 105, GASB Cod. Sec. I50, MD&A

6. Reasons for the disclosure

C. Financial Flexibility

1. Discuss management's expected course of action.

2. Criterion. When it is at least reasonably possible that the entity will not have the ability over the near term to pay its expected cash outflows without taking certain actions. Such actions include entering into new credit agreements, modifying or renewing existing credit agreements, and other significant actions.

3. Examples of expected courses of action that bear on financial flexibility and that may be the subject of discussion include:

   - Borrowing, either—

     a. directly, by borrowing from banks, borrowing from governments, issuing bonds, issuing commercial paper, or

     b. indirectly, by delaying payments to suppliers or employees, extending due dates of loans, or restructuring loans.

   - Liquidating assets, either—

     a. directly, by selling long-term investments, selling (possibly combined with leaseback) plant and equipment, buildings or infrastructure, or

     b. indirectly, by not replacing inventory as it is sold through normal trade channels or not replacing fixed assets as they are consumed in operations.

   - Enacting new taxes or raising existing taxes.
   - Reducing costs.
   - Reducing dividends.
   - Reducing or eliminating services or programs, including deferring maintenance on infrastructure.
   - Issuing capital stock.
   - Filing for bankruptcy protection.

4. Current requirements: SAS No. 59, MD&A

5. Reasons for disclosure

VII. Effective Date

For financial statements issued for fiscal years ending after December 15, 1994, and for financial statements for interim periods in fiscal years subsequent to the year for which this SOP is first applied. Early application is encouraged but not required.

VIII. Minority View

1. Increased responsibility for preparers and independent accountants

2. Subjectivity of the information

3. Cost and benefit of the information

IX. Areas requiring particular attention by respondents

1. Scope

2. Clarity of disclosure criteria

3. Whether information disclosed would be proprietary or confidential

4. Cost/benefit

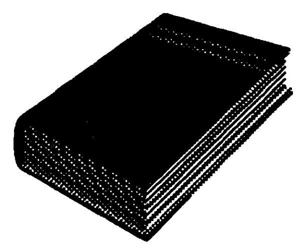
5. Placement of disclosures

6. Range of risks and uncertainties

Comment Deadline: July 31, 1993

PROPOSED SOP

Disclosure of Certain Significant Risks and Uncertainties and Financial Flexibility



INTRODUCTION

- **Volatile business and economic environment**
- **Early warning system**
- **AICPA 1987 report**
- **Selectivity**

SCOPE

- Applies to all entities that prepare GAAP financial statements
- Most recent fiscal year presented
- Does not encompass
  - Management or key personnel
  - Proposed changes in government regulations
  - Internal control structures
  - Acts of God
  - Proposed changes in accounting principles

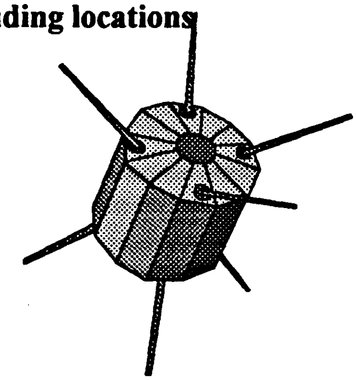
REQUIRED DISCLOSURES

- Nature of operations
- Use of estimates

- Certain significant estimates
- Current vulnerability due to concentrations
- Financial flexibility

NATURE OF OPERATIONS

- Entity's major products or services
- Principal markets, including locations



USE OF ESTIMATES

- Explanation that the preparation of financial statements requires the use of management's estimates:
  - Current requirements: SAS no. 58
  - Reasons for the disclosure

not all F/S are audited.
Narrows expectation gap.

CERTAIN SIGNIFICANT ESTIMATES

- Discuss the potential near-term effects
- Criteria
  - Reasonably possible that the estimate will change in the ***near term***, and
  - Effect of the change would be material

EXAMPLES

- Inventory
- Specialized equipment
- Goodwill and other intangibles
- Deferred tax assets
- Long term investments
- Environmental-related liabilities
- Litigation-related liabilities

CONCENTRATION

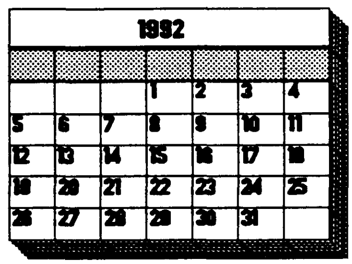
- Disclose any concentrations -- risk of near-term severe impact
- Criterion
  - At least reasonably possible that the events that could cause the near-term severe impact will occur.

FINANCIAL FLEXIBILITY

- Discuss management's expected course of action
- Criterion:
  - When it is at least reasonably possible that the entity will not have the ability over the near term to pay its expected cash outflows without taking certain actions.

EFFECTIVE DATE

For financial statements issued for fiscal years ending after December 15, 1994.



ACCOUNTING FOR INVESTORS' INTERESTS IN THE OPERATIONS OF UNCONSOLIDATED REAL ESTATE JOINT VENTURES

I. Status

At its July 1993 meeting, AcSEC will be asked to clear the proposed statement for exposure.

II. Summary

This proposed statement of position provides guidance on applying generally accepted accounting principles in accounting for investors' interests in the operations of unconsolidated real estate joint ventures (hereinafter referred to as "ventures").

A. Basis of accounting

Investors generally should account for their unconsolidated interests in ventures using the equity method. However, investors that have virtually no ability to influence the venture's operating and financial policies should account for their investments using the cost method.

B. Accounting for venture operations using the equity method

Results of operations of the venture should be determined in conformity with GAAP without regard to unrealized increases in the estimated current values of venture assets. The provisions of the venture agreement should determine how operating results are allocated among the investors for accounting purposes, provided that the resulting allocations are consistent with the effective economic allocations of risks and rewards.

C. Venture losses in excess of investment basis

Because uncommitted investors--investors that are not required to fund a venture's obligations and do not intend to do so--are not liable for venture losses in excess of their investment bases, they generally should not recognize venture losses, regardless of source, that would reduce the carrying amounts of their investments below zero.

D. Statement of cash flows

The cash flows from operating activities reported by an investor in a venture should reflect the investor's allocable share of cash flows from the operating activities of the underlying venture, as determined using FASB Statement No. 95. All distributions in excess of such cash flows from operating activities should be classified as cash flows from investing activities.

III. Disclosures

Investors in ventures should be guided by paragraph 20 of APB Opinion 18, *The Equity Method of Accounting for Investments in Common Stock*, in determining the disclosures to be made in their financial statements. The general allocation terms for each investor concerning cash flows or profits and losses from operations, sales, refinancings, and defined residual ownership interests should be disclosed.

IV. Effective Date

ILLUSTRATION

Facts: On January 1, 19X1, ABC Financial Institution ("ABC") invested $10,000,000 with XYZ Real Estate Acquisition, Inc. ("XYZ") for the purchase of a commercial office building. The property has executed triple net leases to national, creditworthy tenants in order to bring the property to full occupancy in late 19X2. XYZ's initial equity investment totaled $500,000. (For purposes of this Illustration, $500,000 is not considered substantial, using the minimum down payment requirements of FASB Statement No. 66.) The venture agreement has a cumulative preference return of 10 percent, and also provides for ABC to share in 50 percent of the positive operating cash flows from the property. Operating cash flows, by definition in the venture agreement, are determined after deducting the cumulative preference return to ABC and are paid in cash distributions each year. Any sale or financing proceeds will be distributed first to ABC, until ABC receives a priority distribution of $10,000,000 plus the deficit, if any, in the cumulative annual preference return, with the balance of any proceeds allocated 50% to each partner.

Notwithstanding any other facts, the venture agreement provides that all profits and losses are to be allocated 50% to each partner.

Operating results of the ABC project are as follows:

	19X1	19X2	19X3	19X4
Operating income before depreciation	$ 200,000	$1,000,000	$2,700,000	$2,700,000
Depreciation	(300,000)	(300,000)	(300,000)	(300,000)
GAAP basis net income (loss)	$ (100,000)	$ 700,000	$2,400,000	$2,400,000

Cash flows from the ABC project are distributed as follows:

	19X1		19X2		19X3		19X4	
	ABC	XYZ	ABC	XYZ	ABC	XYZ	ABC	XYZ
Preference return to ABC	$ 200,000	--	$1,000,000	--	$1,800,000	--	$1,000,000	--
Operating income (loss) after preference, shared 50/50								
Year 1: -0-								
Year 2: -0-								
Year 3:$ 900,000					450,000	450,000		
Year 4:$1,700,000							850,000	850,000
Total distribution of cash flows	$ 200,000	$ --	$1,000,000	$ --	$2,250,000	$450,000	$1,850,000	$ 850,000
Allocation of net income (loss)	$ --	$ (100,000)	$ 700,000	$ --	$2,300,000	$ 100,000	$1,700,000	$ 700,000
		(1)	(2)		(3)	(3)	(3)	(3)

(1) Because ABC received a preferential distribution and XYZ has a positive capital account under GAAP, all losses are allocated to XYZ to the extent of XYZ's positive capital account. The total loss allocable to any one investor should not exceed the total loss recognized by the venture as a whole.

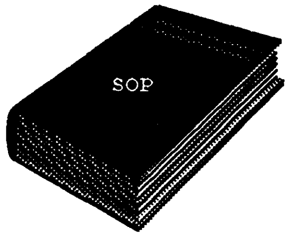
(2) Because ABC's preferential distribution exceeded the net income of the partnership, all income is allocated to ABC.

(3) Income is allocated to ABC up to amount of cumulative preferential distribution. After recovery of prior losses recognized, the excess is allocated in accordance to the partner's percentage interests as follows:

	19X3	19X4
Cumulative ABC preferential distributions	$3,000	$4,000
Income previously allocated to ABC	700	3,000
Income to be allocated to ABC based on cumulative preferences	$2,300	$1,000
Income in excess of preferences		
GAAP income for the year	$2,400	$2,400
GAAP income allocated to ABC per above	(2,300)	(1,000)
Recovery of prior losses to investors (allocated to XYZ)	(100)	--
Excess per venture agreement (50/50)	--	(1,400)
Income allocation recap		
ABC--preference	2,300	1,000
--residual	--	700
ABC subtotal	2,300	1,700
XYZ--prior losses	100	--
--residual	--	700
XYZ subtotal	100	700
Venture total	$2,400	$2,400

PROPOSED SOP

Accounting for ~~Investors'~~ Interests in the Operations of Unconsolidated Real Estate Joint Ventures



guidance on loss allocations

BASIS OF ACCOUNTING

- Equity method
- Cost method – if ~~virtually~~ no ~~control~~ ability to exercise significant influence (APB 18).

ACCOUNTING FOR OPERATIONS

- GAAP - without regard to unrealized increases in current value
- Look to venture agreement for allocations
- Check allocation for effective economic allocation of risks and rewards

LOSS > BASIS

Uncommitted investors investment should *not* be less than zero.

DISCLOSURES

- **APB Opinion 18**
- **Generally,**
  - allocation terms
  - cash flows
  - profits and losses from operations
  - sales
  - refinancing
  - defined residual ownership

SUPPLEMENTAL INFORMATION ON CURRENT VALUES EXPECTED TO BE REALIZED BY REAL ESTATE COMPANIES

I. Status

At its May 19, 1993 meeting, the FASB did not object to the issuance of this exposure draft.

II. Summary

This proposed statement of position provides guidance for optional supplemental reporting of current value balance sheet information, changes in revaluation equity, and related disclosures by reporting entities substantially all of whose assets are real estate and substantially all of whose operations consist of real estate activities.

A. Definition

The term current value is derived from the concept of fair value, as defined in accounting literature, and from the concept of market value, as defined by appraisers.

B. Measurement

1. The current values of a reporting entity's assets and liabilities are based on the entity's intent and ability to realize asset values and settle liabilities.

2. In this SOP, current value refers to the value of specific balance sheet elements—not to the value of the entity as a whole.

III. Effective Date

The provisions of this proposed SOP should be applied to supplemental current value reporting by real estate companies in financial statements for fiscal years, and interim periods in such fiscal years, beginning after December 31, 1993. Restatement of comparative annual financial statements for earlier years is encouraged but not required.

IV. FASB Discussion

A. Valuation Approach

The FASB indicated that it would object to issuance of the proposed exposure draft unless revisions were made to clarify that the valuation approach is based on the discounted amount of future cash flows expected to be realized by the reporting entity. Specifically, it was noted that such cash flows might differ significantly from those that would be realizable under other circumstances by holders of the same or similar properties because of transaction costs, transfer taxes, and property tax assessments unique to ownership by the reporting entity. It was suggested that all related disclosures should be labeled to indicate that the underlying valuations are determined from the point of view of the reporting entity. An example of such a label, which was tentatively supported by the representatives of the Real Estate Committee, would be, "Supplemental Information on Current Value Expected to Be Realized by *Company X*." The title of the proposed SOP was changed accordingly.

B. Reporting

The FASB recommended that assets held for sale be separately identified in the current value balance sheet.

C. Debt collateralized by real estate

The FASB objected (0 yes, 7 no) to the conclusion that debt collateralized by real estate should be reported in the current value balance sheet at par or face value. The FASB recommended adoption of the approach to valuing liabilities set forth in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*.

D. Income taxes

The FASB did not object (2 yes, 5 no) to the two alternative methods of determining the deferred income tax liability recommended in the proposed SOP.

E. Disclosure requirements

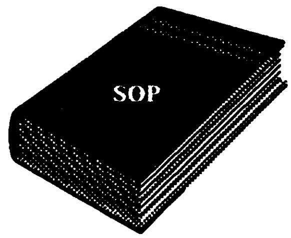
The FASB recommended making the disclosure requirements consistent with the following guidance in paragraph 5 of the July 1990 auditing interpretation of SAS No. 62, *Special Reports*, "Reporting on Current-Value Financial Statements That

Supplement Historical-Cost Financial Statements in a General-Use Presentation of Real Estate Entities":

> The auditor should also consider the adequacy of disclosures relating to the current value financial statements. Such disclosures should describe the accounting policies applied and such matters as the basis of presentation, nature of the reporting entity's properties, status of construction-in-process, valuation bases used for each classification of assets and liabilities, and sources of valuation. These matters should be disclosed in the notes in a sufficiently clear and comprehensive manner that enables a knowledgeable reader to understand the current-value financial statements.

PROPOSED SOP

Supplemental Information on Current Values Expected to be Realized by Real Estate Companies



REQUIREMENTS

- **Optional supplemental reporting of current value balance sheet information**
- **Changes in revaluation equity**
- **Related disclosures**

DEFINITION

- **Current value --**

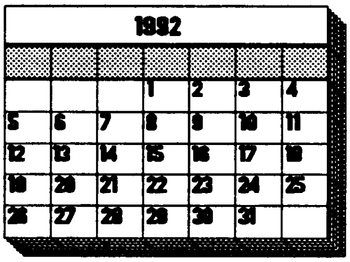
Derived from the concept of fair value, as defined in the accounting literature, and from the concept of market value

MEASUREMENT

- **Current value based on the entity**
- **Specific balance sheet -- not entity as a whole**

EFFECTIVE DATE

For financial statements for fiscals years, and interim periods in such years, beginning after December 31, 1993.



ENVIRONMENTAL LIABILITIES ACCOUNTING GUIDE

I. Summary

Environmental costs have reached staggering proportions and are one of the critical issues facing businesses today.

- Estimates of the costs of only cleaning up sites on the National Priorities List range as high as $750 billion. To put this in perspective, a recent estimate of the private sector liability for retiree health care benefits is $335 billion.

- Some have estimated the cleanup cost to be $25 million per site listed on the National Priorities List. There are about 1,200 sites on the National Priorities List and another 27,000 to 30,000 identified potential sites.

- There are an estimated 2 to 3 million underground storage tanks in the U.S. storing petroleum and hazardous waste products. Most were buried over 20 years ago and have no corrosion protection.

- Ten years ago 2% of capital spending was for environmental matters. Now it is 20%.

- Annual environmental expenditures (in 1986 dollars) grew from $26 billion in 1972 to

$115 billion in 1990. The EPA estimates that by the year 2000, pollution control costs for environmental programs meeting current legislative requirements will reach nearly $160 billion a year, or about 2.8% of the GNP.

II. Background

On January 7 and 8, 1993, the AICPA held an Environmental Issues Roundtable, the objectives of which were to:

- Examine practice problems in applying generally accepted accounting principles and generally accepted auditing standards to environment-related financial statement assertions.

- Identify environmental issues for which the need for authoritative accounting and auditing guidance should be evaluated.

- Provide a starting point for the development of nonauthoritative guidance on applying existing accounting and auditing standards to environment-related matters (including CPE conferences or courses).

The more than 30 participants at the Roundtable represented public practice, industry, the FASB staff, the SEC staff, the American Bar Association, the Canadian Institute of Chartered Accountants, and the AICPA staff.

Among the key findings that emerged from the roundtable were the following:

- Accounting guidance is needed on recognizing and measuring environment-related liabilities, particularly with a focus on an entity's obligation to clean up environment-related problems created in the past.

- Financial statement preparers and independent auditors should be more knowledgeable about the significant federal laws on hazardous waste clean-up and the concepts of strict liability and joint and several liability applicable to clean-up costs. Participants expressed concern that many CPAs are unaware that the nationally recognized problem of environmental clean-up costs affects them directly.

III. Pervasiveness of Problem

A survey by Price Waterhouse indicated that 62 percent of respondents had known environment-related exposures that have not yet been accrued. The survey also indicated that measurement of clean-up costs is difficult and that practice remains mixed with regard to the timing of recording environmental clean-up liabilities.

IV. Description of Project

The project is initially being characterized as an Accounting Guide. Expansion of the project into an Audit and Accounting Guide, however, is not precluded, provided such expansion would not delay issuance of the guide.

The guide would include:

- An educational discussion of major federal legislation dealing with pollution control (responsibility) laws and pollution clean-up (remediation) laws and the need to consider various individual state legislation.

- A summary of relevant current accounting literature.

- Guidance on specific accounting issues that are present in the recognition, measurement, and disclosure of environment-related liabilities. The following are a few of the accounting issues on which practical guidance is needed:

    - At what point should an environmental cleanup liability be recognized, that is, what event triggers the need to record a liability?

- -- What event triggers the need for disclosure?

- -- Should amounts expected to be contributed by other PRPs or recovered from other PRPs through lawsuits be considered in determining the amount of the liability?

- -- Should amounts expected to be recovered through insurance be anticipated?

- -- What kinds of costs should be included in an environmental accrual? That is, should all direct costs be included (this would involve, for example, a portion of the cost of an in-house legal department) or should only incremental or non-continuing costs be included?

- -- Should the accrual consider anticipated changes in technology, environmental policies, laws, or regulations, or future inflation?

- Examples of the application of these accounting issues.

Though the accounting guidance will be based on existing literature, consideration will be given to the need for an effective date and transition provisions. The ability to include a discussion of typical procedures for dealing with environment-related matters in companies will also be considered.

V. Target Dates

Exposure draft: Second quarter of 1994

Final Guide: Fourth quarter of 1994

OVERVIEW OF CERTAIN ENVIRONMENTAL LAWS

The remainder of this presentation is an overview of certain environmental laws, primarily pollution cleanup laws.

POLLUTION CLEANUP LAWS

The vast majority of cleanup provisions are contained in the Superfund laws and in the Corrective Action provisions of RCRA. Superfund provisions apply to facilities that are abandoned, inactive, or insolvent. RCRA provisions apply to facilities that have managed hazardous waste and are still in operation.

Comprehensive Environmental Response, Compensation and Liability Act

Congress enacted the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA or Superfund) in 1980 to facilitate the cleanup of abandoned waste sites. CERCLA established a program to identify sites where hazardous substances have been, or might be, released into the environment; to insure that they are cleaned up by responsible parties or the government; to evaluate damages to natural resources; and to create a claim procedure for parties who have cleaned up sites or spent money to restore natural resources. The Act also created a $1.6 billion fund to cover the cleanup costs of orphan sites and costs incurred while the EPA seeks reimbursement from PRPs. In 1986, the Superfund Amendments and Reauthorization Act (SARA) increased the amount of the trust fund to $8.5 billion, broadened the provisions of Superfund, provided more detailed standards for cleanup and settlement provisions, and allowed criminal sanctions for blatant violations. The increase in the trust fund is supported by taxes on industry.

CERCLA places liability on four distinct classes of responsible parties:

1. current owners or operators of sites at which hazardous substances have been disposed,

2. owners or operators at the time of disposal,

3. generators of hazardous substances at the site, and

4. transporters of hazardous substances to the site.

This liability is imposed *regardless* of whether the party was negligent, whether the site was in compliance with environmental laws at the time of the release, or whether the party participated in or benefitted from the activities giving rise to the release.

"Hazardous substance" is a much broader term than "hazardous waste." It includes any substance identified by the EPA by regulation, pursuant to a number of federal statutes. Covered, for example, are substances considered to be toxic pollutants under the Clean Water Act or hazardous emissions under the Clean Air Act. The list of hazardous substances identified by the EPA contains more than 1,000 chemicals and chemical compounds.

Liability under CERCLA is **strict**. In other words, the statute imposes liability on responsible parties regardless of the level of fault of the party. Moreover, because wastes are commingled, liability under CERCLA is usually **joint and several**. If the defendant can prove, however, that the harm is divisible and there is a reasonable basis for apportionment of costs, the defendant usually is held liable only for its portion of the damage caused. This scheme of liability means that any responsible party is potentially liable for the entire cost of cleanup at a site notwithstanding that the party is responsible for only a small amount of the total waste at the site. Companies that disposed of hazardous substances many years ago--including years prior to the year CERCLA was originally enacted--at sites where there is a release or threatened release may be currently liable for response costs.

Statutory defenses to CERCLA liability are limited, and obtaining insurance to protect against the risk of CERCLA liability is often difficult and expensive. In order to mitigate the potentially harsh effects of the joint and several and strict liability matrix of CERCLA, the statute does permit contribution actions among responsible parties.

EPA has a potent arsenal of enforcement tools at its disposal under CERCLA. Most significant is EPA's power to issue a unilateral administrative order to responsible parties requiring that the respondents clean up a site. A respondent who, without sufficient cause, fails to perform the cleanup is subject to $25,000 per day in penalties. In addition, if EPA performs the cleanup, EPA may recover **four times** its costs in damages and penalties. It is well-settled that judicial review of an EPA order is not available until EPA commences an enforcement action. Therefore, even a party with a reasonably good defense to liability takes great risk in ignoring an EPA order.

CERCLA also has strict notification requirements that require responsible parties to notify EPA whenever hazardous substances in harmful quantities have been released into the environment. Releases that present a significant threat to human health and the environment are placed on the National Priorities List of hazardous waste sites.

Costs to a PRP may include cleanup costs, legal costs, claims to third parties (also referred to as "toxic torts"), and natural resource costs.

Stages of the CERCLA Remediation Process

Notification of liability. A company may first learn of potential involvement in a site through the appearance of the site on a government list such as the National Priorities List, in a database called the Comprehensive Environmental Response, Compensation, and Liability

Information System (CERCLIS), or on a state priorities list. But Superfund problems for a company usually begin in earnest when it is notified by the EPA that it may be a potentially responsible party (PRP). The EPA can do this in several ways. It may--

- Issue a Notice Letter to all PRPs. A Notice Letter is the EPA's formal notice that CERCLA-related action is to be undertaken at a site for which the PRP is considered responsible. Notice Letters are generally sent at least 60 days prior to scheduled obligation of funds for a remedial investigation and feasibility study (RI/FS) at a designated site.

- Summon all targeted PRPs to a meeting to discuss possible actions at a given site.

- Issue a Special Notice Letter to all PRPs. The special notice starts the clock ticking to facilitate an agreement between the EPA and PRPs. The Special Notice Letter establishes a 120-day moratorium (often changed to 180 days) on which the EPA refrains from financing the remedial design or using its powers to issue an administrative order to force the parties to clean up the site.

  The Special Notice Letter provides the names and addresses of other PRPs (for negotiations among the parties) and a draft of a consent decree for each party to share in the costs or assume the responsibility for the site's cleanup. The EPA will also normally include information about the nature of the material at the waste site and any knowledge they have obtained about the amount of waste contributed by each party. This is intended to spur additional research by each party and to serve as a basis for negotiated settlements between the parties.

PRPs usually also receive information requests regarding the wastes they have sent to a designated site and interrogatories from regulators. If PRPs are uncooperative, records can be subpoenaed.

Negotiations. Once notified, the PRPs face the difficult task of organizing to negotiate with the government and perhaps assume responsibility to carry out the investigation or remedial work.[1] If the PRPs are unable to reach an agreement among themselves, the EPA has the power to clean up the site and sue for full reimbursement of the costs. Since self-managed remediation expenses are typically a fraction of EPA charges, it is generally in the PRPs' best interests to assume responsibility for site cleanups. The 60-day period given with the Notice Letter is intended to give multiple PRPs sufficient time to organize and to make a good faith offer to the government to perform a specified activity.

Remedial investigation/feasibility study (RI/FS). The remedial investigation is a

[1] The negotiations do not require participation by all PRPs.

comprehensive study that seeks to delineate the extent of the contamination and define pathways for receptors for exposure. The remedial investigation usually involves extensive sampling of soil, ground water, and air in and around the vicinity of the site.

Following the remedial investigation, a feasibility study is performed. The feasibility study uses the information generated by the remedial investigation to evaluate alternative remedial actions.

The remedial investigation and the feasibility study together typically take two years or more to complete and typically cost in excess of $1 million.

Remedial action plan. Once the RI/FS is complete, a program must be decided on for remediation of the site. The decision process includes the PRPs, the EPA, and outside public participation. The program is published in a document known as a Record of Decision (ROD). The ROD is part of the written administrative record. Judicial review of EPA cleanup decisions may be limited to the administrative record.

Upon entering into a settlement with the government, an Administrative Order on Consent, through which the PRP agrees to pay for correction of violations, take the required corrective or cleanup actions, or refrain from an activity in return for the regulatory agency's commitment to a defined plan of remediation, is entered as an order in federal district court or a state court.

A consent decree is mandatory in settlements under CERCLA about remedial action.

Remedial design. Following issuance of the ROD and the consent decree, the site enters into the remedial design phase. This phase includes development of engineering drawings and specifications for a site cleanup.

Remedial action. Actual construction and implementation of a Superfund remedial design that results in long-term site cleanup.

Litigation. PRPs that participated in the cleanup sue PRPs that did not participate in the cleanup to recover costs, assuming those parties can be found and are solvent. CERCLA expressly provides that any responsible party who pays CERCLA response costs may recover at least a part of such costs from other responsible parties under a statutory right of contribution. In resolving contribution claims, courts are authorized by CERCLA to apportion liability for response costs among responsible parties using "such equitable factors as the court determines are appropriate."

Operation and maintenance. Activities conducted at a site after Superfund site remedial action is completed to ensure that the remedy is effective and operating properly. For example, operating a system to pump and treat groundwater is operation and maintenance, while actual construction of the system is remedial action. Operation and maintenance may continue for 30 years or longer.

Delisting/completion. If cleanup standards, standards of control, and other environmental protection requirements, criteria, or limitations (known as "Applicable or Relevant and Appropriate Requirements" or "ARARs") are met, a remedial action may be complete. But delisting of a site from the National Priorities List occurs infrequently.

Resource Conservation and Recovery Act

The Resource Conservation and Recovery Act of 1976 was originally intended to provide "cradle to grave" tracking of hazardous wastes. The 1984 Hazardous and Solid Waste Amendments to RCRA, however, expanded owner responsibility for cleanup of hazardous waste contamination at licensed waste facilities. As amended, RCRA requires facilities--whether they continue operating or intend to close--to clean up any contamination from ongoing or past practices. The 1984 amendments also created the Underground Storage Tank program, which requires, among other things, that owners or operators of existing tank systems used for storage of petroleum and petroleum-based substances and certain other designated hazardous substances upgrade or replace those systems, or close some or all of them in accordance with standards specified by the EPA if those tank systems do not meet new tank standards.

State Laws

Most states have also enacted laws that are similar to the federal statutes discussed here. Furthermore, under certain federal statutes, such as RCRA, states are allowed to promulgate regulations to implement federal programs. In most such cases, states are free to enact more stringent provisions. Some state laws are enacted under state water programs, and several are tied to facility divestitures. The latter require companies to certify that a site is free of unacceptable contamination as a condition of sale. An example of such a law is New Jersey's Environmental Cleanup Responsibility Act (ECRA).

ECRA requires specified industrial establishments (i.e., with specified SIC codes) whose operations involve the generation, manufacture, refining, transportation, treatment, storage, handling, or disposal of hazardous substances or wastes to clean up any contamination on their property before closure, sale, or transfer of their operations. "Hazardous substances" for purposes of ECRA are generally the same as defined by the EPA, except that they also include petroleum products.

ECRA and its implementing regulations require notification of the state Department of Environmental Protection before execution of the sales agreement or decision to close operations, detailed submissions outlining the history of site operations and management of hazardous wastes, a site inspection, and submission of a sampling plan. Before a facility subject to ECRA can be transferred, the owner or operator must submit, and have approved by the state, either a Negative Declaration or a cleanup plan, including the provision of financial security for the cleanup. A Negative Declaration is a written affidavit, accompanied by specified evidence, stating that (1) there has been no discharge of hazardous substances or waste on site or (2) any discharge has been cleaned up in accordance with procedures approved by the state Department of Environmental Protection, and there remain no hazardous substances or wastes on-site above a level found acceptable by the Department.

ECRA permits deferral of implementation of a cleanup plan when the premises would be subject to substantially the same use by the new owner or transferee and the deferral poses only an insignificant threat of actual or potential harm to the public health or the environment. The owner or operator must apply to the Department of Environmental Protection for deferral and must provide financial assurance for the cleanup plan. If granted, the deferral is effective until the use changes or until the transferee closes, terminates, or transfers operations.

Property owners in New Jersey may need to obtain letters from the state confirming for creditors or insurers the nonapplicability of ECRA to a particular site.

Connecticut has also adopted a statute based on ECRA.

POLLUTION CONTROL LAWS

Resource Conservation and Recovery Act

The Resource Conservation and Recovery Act (RCRA) provides comprehensive federal regulation of hazardous wastes from point of generation to final disposal. All generators of hazardous waste, transporters of hazardous waste, and owners and operators of hazardous waste treatment, storage, or disposal (TSD) facilities must apply for and obtain a RCRA permit and comply with the applicable requirements of the statute, including:

(a) hazardous waste determination;

(b) manifest requirements;

c) packaging and labeling; and

(d) recordkeeping and annual reporting.

Relaxed requirements under RCRA are imposed on certain small quantity generators (between 100 and 1,000 kg of a waste per month) where the waste is reclaimed pursuant to specific contractual agreements.

With some exceptions, a generator that accumulates hazardous waste in excess of 90 days will be deemed the operator of a TSD facility and be subject to the more comprehensive TSD regulations. Those regulations require companies to, among other things, prepare emergency contingency plans for approval by EPA and local response authorities (i.e., fire, police, and hospital), conduct and maintain records of personnel training, maintain specified response equipment, and prepare annual reports.

Each TSD facility is also subject to specific requirements designed to prevent any release of hazardous waste into the environment. These regulations require containers and tanks to be of sufficient integrity to contain hazardous wastes properly, and they require that in certain cases containers be separated or protected by dikes, berms, or walls. Surface impoundments, waste piles, and landfills must be equipped with liners to prevent any migration of wastes into soil, groundwater, or surface water during the active life of the facility and must be constructed to prevent runoff or breaks. Land treatment units that treat hazardous wastes biologically must ensure that hazardous wastes are degraded, transformed, or immobilized within the treatment zone and do not reach the underlying water table.

To insure proper compliance with TSD regulations, RCRA imposes groundwater monitoring requirements on surface impoundments, waste piles, land treatment units, or landfills used to treat, store, or dispose of hazardous wastes.

RCRA also authorizes EPA to conduct removal actions, seek affirmative injunctive relief, and maintain cost-recovery actions where an imminent and substantial endangerment to the public health or welfare or to the environment is determined to exist.

RCRA requires EPA to regulate underground storage tanks. Most states have enacted their own underground storage tank regulations as well.

Clean Air Act

The Clean Air Act provides comprehensive federal regulation of all "sources" of air pollution. The Act empowers EPA to promulgate uniform standards of performance for certain "new" and "modified" sources, and facility-specific standards and limitations for existing sources. These standards limit the type and amount of pollutants that may be emitted into the air by a specific source. The facilities' standards and limitations are designed to meet regional ambient air quality standards for primary pollutants (regulation of which is required to protect the public health) and secondary pollutants (regulation of which is required to protect the public welfare). In addition, EPA is empowered by the Act to promulgate emissions standards for "hazardous" air pollutants that are listed in the statute and that present a threat of adverse health effects.

On November 15, 1990, the President signed sweeping new amendments of the Clean Air Act into law. The amendments are designed to address major environmental concerns raised in the 1980s, including acid rain, urban air pollution, toxic air emissions, and ozone-depleting chemicals. The major provisions of the Clean Air Act amendments require massive emissions reduction in the electric utility industry, operating permits for existing facilities, an expansion of the air toxics program to regulate 189 toxic air pollutants, and new source categories (including smaller sources, such as dry cleaners).

Clean Water Act

The Clean Water Act provides comprehensive federal regulation of all sources of water pollution.

OTHER ENVIRONMENTAL LAWS

- Emergency Planning and Community Right-To Know Act
- Toxic Substances Control Act
- The Occupational Safety and Health Administration "OSHA" Hazard Communication Program

- Toxic Substance Control Act of 1976 (e.g., asbestos, PCB)
- Occupational Safety and Health Act of 1979
- National Environmental Policy Act (environmental impact statements)
- Safe Drinking Water Act
- The Refuse Act
- Federal Insecticide, Fungicide and Rodenticide Act
- Consumer Product Safety Act
- Noise Control Act
- Hazardous Materials Transportation Act
- Coastal Zone Management Act