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ACCOUNTING AND AUDITING DEVELOPMENTS 1979

December 1978 to November 1979

Touche Ross & Co.
ACCOUNTING AND AUDITING DEVELOPMENTS 1979

December 1978 to November 1979

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FOREWORD

Accounting and Auditing Developments 1979 summarizes most of the authoritative pronouncements that have been issued in the last year, as well as a number of information releases that address issues of current interest. The summaries have been prepared primarily to remind our clients and staff of recent developments affecting financial accounting and reporting and should not be considered definitive or complete. The source documents themselves should be consulted to determine detailed requirements. In addition, because accounting and auditing information is changing continually, often with little advance notice, we urge clients to contact their Touche Ross account executive to be sure that the information at hand is the latest available.

The material in this booklet is arranged according to the issuer of the pronouncement, that is, the FASB, the SEC, the AICPA or other rule making body. However, there are situations where one issue is addressed by more than one organization; accountants' independence, for example, is the subject of releases by both the SEC and the AICPA. Thus, we have included, at the end of the booklet, a topical index to aid the reader in finding all the summaries on a given subject.

Additional copies of this booklet are available on request from:

Library
Touche Ross & Co.
1633 Broadway
New York, New York 10019

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FINANCIAL ACCOUNTING STANDARDS BOARD

STATEMENTS OF FINANCIAL ACCOUNTING STANDARDS

SFAS No. 24, Reporting Segment Information in Financial Statements That are Presented in Another Enterprise's Financial Report, exempts certain companies from the requirement to disclose segment information.

Specifically: If consolidated or combined financial statements are accompanied by a complete set of separate parent company or investee company financial statements, the following companies need not disclose segment information in the separate financial statements:

- The parent company or affiliated companies that have been consolidated or combined in the primary financial statements
- Certain foreign investee companies
- Investee companies accounted for by the cost or equity method if that segment information is not significant in relation to the primary financial statements.

Materiality tests are specified for other investees' financial statements, which would otherwise have been required to present segment data. The Statement became effective January 1, 1979 retroactive to fiscal years beginning after December 15, 1976.

SFAS No. 25, Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies, resolves, at least temporarily, the conflict between the FASB, which prescribes the successful efforts accounting method, and the SEC, which permits either successful efforts or full cost (at least until the Commission's reserve recognition accounting method takes effect). Thus, No. 25:

- Suspends the effective date of SFAS 19 as it applies to successful efforts. (Oil and gas producing companies not subject to SEC reporting requirements thus are permitted to continue their present methods of accounting)
- Retains, with revision of the effective date, the provisions of SFAS No. 19 for income tax allocation requirements; classification of production payments payable in cash as debt; and disclosure of reserve quantities and related costs (however, the reserve data may now be presented outside the financial statements)
- Requires disclosure of the method of accounting for costs incurred in oil and gas producing activities
- Rescinds the reserve definitions of SFAS 19 and requires, for financial reporting purposes, the use of the reserve definitions developed by the Department of Energy for its Financial Reporting System and adopted by the SEC for its reporting purposes.
SFAS No. 26, Profit Recognition on Sales-Type Leases of Real Estate, specifies that a lease that would otherwise be classified as a sales-type lease under SFAS 13 and that results in a “sales-type” profit shall be classified as an operating lease by the lessor unless at the beginning of the lease term it also meets the conditions for full and immediate profit recognition described in the AICPA Industry Accounting Guide, Accounting for Profit Recognition on Sales of Real Estate. This means that a lessor may not classify a lease as a sales-type lease and recognize a “sales-type” profit unless, for example, the lease payments at the beginning of the lease term are at least equal to the minimum down payment requirements specified by the Accounting Guide, which range from 5 to 25 percent depending on the type of property. The Statement does not affect the classification of a sales-type lease that results in a “sales-type” loss, nor does it affect the classification of a lease that would be classified as a direct financing lease.

The Statement is effective for lease agreements recorded or revised after July 31, 1979, with retroactive application required for those who have not yet restated for SFAS 13. Those who have already applied the provisions of SFAS 13 may, but are not required to, apply the provisions of SFAS No. 26 retroactively.

SFAS No. 27, Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases, amends SFAS 13 so that a lessor will now classify such a renewal or extension as a sales-type lease if the renewal or extension occurs at or near the end of the existing lease, which, according to the FASB, is the last few months of an existing lease.

This Statement is effective for lease agreement renewals and extensions recorded on or after September 1, 1979, with retroactive application required for those who have not yet restated for SFAS 13. Those who have already applied the provisions of SFAS 13 may, but are not required to, apply the provisions of SFAS No. 27 retroactively.

SFAS No. 28, Accounting for Sales with Leasebacks, amends SFAS 13, which previously treated a sale-leaseback as a single financing transaction in which any profit or loss on the sale is deferred and amortized by the seller. Now, however, SFAS 28 requires the seller to recognize some profit or loss in either of the following limited circumstances:

• If the seller retains the use of only a minor part of the property through the leaseback, the sale and the lease would be accounted for based on their separate terms. However, if the rentals called for by the lease are unreasonable in relation to market conditions at the inception of the lease, an appropriate amount would be deferred or accrued by adjusting the profit or loss on the sale. The amount
deferred or accrued would be amortized as an adjustment of those rentals.

- If the seller retains more than a *minor part* but less than *substantially all* of the use of the property through the leaseback, and the profit on the sale exceeds the present value of the minimum lease payments called for by the leaseback for an operating lease or the recorded amount of the leased asset for a capital lease, that excess would be recognized as profit at the date of the sale.

"Substantially all" and "minor" are used here in the context of the concepts underlying the classification criteria of SFAS 13. In that context, a test based on the 90 percent recovery criterion of SFAS 13 could be used as a guideline; that is, if the present value of a reasonable amount of rental for the leaseback represents 10 percent or less of the fair value of the asset sold, the seller-lessee could be presumed to have transferred to the purchaser-lessee the right to substantially all of the remaining use of the property sold, and the seller-lessee could be presumed to have retained only a minor portion of such use.

The Statement is effective for lease agreements recorded or revised on or after September 1, 1979. Retroactive application is required for those who have not yet restated for SFAS 13. Enterprises that have already applied the provisions of SFAS 13 may, but are not required to, apply the provisions of the Statement retroactively.

**SFAS No. 29, Determining Contingent Rentals**, defines contingent rentals as the increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors on which lease payments are based. Lease payments that depend on a factor that exists and is measurable at the inception of the lease, such as the prime interest rate, would be included in minimum lease payments based on the factor at the inception of the lease [emphasis added]. Lease payments that depend on a factor that does not exist or is not measurable at the inception of the lease, such as future sales volume, would be contingent rentals in their entirety and, accordingly, would be excluded from minimum lease payments and included in the determination of income as they accrue.

The Statement is effective for lease agreements recorded or revised on or after October 1, 1979. Retroactive application is required for those who have not yet restated for SFAS 13. Enterprises that have already applied the provisions of SFAS 13 may, but are not required to, apply the provisions of the Statement retroactively.

**SFAS No. 30, Disclosure of Information About Major Customers**, amends paragraph 39 of SFAS 14 which required certain business enterprises to disclose aggregate sales to domestic government agencies or to foreign governments. However, the amended paragraph now requires
disclosure of sales to any individual government (i.e., the federal
government, a state government, a local government or a foreign
government) if sales to that government are 10% or more of total sales. If
sales are concentrated in a particular department or agency of
government, disclosure of that fact and the amount of revenue derived
from each source is encouraged, but not required. Thus, the Board is
saying that sales to governmental customers are to be disclosed in the
same way as sales to any other customer.

The Statement is effective for fiscal years beginning after December 15,
1979. Earlier application is encouraged and retroactive application is
permitted but not required.

SFAS No. 31, Accounting for Tax Benefits Related to U.K. Tax
Legislation Concerning Stock Relief, recognizes the United Kingdom’s
recently modified inventory relief rule whereby companies would be
allowed to treat as permanent differences the deductions from taxable
income for increases in the carrying value of inventories, if inventories
are not subsequently decreased within six years. If the tax benefits have
been deferred in anticipation of recapture (reversal), the deferred amount
must be recognized as a reduction in income tax expense in the period in
which the tax benefits are no longer subject to recapture or it is probable
they will not be recaptured. The Statement is effective for annual or
interim financial statements issued after September 30, 1979.

SFAS No. 32, Specialized Accounting and Reporting Principles and
Practices in AICPA Statements of Position and Guides on Accounting
and Auditing Matters, an amendment of APB No. 20, Accounting
Changes, establishes the specialized accounting and reporting principles
and practices contained in AICPA SOPs and accounting and auditing
guides as preferable accounting principles for purposes of justifying a
change in accounting principle. Four audit guides and one SOP (75-4) are
excluded because they do not contain specialized accounting and
reporting principles and practices; in addition, the state and local
government audit guides and related SOPs 75-3 and 77-2 are excluded for
the present because of ongoing studies of governmental accounting and
reporting.

The Statement is effective October 31, 1979.

SFAS No. 33, Financial Reporting and Changing Prices, requires certain
large publicly-held companies to disclose the effects of inflation in their
annual reports for fiscal years ending on or after December 25, 1979.
Publicly-held companies with more than $1 billion in assets or more than
$125 million of combined inventories and property, plant, and equipment
(gross of depreciation) will be required to disclose the supplemental
information. Note that this information is not considered a part of the basic financial statements, but may be included either as supplemental financial information or in a note to the financial statements at the company’s option.

For the first year under the Statement, companies will be required to disclose certain minimum constant dollar information (historical cost data restated using the Consumer Price Index – All Urban Consumers) for the current year: income from continuing operations, purchasing power gain or loss on net monetary items, net assets at year-end, and earnings per common share from continuing operations; and for the last five years: net sales and other operating revenues, cash dividends declared per common share, market price per common share at year-end and the average level of the Consumer Price Index during the year.

For the second year under the Statement, companies will be required to disclose, in addition to the selected constant dollar data, certain comparative current cost information, restating the historical cost of inventory and property, plant, and equipment. Disclosure of this information is optional for the first year, but the second year disclosures require comparative disclosures for both years. It should be noted that current cost data under the FASB Statement would not necessarily agree with ASR 190 disclosures, especially with respect to property, plant, and equipment. (See the ASR 271 summary for the SEC’s waiver of replacement cost disclosure requirements for companies complying with SFAS No. 33.) Also, certain assets are exempted from current cost disclosures – investment real estate, oil and gas and other mineral reserves, and timberlands.

Most companies will probably only give constant dollar information for 1979, which should not present significant implementation or audit problems (however, see the summary of the AICPA Auditing Standard Board’s proposed SAS on reporting on required supplemental information).

The Firm is now preparing a manual that will assist companies in the preparation of the information required by the FASB Statement. This manual will be a “how-to-do-it” guide for use by those who will be directly involved in the preparation of the required information.

**SFAS 34, Capitalization of Interest Cost**, establishes standards for capitalizing interest cost as part of the historical cost of acquiring certain assets. To qualify for interest capitalization, assets must require a period of time to get them ready for their intended use. Examples are assets that an enterprise constructs for its own use (such as facilities) and assets intended for sale or lease that are constructed as discrete projects (such as ships or real estate projects). Interest capitalization is required for those assets if its effect, compared with the effect of expensing interest, is
material. If the net effect is not material, interest capitalization is not required. However, interest cannot be capitalized for inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis.

The interest cost eligible for capitalization shall be the interest cost recognized on borrowings and other obligations. The amount capitalized is to be an allocation of the interest cost incurred during the period required to complete the asset. The interest rate for capitalization purposes is to be based on the rates on the enterprise’s outstanding borrowings. If the enterprise associates a specific new borrowing with the asset, it may apply the rate on that borrowing to the appropriate portion of the expenditures for the asset. A weighted average of the rates on other borrowings is to be applied to expenditures not covered by specific new borrowings. Judgment is required in identifying the borrowings on which the average rate is based.

INTERPRETATIONS

FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, clarifies the provisions of APB No. 15 and APB No. 25 and generally provides that:

- Compensation related to stock appreciation rights (SARs) is to be accrued over the periods the employee performs the services (the “service period”); however, if the service period is not specified, or is longer than the vesting period, the expense recognition period is the vesting period.

- Accrued compensation is to be adjusted in periods subsequent to the service period, but prior to exercise, to reflect market value changes currently if the measurement date occurs after the end of the service period. There is to be no spreading of this adjustment.

- Compensation related to “combination plans” is to be accrued based on the option the employee is most likely to elect. The FASB assumes that the employee will elect the SAR unless there is persuasive evidence to the contrary. If the employee elects to exercise the stock option, any accrued compensation is to be recorded as consideration for the stock (credited to capital).

- SARs and other variable plans payable in stock are considered common stock equivalents per APB No. 15 – those payable in cash are not.

For companies reporting to the SEC, any compensation recorded under this Interpretation, including any adjustments to adopt the accounting specified by this Interpretation for preexisting grants, should be included in reportable compensation.

The Interpretation is applied prospectively for awards granted in fiscal
years beginning after December 15, 1978, with the following provisos regarding application to earlier periods (retroactive restatement of previously issued financial statements is expressly prohibited):

- Application to awards granted in fiscal years beginning before December 15, 1978 is encouraged, but only if financial statements for the period have not been previously issued.
- The Interpretation may be applied to all outstanding awards, irrespective of period of grant; if it is applied, the cumulative effect is to be accounted for as a change in estimate at the end of the current period. (Note, this is a change in estimate, not an accounting change; accordingly, it is included in operating income.)

FASB Interpretation No. 29, Reporting Tax Benefits Realized on Disposition of Investments in Certain Subsidiaries and Other Investees, clarifies paragraphs 11 and 17 of APB No. 23 and paragraph 9 of APB No. 24.

The Interpretation requires such tax benefits to be classified the same as the classification accorded the gain or loss on disposition of the investment (for example, as results of continuing operations, as extraordinary, or as disposal of a segment of a business).

The Interpretation is effective for dispositions after March 31, 1979. Reclassification in previously issued financial statements is permitted but not required.

FASB Interpretation No. 30, Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets, clarifies the application of APB No. 29 to involuntary conversions of nonmonetary assets (such as property or equipment) to monetary assets (such as insurance proceeds) by requiring that gain or loss be recognized when a nonmonetary asset is involuntarily converted to monetary assets even though an enterprise reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets.

The Interpretation is effective for years beginning after November 15, 1979. Earlier application is encouraged.

STATEMENTS OF FINANCIAL ACCOUNTING CONCEPTS

The Board's first Statement of Financial Accounting Concepts, Objectives of Financial Reporting by Business Enterprises, defines those objectives. Basically, financial reporting should provide information useful to investors and creditors in making investment and credit decisions, information that helps investors and creditors to assess the likelihood of
receiving cash, and information about the economic resources of an enterprise. The elements of financial statements, dropped from this SFAC, will be the subject of a subsequent statement.

A proposed Statement of Financial Accounting Concepts, *Qualitative Characteristics: Criteria for Selecting and Evaluating Financial Accounting and Reporting Policies*, defines the qualitative criteria that should be used to select, from acceptable alternatives, the most useful accounting principle. The primary criteria are relevance and reliability, supported by materiality, neutrality, comparability and consistency.

**INVITATIONS TO COMMENT**

The Board has inaugurated a new series of documents called “FASB Invitations to Comment,” whereby the Board will release for comment statements and position papers prepared by other accounting and auditing experts with the objective of considering comments, deliberating the issues and issuing an exposure draft of a proposed SFAS. The first Invitation to Comment, *Accounting for Certain Service Transactions*, concerns the AcSEC draft SOP. The FASB seeks full, detailed comments on revenue and cost recognition methods in various service industries.

**TECHNICAL BULLETINS**

The Board has authorized its staff to issue FASB Technical Bulletins, which will deal with implementation questions on the application of financial accounting pronouncements – FASB Statements and Interpretations, APB Opinions and Accounting Research Bulletins. The new Bulletins will not establish new standards nor amend existing standards. A draft of the first Technical Bulletin, 79-1, *Purpose of FASB Technical Bulletins and Procedures for Issuance*, explains the purpose of Bulletins and procedures for issuing them.
AICPA - AUDITING STANDARDS BOARD

STATEMENTS ON AUDITING STANDARDS

SAS No. 24, Review of Interim Financial Information (supersedes SAS No. 10 and SAS No 13), applies to reviews of separate interim financial information issued by a public entity and to interim financial information included in a note to audited financial statements of a public or nonpublic entity. This Statement does not apply to interim financial information included in a 1933 Act filing unless the accountant has examined and reported on financial statements which include the interim financial information in a note.

The procedures for reviewing interim financial information consist primarily of inquiries and analytical review concerning significant accounting matters relating to the financial information to be reported. The procedures that the accountant ordinarily should apply are:

- Inquiry concerning (1) the accounting system and the manner of recording, classifying, and summarizing transactions, and (2) any significant changes in the system of internal accounting control.
- Analytical review to provide a basis for inquiry about relationships and unusual items. Analytical review procedures consist of (1) comparison of the immediately preceding interim period and corresponding previous period(s), (2) comparison with anticipated results, and (3) study of the relationships of elements that would be expected to conform to a predictable pattern based on experience.
- Reading the minutes of meetings of stockholders, board of directors, and committees of the board of directors.
- Reading the interim financial information to evaluate conformity with generally accepted accounting principles.
- Obtaining reports from other accountants, if any.
- Inquiry of officers and other executives concerning (1) whether the interim financial information has been prepared in conformity with generally accepted accounting principles consistently applied, (2) changes in the entity's business activities or accounting practices, (3) matters as to which questions have arisen in the course of applying the foregoing procedures, and (4) subsequent events that would have a material effect on the presentation of such information.
- Obtaining written representations from management concerning its responsibility for the financial information, completeness of minutes, subsequent events, and other matters appropriate in the circumstances.
The SAS also gives examples of the form of an accountant’s report and covers circumstances which would require modification of the accountant’s report.

This Statement is effective for reports on financial statements (information) for interim periods ending on or after March 31, 1979.

**SAS No. 25, The Relationship of Generally Accepted Auditing Standards to Quality Control Standards**, replaces SAS No. 4, *Quality Control Considerations for a Firm of Independent Auditors*. The Statement acknowledges the authority of the AICPA quality control standards committee while making clear that existing standards are being maintained and quality control policies and procedures that a firm establishes may affect the conduct of individual audits.

The statement describes the relationship of auditing standards to quality control standards and provides that a CPA firm should establish quality control procedures to provide it with reasonable assurance of conforming with generally accepted auditing standards. The elements of quality control identified in SAS No. 4 have been incorporated into the first statement on quality control standards.

In a related matter, the AICPA has issued its first statement on quality control standards entitled *System of Quality Control for a CPA Firm*. The statement provides that a CPA firm shall have a system of quality control and describes the elements of quality control and other matters essential to the effective implementation of the system.

**SAS No. 26, Association With Financial Statements**, defines association as it is used in the fourth reporting standard and identifies the professional standards applicable when an accountant is associated with (1) the financial statements of a public entity or (2) a nonpublic entity’s financial statements he has been engaged to examine in conformity with GAAS. The statement provides guidance on report language for reports on several types of unaudited financial statements of public companies presented alone or in comparative form with audited financial statements.

A proposed Statement on Auditing Standards, *Reporting on Required Supplemental Information*, would require the auditor to apply certain limited procedures to supplemental information required by the FASB and to report the nature of the procedures applied and the degree of responsibility he is taking, either in a separate report or in an additional paragraph of the report on the financial statements.

It should be assumed that this SAS will be effective for annual reports containing the information required by FASB Statement No. 33.
Although the information will not be required to be audited and in most cases will not be a part of the financial statements we will be associated with the data by performing limited procedures and explicitly reporting on the information (probably a negative assurance). If the information is included in an unaudited footnote to the financial statements at the company’s option, we will of course be directly associated even though no explicit reporting will be required.

INTERPRETATIONS

The Auditing Standards Board has issued five Auditing Interpretations: (1) auditors may not provide "SAS 24 type" negative assurance to an underwriter, (2) SAS 24 type reports on interim financial information should not be included in 1933 Act filings with the SEC, (3) a note disclosing a subsequent event after the date of the financial statements may not be labeled unaudited, (4) the first example in AU 509.39 on qualifying an opinion for an uncertainty should no longer be used, since SFAS 16 has virtually eliminated future adjustments of present financial statements and (5) the materiality measurement of uncertainties should be related to the specific financial statement data applicable to the uncertainty.

In addition, the staff of the Auditing Standards Division has prepared four new auditing interpretations and is issuing revisions of three existing ones. Two of the interpretations are on SAS No. 11, Using the Work of Specialists:

- **Applicability of Guidance on the Use of Specialists** states that SAS No. 11 applies when the auditor intends to use the work of a specialist engaged or employed by management to prepare, or assist in the preparation of, amounts or disclosures in the financial statements.

- **Exclusion of Specialists on the Audit Staff** states that SAS No. 11 applies when a specialist with an auditor’s firm provides advisory services to a client and the auditor decides to use that specialist’s work as evidential matter.

Two of the interpretations are on SAS No. 2, Reports on Audited Financial Statements:

- **The Materiality of Uncertainties** states that in considering whether to qualify his opinion for an uncertainty, the auditor should consider the potential effect on the financial statement that is most appropriate in the circumstances. The interpretation gives examples of uncertainties that should be evaluated in relation to the balance sheet and of others that should be evaluated in relation to the income statement.

- **Reporting on an Uncertainty** states that in wording a "subject to" opinion, in most instances it is inappropriate to refer to the effects, if
any, "on the financial statements of the ultimate resolution of the matter." It is preferable to refer to the effect of "adjustments as might have been required."

Three interpretations became outdated because they pertained to a specific SAS, APB Opinion, or FASB Statement even though the guidance was applicable by analogy to similar situations. Thus, the interpretations have been rewritten from a more general viewpoint. The revisions are titled:

- The Impact on an Auditor’s Report of an FASB Statement prior to the Statement’s Effective Date.
- The Effects of Changes in Accounting Principles and Classification on Consistency.
- Reports on Engagements Solely to Meet State Regulatory Examination Requirements.

The texts of these interpretations appeared in the October Journal of Accountancy, the four new ones in the "Official Releases" section, and the three revisions in "Professional Notes."

AICPA – ACCOUNTING AND REVIEW SERVICES COMMITTEE

SSARS No. 1, Compilation and Review of Financial Statements, is the first pronouncement of this senior technical committee, which has been designated "to issue pronouncements in connection with the unaudited financial statements or other unaudited financial information of a nonpublic entity."

The Statement basically separates unaudited financial statement services into two types of engagements and provides for the expression of limited assurance by the accountant. These two services are:

1. **Compilation**, which is "presenting in the form of financial statements information that is the representation of management (owners) without undertaking to express any assurance on the statements..."

2. **Review**, which is "performing inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles..."

Essentially, except for the performance of certain analytical procedures and the expression of limited assurance, a "review" is basically the same as our present unaudited financial statements service.
The wording for a Compilation or a Review report is contained in paragraphs 17 and 35, respectively, of SSARS No. 1.

**Internal Use Only Reports.** SSARS No. 1 was issued with the intention of eliminating internal use only statements, although there is no flat proscription against them. The Committee's approach to this issue was to consider financial statements that omit substantially all disclosures as a compilation engagement on which the accountant's report contains no restriction to internal use. The report language states that (1) management has omitted substantially all disclosures, (2) knowledge of those disclosures might influence a reader and, accordingly, the statements are not designed for anyone without personal knowledge of the omitted disclosures. The Committee specifically expected accountants, who may have performed a review but were faced with such disclosure omissions, to drop down to a compilation report as set forth in paragraph 21 (but see interpretations below).

**Additional Information.** Paragraph 43 of SSARS No. 1 sets forth the reporting treatment of additional information accompanying the basic financial statements that have been reviewed or compiled.

When the accountant has compiled both the basic financial statements and other data presented only for supplementary analysis purposes, his compilation report should also include the other data. This may be handled by the insertion of the phrase "and the additional information on pages 00 - 00" after "...year then ended" in the first paragraph of the compilation report, and in the final paragraph the phrase, "and additional information" after the wording "accompanying financial statements."

**Financial Statement Report Format.** SSARS No. 1 requires that each page of the financial statements contain a reference to the accountant’s review or compilation report. This new referencing replaces the use of the term "Unaudited."

**INTERPRETATIONS**

The staff of the Institute's Accounting and Review Services Committee has prepared the following three interpretations of SSARS No. 1, Compilation and Review of Financial Statements:

- **Omission of Disclosures in Reviewed Financial Statements** states that the special reporting provision applicable to compiled financial statements that omit substantially all required disclosures are not applicable to reviewed financial statements.

- **Financial Statements Included in SEC Filings** states that when a nonpublic entity is required to file unaudited financial statements
with the SEC, an accountant may consider it appropriate to follow the guidance in Statements on Auditing Standards.

- Reporting on the Highest Level of Service clarifies the statement in paragraph 5 of SSARS No. 1 that states when an accountant performs more than one service with respect to the financial statements of an entity he should issue the report that is appropriate for the highest level of service rendered. The interpretation describes the applicability of this statement in varying circumstances.

The interpretations are to be published in the December Journal of Accountancy.

SSARS No. 2, Reporting on Comparative Financial Statements, establishes standards for reporting on comparative financials of nonpublic companies when multi-period financial statements have been compiled or reviewed in accordance with SSARS No. 1. The Statement provides guidance on:

- The continuing accountant’s standard report
- The continuing accountant’s changed reference to a departure from GAAP
- A predecessor’s compilation or review report
- Reporting when one period is audited
- Reporting on financial statements that previously did not omit substantially all disclosures, and
- Change of status – public/nonpublic entity

The Statement is effective for reports on comparative financial statements for periods ending on or after November 30, 1979, with earlier application encouraged for periods ending July 1, 1979 or later.

AICPA – ACCOUNTING STANDARDS DIVISION

STATEMENTS OF POSITION

Touche Ross Policy

SOPs are expressions by the Accounting Standards Executive Committee of preferred practice and do not establish authoritative and binding generally accepted accounting principles. (The FASB and the SEC continue discussing whether SOPs should have more authority, and the SEC has expressed generally affirmative views in its report to Congress.) The Firm’s position is that clients already following GAAP differing from the preferred practice stated in the SOP (these various methods are usually described in the SOP) need not adopt the SOP’s preference, though they should give it careful consideration. If, by SEC action and/or precedents in practice, the SOP’s preference becomes established as de facto GAAP (at least for publicly-held clients), the Firm will provide guidance for each situation.
SOP 78-8, Accounting for Product Financing Arrangements, indicates that a transaction in which a sponsor (the company seeking to finance product acquisition or the holding of product for future use or resale):

- Sells a product to another entity (the company through which the financing flows), and in a related transaction agrees to buy the product back;
- Is a party to an arrangement whereby an entity purchases a product on the sponsor's behalf, and the sponsor in a related transaction agrees to buy the product from the entity; or
- Controls the disposition of the product that has been acquired by the other entity in accordance with the arrangements described in either of the two cases above

is for purposes of this SOP to be treated as a financing, not a sale.

Product financing arrangements apply to products that have been produced by or were originally acquired by the sponsor or acquired by another entity on behalf of the sponsor and have the following characteristics:

- The sponsor is required to purchase the product at specified prices which are not subject to future market price fluctuations except for holding costs.
- The predetermined prices cover at least substantially all costs associated with acquisition of the product plus holding costs.

Other characteristics that commonly exist in product financing arrangements but that are not necessarily present in all such arrangements are:

- The purchasing entity was established expressly for that purpose
- The product is primarily to be used or sold by the sponsor
- The product is stored on the premises of the sponsor
- The debt of the purchasing entity is guaranteed by the sponsor.

This statement of position is not intended to modify any of the conclusions in SOP 75-1, Revenue Recognition When Right of Return Exists, and does not apply to transactions that qualify as sales in accordance with the provisions of that statement.

In substance, the sponsor of a product financing arrangement that demonstrates all of the characteristics described above bears substantially all of the risks and rewards of ownership of the product. The assets and related liabilities that result from such product financing arrangements should be reported in the financial statements of the sponsor.

An accounting change to adopt the recommendations of this statement of position should be made for balance sheets as of December 20, 1979, and later. Early adoption of these recommendations and retroactive application are encouraged.
SOP 78-9, Accounting for Investments in Real Estate Ventures, states that ownership of real estate or real estate development projects by two or more entities may take several forms. The most common forms are as follows:

- A corporate joint venture
- A general partnership
- A limited partnership
- An undivided interest.

Corporate Joint Ventures. An investment in a corporate subsidiary that is a real estate venture should be accounted for by the investor-parent using the principles applicable to investments in subsidiaries rather than those applicable to investments in corporate joint ventures. Minority shareholders in such a real estate venture should account for their investment using the principles applicable to investments in common stock set forth in APB Opinion 18 or in FASB Statement No. 12.

General partnerships. Investments in noncontrolled general partnerships should be accounted for and reported under the equity method. Paragraph 19 of APB Opinion 18 should be used as a guide in applying the equity method.

A general partnership that is controlled, directly or indirectly, by an investor is, in substance, a subsidiary of the investor. A controlling investor should account for its investment under the principles of accounting applicable to investments in subsidiaries.

Limited partnerships. The equity method of accounting for investments is generally appropriate for the limited partners, except in such cases where an interest may be very minor. In such cases accounting for the investment using the cost method may be appropriate.

In some instances, a limited partner may be in control of the partnership and should account for its investment as a subsidiary. Noncontrolling limited partners should account for their investments by the equity method or by the cost method, as appropriate.

Undivided interests. If real property owned by undivided interests is subject to joint control by the owners, then investor-venturers should not present their investments by accounting for their pro rata share of the assets, liabilities, revenues, and expenses of the ventures. Such investments should be presented in the same manner as investment in noncontrolled partnerships. If, however, the approval of two or more of the owners is not required for decisions regarding the financing, development, sale, or operations of real estate owned and each investor is entitled to only its pro rata share of income, is responsible to pay only its pro rata share of expenses, and is severally liable only for
indebtedness it incurs in connection with its interest in the property, the investment may be presented by recording the undivided interest in the assets, liabilities, revenue, and expenses of the venture.

*Income and loss.* The accounting by an investor for losses otherwise allocable to other investors should be governed by the provisions of FASB Statement No. 5 relating to loss contingencies. Accordingly, the investor should record a proportionate share of the losses otherwise allocable to other investors if it is probable that they will not bear their share. In this connection, each investor should look primarily to the fair value of the other investors' interests in the venture and the extent to which the venture's debt is nonrecourse in evaluating their ability and willingness to bear their allocable share of losses.

Specified profit and loss allocation ratios should not be used to determine an investor's equity in venture earnings if the allocation of cash distributions and liquidating distributions is determined on some other basis.

*Contributions.* An investor that contributes real estate services or intangibles to the capital of a real estate venture generally should record its investment in the venture at the investor's cost (less related depreciation and valuation allowances) of the real estate contributed, regardless of whether the other investors contribute cash, property, or services. An investor should not recognize profit on a transaction that in economic substance is a contribution to the capital of an entity, because a contribution to the capital of an entity is not the culmination of the earnings process.

An investor contributing property to a venture may obtain a disproportionately small interest in the venture based on a comparison of the carrying amount of the property with the cash contributed by the other investors. That situation might indicate that the investor contributing the property has suffered a loss that should be recognized.

The SOP is effective for fiscal years beginning after December 24, 1978. Earlier application of the recommendations is encouraged.

*SOP 78-10, Accounting Principles and Reporting Practices for Certain Nonprofit Organizations,* provides guidelines for nonprofit organizations not covered by existing AICPA industry audit guides, but which prepare financial statements in conformity with generally accepted accounting principles.

Highlights are:
- Accrual basis accounting should be used if the financial statements are to be in conformity with GAAP
Fund accounting may be used when needed to segregate unrestricted from restricted resources. The presentation of totals of all fund groups in all financial statements is preferable, although not required.

The basic financial statements to be used are a balance sheet, a statement of activity and a statement of changes in financial position. No single format is prescribed. Comparative financial statements are recommended, but not required. If comparative information is summarized, sufficient disclosure must be made in the summarized data and in the supporting notes.

Current restricted resources and resources restricted for future acquisition of fixed assets should be reported in the balance sheet as deferred revenue until the restrictions are met. Recognition of expenses that satisfy donor restrictions results in recognition of equivalent amounts of revenue or support in that period.

Nonexpendable gifts, grants and bequests restricted by donors to endowment, plant and loan funds which cannot be spent currently because of restrictions should be disclosed as “capital additions” or “nonexpendable additions.”

If the financial activity statement includes capital additions, there should be two clearly labeled “excess (deficiency) of revenue over expense” line-item captions, one before “capital additions” and one after.

If a reporting organization controls another organization having a compatible purpose, combined statements should be presented if certain conditions exist. If affiliated organizations are not combined because they do not meet the combining criteria, the existence and the relationship to the reporting entity should be disclosed.

Pledges that are legally enforceable should be recorded as assets at their estimated realizable values.

Contributed services should not be recorded as a contribution and expense unless they meet certain criteria defined in the SOP. The methods used in valuing contributed services should be disclosed.

Donated materials and facilities should be recorded at fair value, if estimable.

Investments in marketable debt securities should be reported at amortized cost, market value, or lower of amortized cost or market if there is both the ability and intention to hold the securities to maturity.

If marketable equity or debt securities are not being held to maturity, either market value, or lower of cost or market should be used for valuation. Other investments should be reported at either fair value, or lower of cost or fair value. Investment pools should use the “market value unit” method.

Unrestricted investment income from all funds should be reported as revenue when earned.
• Property, plant and equipment should be recorded at cost and depreciated (if exhaustible) over the asset’s estimated useful life.

SOP 79-1, Accounting for Municipal Bond Funds, proposes to amend the AICPA Industry Accounting and Audit Guide, Audits of Investment Companies (Audit Guide) to include accounting for municipal bond funds.

Highlights of the SOP are:
• The guidelines set forth in the Audit Guide should be followed by valuing over-the-counter securities
• Quotations should always be obtained from an "unaffiliated" (independent) source
• The portfolio should be valued consistently using either bid price or mean between bid and asked price, as described in the fund’s prospectus
• The fund’s management is responsible for determining values of portfolio securities in accordance with the fund’s policies
• Management must be satisfied that control procedures of the fund, or a pricing service (if used), provide reasonable assurance that material pricing errors would be prevented or detected
• If market quotations are not readily available, or not indicative of the value of the bond, fair value as determined by the board of directors should be used. Fair value, as determined by the sponsor or trustee, should be used if the entity is a unit investment trust
• Auditors should consult ASRs 113 and 118 and the Audit Guide in determining the reliability of fair value and for guidance on reporting on financial statements where a material portion of securities is valued "in good faith"
• Valuation of bonds that are held in an insured portfolio and that are in default, or for which probability of default is indicated, requires a "fair value" determination, and should be identified in the financial statements. Disclosure should also be made of the intention of the fund to hold those securities until maturity in order to realize the benefits of the insurance
• Municipal securities should be grouped in the financial statements either by state or municipality within the state or by purpose of issue, whichever is more meaningful
• Valuation methods used by the fund should be disclosed in the financial statements.

The SOP also discusses the tax considerations of operating a municipal bond fund.

The SOP is effective prospectively for financial statements issued after January 15, 1979.
SOP 79-2, Accounting by Cable Television Companies, provides generally that capitalization of facility and certain start-up costs should continue until the first subscriber hook-up.

Before the first earned subscriber revenue, management must determine a prematurity period for purposes of determining capitalized costs, depreciation, and amortization. This period begins with the first earned subscriber revenue. Its end will vary with circumstances at the system, but will be determined based on the company's plans for completion of its first major construction period or achievement of a specific predetermined subscriber level at which no additional cash investments will be required for other than physical facilities and interest. There should be a presumption that the period should not be longer than two years. Once determined, the prematurity period should not be changed except under highly unusual circumstances.

During the prematurity period:

- Subscriber-related costs and selling, marketing, and administrative expenses should be accounted for as period costs and should not be considered for capitalization
- Management must distinguish between costs of physical facilities, costs attributable solely to current operations and their administration and the generally fixed costs relating to the cable TV system and signal, which are attributable to both current and future operations
- All revenues except those from hookups should be reported as system revenues, and the portion of costs, depreciation, and amortization charged to expense under the formula described in the SOP, as well as the period costs described previously, should be included in appropriate categories of costs of services.

A portion of a cable TV system that can be clearly distinguished from the remainder of the system should be accounted for as a separate system. Costs incurred by the remainder of the system should be charged to the portion only if they are specifically identified with the operations of that portion.

Hookup revenues should be allocated to systems revenue to the extent of direct selling costs, which are charged to expense. The excess of hookup revenues over direct selling costs is deferred and taken into income over the expected subscription period.

The costs of programming material produced for internal use or for sale to others should be accounted for in accordance with the provisions of the AICPA Industry Accounting Guide, Accounting for Motion Picture Films. Purchased program material should be accounted for in accordance with the recommendations made in the Division's SOP 75-5, Accounting Practices in the Broadcasting Industry.
The addendum to APB Opinion 2 regarding rate-regulated industries does not apply to the financial statements of cable TV companies.

The SOP should be applied generally in financial statements for fiscal years beginning after December 15, 1978.

**SOP 79-3, Accounting for Investments of Stock Life Insurance Companies**, expresses the division's conclusions on accounting for all investments and related realized and unrealized gains or losses of stock life insurance companies and on accounting for real estate. The SOP applies only to stock life insurance companies.

Conclusions reached are as follows:

- Bonds should be carried at amortized cost if the company has both the ability and intent to hold the bonds until maturity and there is no decline in the market value of the bonds other than a temporary decline. In those rare instances in which a company is a trader in bonds and does not intend to hold the bonds until maturity, the bonds should be carried at market; temporary fluctuations in the market value of the bonds should be recognized as unrealized gains or losses.

- Common and nonredeemable preferred stocks should be carried at market. Preferred stocks that by their terms must be redeemed by the issuing company should be carried at amortized cost if the company has both the ability and intention to hold the stocks until redemption and there is no decline in the market value of the stocks other than a temporary decline.

- Mortgages should be accounted for at unpaid principal or amortized cost if purchased at a discount or premium unless collectibility is uncertain. Real estate investments should be accounted for at depreciated cost unless there is an impairment in value. Amortization, depreciation, and other related charges or credits should be charged or credited to investment income. Charges and credits to valuation accounts should be included in realized gains and losses.

- Realized gains and losses on all assets held for investment should be included in the statement of income below operating income and net of applicable income taxes. Realized gains and losses on the sale of other assets, such as property used in the business and operating subsidiaries, should be included in the statement of income before applicable income taxes. Unrealized investment gains and losses should be recognized in stockholders' equity net of applicable income taxes and should not be included in net income.

- If a decline in the value of an investment in a security below its cost or amortized cost is other than temporary, the investment should be
written down to its net realizable value, which becomes the new cost basis. The amount of the write-down should be accounted for as a realized loss. A recovery from the new cost basis should be recognized only at sale, maturity, or other disposition of the asset, as a realized gain.

- Real estate should be classified either as an investment or as property used in the business, based on its predominant use. Depreciation and other real estate operating expenses should be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. Imputed investment income and rent expense should not be attributed to real estate used in the business.

The SOP is effective for annual periods ending after July 1, 1979. Earlier application is encouraged.

SOP 79-4, Accounting for Motion Picture Films, modifies the industry accounting guide and concludes that “restrictions on timing of showings other than the first showing should not affect the recognition of revenue when there is no conflicting license preventing usage by the licensee.” Its provisions are to be applied prospectively to license agreements with initial availability dates after December 31, 1978.

AICPA – PUBLIC OVERSIGHT BOARD

The Public Oversight Board’s report, Scope of Services by CPA Firms, permits most management advisory services so long as they do not impair the accountant’s independence. There would be restrictions on certain executive recruiting services and on actuarial services provided to insurance company audit clients.

AICPA – SEC PRACTICE SECTION

The Peer Review Manual describes membership requirements of the AICPA Division of CPA Firms, SEC Practice Section, and standards and procedures for quality control review of a member firm’s practice (Touche Ross is a member). We have already published formal policy statements and procedures dealing with the Section’s requirements for concurring partner review, reporting to clients’ boards of directors, continuing professional education, and rotation of audit partners in charge of SEC engagements.

AICPA – COMMITTEES

Checklist for Existence of Possible Fraud. The AICPA subcommittee on methods, perpetration and detection of fraud has prepared a preliminary
list of conditions or events — "warning signs" — that should alert the auditor to the possible existence of a fraud situation.

The AICPA list (from the March 12 CPA Letter) is reprinted below:

1. Highly domineering senior management and one or more of the following, or similar, conditions are present:
   - An ineffective board of directors and/or audit committee
   - Indications of management override of significant internal accounting controls
   - Compensation or significant stock options tied to reported performance or to a specific transaction over which senior management has actual or implied control
   - Indications of personal financial difficulties of senior management
   - Proxy contests involving control of the company or senior management's continuance, compensation or status.

2. Deterioration of quality of earnings evidenced by:
   - Decline in the volume or quality of sales (for example, increased credit risk or sales at or below cost)
   - Significant changes in business practices
   - Excessive interest by senior management in the earnings per share effect of accounting alternatives.

3. Business conditions that may create unusual pressures:
   - Inadequate working capital
   - Little flexibility in debt restrictions such as working capital ratios and limitations on additional borrowings
   - Rapid expansion of a product or business line markedly in excess of industry averages
   - A major investment of the company's resources in an industry noted for rapid change, such as a high technology industry.

4. A complex corporate structure where the complexity does not appear to be warranted by the company's operations or size.

5. Widely dispersed business locations accompanied by highly decentralized management with inadequate responsibility reporting system.

6. Understaffing which appears to require certain employees to work unusual hours, to forego vacations and/or to put in substantial overtime.

7. High turnover rate in key financial positions such as treasurer or controller.
8. Frequent change of auditors or legal counsel.

9. Known material weaknesses in internal control which could practically be corrected but remain uncorrected, such as:
   - Access to computer equipment or electronic data entry devices is not adequately controlled
   - Incompatible duties remain combined.

10. Material transactions with related parties exist or there are transactions that may involve conflicts of interest.

11. Premature announcements of operating results or future (positive) expectations.

12. Analytical review procedures disclosing significant fluctuations which cannot be reasonably explained, for example:
   - Material account balances
   - Financial or operational interrelationships
   - Physical inventory variances
   - Inventory turnover rates.

13. Large or unusual transactions, particularly at year-end, with material effect on earnings.

14. Unusually large payments in relation to services provided in the ordinary course of business by lawyers, consultants, agents and others (including employees).

15. Difficulty in obtaining audit evidence with respect to:
   - Unusual or unexplained entries
   - Incomplete or missing documentation and/or authorization
   - Alterations in documentation or accounts.

16. In the performance of an examination of financial statements unforeseen problems are encountered, for instance:
   - Client pressures to complete audit in an unusually short time or under difficult conditions
   - Sudden delay situations
   - Evasive or unreasonable responses of management to audit inquiries.

Report of the Special Advisory Committee on Internal Accounting Control (AICPA) – A Summary. Internal accounting control is a term developed by and for auditors to highlight those aspects of an entity’s processing and control system that can provide a basis for setting the
scope of the examination of financial statements. Both the Foreign Corrupt Practices Act (Act) of 1977 and the Report, Conclusions and Recommendations of the Commission on Auditors' Responsibilities have increased the need for information concerning management's role and responsibilities for devising and maintaining a system of internal accounting control.

The Act requires publicly held entities to have internal accounting control systems that provide reasonable assurance that the objectives of internal accounting control are met. However, the definition of internal accounting control and how it is applied have only been discussed in terms of the external auditor, not management. Thus, the AICPA Report was designed to consider an appropriate formulation for use by management as an aid in:

- Appraising the effectiveness of its continuing evaluation and monitoring of internal accounting control
- Considering whether the company complies with the internal accounting control provisions of the Act.

The report was excerpted and organized into the following questions:

- What are the scope and objectives of internal accounting control?
- Does it extend to internal financial reports?
- What is the importance of the internal accounting control environment?
- Must all companies subject to the Act do something new or different?
- How can management evaluate internal accounting control?
- What about the cycle approach to evaluating internal accounting control (The Touche Ross Audit Process Approach)?
- How would management evaluate specific control procedures and techniques?
- EDP involves different risks – does that affect the evaluation of internal accounting control?
- Which accounting tasks are frequently performed “automatically” in EDP?
- How specifically does “automatic processing” affect management’s evaluation considerations?
- What general guidance is available to help management understand and evaluate EDP exposures and controls?
- Does the Act affect the level of management documentation?
- What are the factors involved in management’s assessment of the cost/benefit relationship?
- How can management monitor compliance?
- How do the auditor’s concepts of reasonable assurance and the inherent limitations in internal accounting control relate to compliance with the Act?
Management’s Report on Financial Statements – AICPA Special Advisory Committee Report. The Commission on Auditor’s Responsibilities recommended that management include in annual reports to shareholders a statement that management is responsible for the financial statements. A special AICPA advisory committee has considered this recommendation and issued a tentative conclusion that acknowledges management responsibilities for the financial statements and provides a discussion and illustration of each aspect of such a report, including representations on:

- **Financial statements.** This would address all information in the annual report whether audited or unaudited. The illustrative example is:

  Management is responsible for all the information and representations contained in the financial statements and other sections of the annual report. Management believes that the financial statements have been prepared in conformity with generally accepted accounting principles appropriate in the circumstances to reflect in all material respects the substance of events and transactions that should be included and that the other information in the annual report is consistent with those statements. In preparing the financial statements, management makes informed judgments and estimates of the expected effects of events and transactions that are currently being accounted for.

- **Internal accounting control.** This section should emphasize the concept of reasonable assurance (versus absolute assurance) as to whether the objectives of internal accounting control have been met. Also, the tentative conclusions indicate that management may wish to comment on the broader concept of internal control, including controls not part of internal accounting control, such as those related to operational efficiency and adherence to management policies. However, the illustrated section does not address these broader controls and says:

  In meeting its responsibility for the reliability of the financial statements, management depends on the company’s system of internal accounting control. This system is designed to provide reasonable assurance that assets are safeguarded and 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. In designing control procedures, management recognizes that errors or irregularities may nevertheless occur. Also, estimates and judgments are required to assess and balance the relative cost and expected benefits of the controls. Management believes that the company’s accounting controls provide reasonable assurance that errors or irregularities that could be material to the financial statements are prevented or would be detected within a timely period by employees in the normal course of performing their assigned functions.
• **Audit committee.** The objective of this discussion is to explain the review and oversight role of the audit committee in evaluating management’s performance of its financial reporting responsibility. It is illustrated in the following manner:

The board of directors pursues its oversight role for these financial statements through the audit committee which is composed solely of directors who are not officers or employees of the company. The audit committee meets with management and internal auditors periodically to review the work of each and to monitor the discharge by each of its responsibilities. The audit committee also meets periodically with the independent auditors who have free access to the audit committee or the board, without management present, to discuss internal accounting control, auditing, and financial reporting matters.

• **Independent auditor.** This section’s objective is to clarify the role of the independent auditor in relation to the financial statements. That is illustrated in the following manner:

The independent auditors are engaged to express an opinion on our financial statements. Their opinion is based on procedures believed by them to be sufficient to provide reasonable assurance that the financial statements are not materially misleading and do not contain material errors.
SEC ACCOUNTING SERIES RELEASES

ACCOUNTING SERIES RELEASES*

ASR 257, Requirements for Financial Accounting and Reporting Practices for Oil and Gas Producing Activities. The SEC adopted most of the "successful efforts" accounting method requirements of SFAS No. 19, Financial Accounting and Reporting by Oil and Gas Producing Companies, for those companies wishing to adopt or continue this alternative. However, the SEC moved to adoption of the definitions espoused by the Department of Energy for its Financial Reporting System rather than those of the FASB. The Release also provides an exemption from the disclosure requirements for certain diversified companies and clarifies the application of these new rules to rate-regulated enterprises. The Release is effective for fiscal years ending after December 25, 1978 when presented with fiscal years ending after December 25, 1979.

ASR 258, Full Cost Accounting Practices (Oil and Gas). The SEC has set out detailed uniform rules for the application of full cost accounting for those companies having a proclivity for this method. The following is a brief summary of some of the more significant changes:

- Costs to be amortized do not include costs of unproved properties that are "unusually significant" (such as the costs of acquiring and evaluating major offshore leases). However, the SEC does not give any guidance on how to determine what is "unusually significant."

- Amortization utilizing the unit-of-production method is to be based on physical units (energy content) except where distortions would be caused due to regulated prices which do not bear an economic relationship to the energy content of the product.

- The capitalized cost ceiling computation shall be made separately for significant investments in unproved properties. The regulations do, however, provide for appeals in unusual situations.

- The effective date has been temporarily delayed for the disclosure requirements "as if" successful efforts accounting had been used (the "as if" requirement has since been rescinded by Release No. 33-6029).

- The requirement to apply the investor's accounting method to equity investees has been removed.

- Depreciation of natural gas cycling and processing plants may be computed on some method other than units-of-production.

*Does not include Accounting Series Releases concerning only actions against accountants.
• Guidance is provided for applying some of the more confusing concepts, such as the “significant alternative” guidelines in accounting for mineral property conveyances.

The requirements of this release are effective at the same time as those of ASR 257.

**ASR 259, Small Life Insurance Companies – Quarterly Reporting.** The Commission has again deferred the effective date for quarterly reporting by life insurance companies whose shares are not actively traded. (The quarterly reporting requirement was first announced in ASR 197 and deferred in ASR 228; the term “actively traded” is defined in ASR 218.)

The reason for the present deferral is that the Commission is studying the broader question of reporting problems of small companies, and, presumably, the conclusions of that study will be applied to those insurance companies whose shares are not actively traded.

The new date is for quarters in fiscal years ending on or after December 25, 1980.

**ASR 261, Accounting Changes by Oil and Gas Producers.** The SEC will not object to changes by registrants to either successful efforts or full cost (as mandated by the SEC), regardless of what method a registrant was using before, if conforming the company’s present accounting method to the same method as mandated by the SEC will have a significant impact on the registrants’ financial statements. In such cases, registrants will not have to establish preferability or furnish a letter from their CPAs regarding preferability. Generally, the Commission expects registrants to choose the mandated method most closely akin to their present method.

Further, “full cost” registrants may change to the mandated full cost method without establishing preferability, even if the impact of the change is not significant. However, the SEC indicates that subsequent changes, once the choice permitted by this Release has been made, would not be in the interests of investors; thus registrants would have to stay with the method they have selected until the SEC’s reserve recognition accounting is adopted.

**ASR 264, Scope of Services by Independent Accountants,** discusses the possible adverse effects on auditor independence when an accounting firm renders nonaudit management advisory services. Specifically, the ASR cautions auditors, audit committees, boards of directors and managements to be aware of certain factors that might impair, or give the appearance of impairing, independence. Those factors are: dependence upon MAS practice, avoidance of assuming management’s role,
avoidance of self-review, the impact on audit quality, the relation of the MAS engagement to audit skills and economic benefit.

The SEC's views on each of these factors are summarized as follows:

- **Dependence upon MAS practice.** This factor has two aspects. First, what is the relationship between all MAS and all audit services offered by the firm? Second, what is the relationship between MAS and audit services for the specific engagement? The implication is that, at some point, not defined in ASR 264, the percentage of MAS to audit services is too high.

- **Avoidance of supplanting management's role.** The ASR suggests that weak management increases the possibility that outside individuals providing MAS will find themselves called upon to assume a *de facto* management role.

- **Avoidance of self-review.** The accountant must realize, particularly in areas where management is weak, that there is the potential of self-review. If the auditor elects to perform the MAS engagement, the ASR says he must exercise extreme care and have heightened sensitivity to assure objective evaluation.

- **Impact on audit quality.** While it is recognized that MAS provides the accounting firm with a broader knowledge of the client's business, when these services are performed by a separate department or personnel of the accounting firm with little or no interaction, this transfer of knowledge would not appear to exist. Further, the SEC warns that, if the information obtained in the MAS engagement is not communicated to the auditor, the accounting firm would run a substantial risk.

- **Relation of MAS engagement to audit skills.** While the SEC does not view this factor to be explicitly included among the considerations addressed in deciding to accept a certain MAS engagement, nevertheless they believe that public trust and confidence are eroded when auditors engage in what becomes principally a management consulting business.

- **Economic benefit.** Care must be exercised to assure that the benefits weighed against the potential adverse effects represent a real advantage.

Some MAS engagements which the SEC believes may be difficult to justify are actuarial services, psychological testing, consumer surveys and opinion polls, plant layout services, and employee compensation and benefit consulting. However, the SEC recognizes that there may be justification in special cases for rendering such services to audit clients.

In concluding its views, the SEC states that it is not proscribing particular nonaudit services nor seeking to deprecate the very real benefits which may accrue from certain auditor MAS engagements. Rather they are
seeking to reinforce the sensitivity of interested parties to the considerations involved in judging whether particular nonaudit services should be rendered by a registrant’s auditors.

Touche Ross position:

Touche Ross urges the Commission to withdraw ASR 264, in part because many publicly held companies see the Release as a categorical ban – not simply a sensitization – on any nonaudit service by their independent accountants. Admittedly, the issue of the scope of services and auditor independence is complex, but the overreaction of ASR 264 could carry serious costs to the profession, the financial community and, ultimately, society. Instead, we think that the Commission should follow its own stated policy of allowing the accounting profession the opportunity to further pursue self-regulation. The benefits of prudent management advisory services by CPAs far outweigh the costs imposed by this ASR. If, however, the Commission intends to retain restrictions on the scope of CPA services, we believe that the issue should at least be opened to public dialogue in an appropriate forum.

ASR No. 268, Presentation in Financial Statements of Redeemable Preferred Stock, requires that mandatory redemption preferred stock and certain other preferred stocks be presented separate from equity in financial statements. Also, separate footnote disclosure is required of the future cash obligations incurred by issuance of such securities. These securities are defined as: “...any stock which (i) the issuer undertakes to redeem at a fixed or determinable price on a fixed or determinable date(s), whether by operation of a sinking fund or otherwise; (ii) is redeemable at the option of the holder; or (iii) has conditions for redemption which are not solely within the control of the issuer...”

The SEC believes that mandatory redemption preferred stock, and certain similar securities as defined above, have debt characteristics which require their separation from conventional equity capital. But the SEC refuses to deal with the questions of whether these preferred stocks are liabilities or whether their preferred dividends should be treated as other than dividends. These questions are left to the FASB. The SEC Release is termed an “interim solution” until the FASB acts.

The Release does not require any change in the calculation of debt-to-equity ratios. However, if material amounts of redeemable preferred stocks are part of the denominator in a debt to equity ratio, then an additional ratio should be presented which excludes this stock from equity and adds the stock to the debt amount. This double ratio presentation approach also applies to tables, charts, graphic illustrations, etc., presented in annual shareholder reports designed to meet Regulation S-X requirements.
**Examples.** Pursuant to Regulation S-X, balance sheet presentation (liabilities and equity section only) for registrants having redeemable preferred stocks outstanding would appear as follows:

<table>
<thead>
<tr>
<th>Liabilities (details omitted)</th>
<th>$ 5,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redeemable preferred stock:</td>
<td></td>
</tr>
<tr>
<td>Authorized and outstanding,</td>
<td></td>
</tr>
<tr>
<td>100,000 shares of</td>
<td></td>
</tr>
<tr>
<td>$100 par value (Note X)</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Nonredeemable preferred stocks,</td>
<td></td>
</tr>
<tr>
<td>common stocks, and other</td>
<td></td>
</tr>
<tr>
<td>stockholder equity:</td>
<td></td>
</tr>
<tr>
<td>Preferred stock authorized</td>
<td></td>
</tr>
<tr>
<td>and outstanding, 500,000</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>shares of $20 par value</td>
<td></td>
</tr>
<tr>
<td>Common stock authorized and</td>
<td></td>
</tr>
<tr>
<td>outstanding, 5,000,000 shares</td>
<td></td>
</tr>
<tr>
<td>of $1 par value</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>20,500,000</td>
</tr>
<tr>
<td>Total</td>
<td>35,500,000</td>
</tr>
<tr>
<td></td>
<td>$50,500,000</td>
</tr>
</tbody>
</table>

Footnote disclosure required is as follows:

Note X – Redeemable Preferred Stocks. The Company has issued and outstanding 100,000 shares of $100 par value nonconvertible, nonvoting redeemable preferred stock. This security was issued on July 1, 1979 and is redeemable at par on June 30, 1984. The $9.75 per share annual dividend is cumulative and nonparticipating.

1. If the carrying value is different from the redemption amount, the registrant must describe the accounting treatment for the differences in the Redeemable Preferred Stock footnote.

2. This caption is optional.

3. If redemption features include sinking fund provisions, or redemption is at the option of holders or is out of future earnings, this information should also be disclosed. In addition, rights of holders upon default, changes in outstanding shares during the year and, if a multiple series of such issues are outstanding, a five-year format statement of the amount required for redemption in each of the five years should also be disclosed.

**Other Stockholders Equity.** Under this caption, separate captions should be included for paid-in capital, other additional capital and retained earnings (appropriated and unappropriated).
Effective Date and Applicability. The Release is effective for fiscal periods ending on or after September 15, 1979. Financial statements for prior periods which are included for comparative purposes must be reclassified. Registrants who do not have redeemable preferred stock are not affected by this Release. They may continue to use a “Stockholders’ Equity” heading and show a combined total.

ASR 269, Oil and Gas Producers – Supplemental Disclosures on the Basis of Reserve Recognition Accounting, prescribes final rules for presentation of a supplemental summary of oil and gas producing activities prepared on the basis of reserve recognition accounting (RRA), effective for financial statements for years ending after December 25, 1979. There are important differences between the rules adopted and the rules initially proposed in Release 33-5969. There are also certain changes in previous requirements for disclosure of future revenues from production.

ASR 269 also deletes the requirements to segregate the present value of estimated future net revenue from production between proved reserves added in the current year and those added in previous years, since reconciliation of beginning and end-of-year present value of estimated future net revenues is now required.

The SEC encourages, but does not require, presentation of present value information and the supplemental RRA summary in annual reports to shareholders for fiscal years ending before December 26, 1980. If the information is omitted from the shareholders’ report, a footnote to the financial statements should indicate that it is available in Form 10-K. However, the information will be required in shareholder reports for fiscal years ending after December 25, 1980.

The safe harbor provision covering the disclosure of estimated future net revenue information has been extended to cover supplemental RRA disclosures.

ASR 270, Oil and Gas Producers – Postponement of Audit Requirement for Reserve Information, postpones application of audit requirements for reserve information and the supplemental summary until fiscal years ending after December 25, 1980. In addition, the disclosure of oil and gas reserve information and the supplemental RRA summary may be designated “unaudited” in financial statements, a note thereto or in a separate schedule, for fiscal years ended before December 26, 1980.

ASR 271, Deletion of Requirement to Disclose Replacement Cost Information, withdraws the ASR 190 reporting requirements for fiscal
years ending on or after December 25, 1980. However, for the current year, 
(1) ASR 190 requirements are not waived unless the company adopts the 
current cost disclosures of SFAS No. 33 for the current year, (2) a 
company meeting the ASR 190 requirements for the first time this year 
will not be required to report ASR 190 disclosures if the company’s assets 
are less than the FASB’s $125 million size test, and (3) a company 
previously reporting under ASR 190 which does not meet the FASB’s 
$125 million size test will be required to report under ASR 190 for the 
current year. If a company chooses to adopt the current cost disclosures 
for the current year, the safe harbor provision will apply to those 
disclosures.

ASR 272, Rescission of Moratorium on Capitalization of Interest Costs, 
recognizing SFAS No. 34, Capitalization of Interest, rescinds the 
Commission’s moratorium on interest capitalization. There are some 
differences in the SEC’s amended Rule 3-16(r) and the FASB Statement. 
Although SFAS 34 is prospective for fiscal years beginning after 
December 15, 1979, under Rule 3-16(r) its disclosure requirements must 
be followed for prior years’ financial statements when reissued in the 
future. The revised Rule became effective November 6, 1979, while the 
moratorium rescission is effective upon adoption of SFAS No. 34.

STAFF ACCOUNTING BULLETINS

SAB No. 28, Interpreting Certain Electric Utility Company Accounting 
and Disclosure Matters, presents the staff’s view of accounting and 
disclosures to be made by electric utility companies concerning: (1) 
financing through use of construction intermediaries, (2) interests in 
jointly-owned electric utility plants, and (3) long-term contracts for 
purchase of power.

Financing Through Construction Intermediaries. Work in progress and 
related debt of a utility company’s construction intermediary should be 
included in the utility’s balance sheet under utility plant and long-term 
liabilities (appropriately disclosed), respectively. Also, any interest cost 
capitalized must be included in the income statement and offset in the 
balance sheet under the caption, “Allowance for borrowed funds used 
during construction.”

A note should detail the organization, purpose, and authority of the 
construction intermediary to incur construction debt.

Jointly-Owned Electric Utility Plants. A participating utility should disclose:
• The extent of joint interests
• By interest, the amount of utility plant in service, accumulated
depreciation (if available), amount of plant under construction and the owner’s proportionate share (in tabular form). Plant subcategories, such as production, transmission and distribution, also may be shown

• The share of direct expenses of joint plants included by the participant in its operating expenses – fuel, maintenance, purchased power, etc.

Long-term Contracts for Purchase of Electric Power. A note should be included presenting the terms and significance of such contracts – including date of contract expiration, share of plant output being purchased, estimated annual cost, annual minimum debt service and the outstanding debt (or lease) obligation. Additional disclosure should be made if such arrangements provide in excess of five percent of the purchasing utility’s estimated future system capability.

SAB No. 29, Disclosure of Effect on EPS of Other Than Changes in Net Income, says that, when there are material changes in the amount of earnings per share resulting from factors other than changes in net income, those changes should be explained in management’s discussion and analysis of the summary of earnings. An example of an “other” change in EPS would be a registrant’s purchase of its own shares – EPS might be materially affected and, if so, should be covered in management’s discussion. The SAB gives a sample disclosure of a simple issuer equity purchase transaction.

SAB No. 30, Accounting for Divestiture of a Subsidiary or Other Business Operation, states that certain transfers of operations should not be treated as divestitures for accounting purposes, and the assets, liabilities and the operating results of the transferred entity should continue to be reported in the “seller’s” financial statements. Specifically, divestitures are not permitted when a company transfers certain operations to a “purchaser” but retains the risks of ownership, remains contingently liable for performance on future contracts and guarantees the debt of the transferred company.

SAB No. 31, Balance Sheet Presentation of Capital to be Contributed by Affiliates of Corporate General Partners, states that, when a corporate general partner holds notes or receivables from a parent or affiliate, often to meet the “substantial assets” test of the IRS and thereby qualify for the safe harbor provision, those notes and receivables are to be treated the same as unpaid stock subscriptions receivable – that is, they must be deducted from stockholders’ equity in the corporate general partner’s balance sheet.
SAB No. 32, Accounting Changes Not Retroactively Applied Due to Immateriality, states that, if retroactive application of an accounting change is required but prior periods are not restated because the amounts are immaterial, the cumulative effect of the change should be included in determination of income for the period in which the change was made. But, if the cumulative effect is material to current operations or to the trend in earnings, prior period income statements would have to be adjusted.

SAB No. 33, Disclosure of Services to Employee Benefit Plans, amends SAB 25, stating that, when the company engages the independent accountants for general audit services to an employee benefit plan, those services should be included as part of the audit function. Other specific nonaudit services provided to the plan, however, must be included with the issuer’s disclosure of nonaudit services.

SAB No. 34, Deletion of SAB 5, withdraws SAB 5, Exchanges of Assets between Debtors and Creditors, because the disclosure requirements therein are now covered by SFAS No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings.

SAB 35, Disclosure Rules for Oil and Gas Producers, provides interpretations of disclosure rules under ASRs 253, 257 and 269. It also provides an illustration of income tax calculations under RRA and interpretations pertaining to estimation of quantities of proved reserves, computation of future net revenues and disclosure of reserve information.

OTHER SELECTED SEC RELEASES

Release No. 33-6001, SEC Reminder: Registrants Must Disclose Material Impact of Wage and Price Standards on Operations, indicates that registrants must, under existing security laws, disclose any material impact that the standards might have on their operations. Examples are a possible loss of government sales if a company does not comply with the standards or decreases in income if compliance with the standards prevents increased costs from being passed on in the form of price increases.

Release No. 33-6003, SEC Amends Regulation S-K, Management Remuneration Reporting Requirements Including Personal Benefits, finalizes requirements for disclosure of management remuneration. These requirements appear at Item 4 of Regulation S-K. Several
disclosure forms are affected, including Forms S-1 and S-11 (under the 1933 Act) and Forms 10, 10-K and Proxy Regulation 14A (under the 1934 Act).

• The remuneration of only the five most highly compensated executive officers or directors is required to be reported. Previously, the management remuneration table reported each director whose aggregate direct remuneration exceeded $40,000 and each of the three highest paid officers of the registrant whose aggregate direct remuneration exceeded $40,000 (but see 33-6027).

• The “Remuneration Table” has been revised to add a column reflecting salaries and similar amounts actually distributed or accrued during the latest fiscal year; a column reflecting the aggregate of certain other forms of noncontingent remuneration for services during the fiscal year (such as insurance premiums and personal benefits) and a column reflecting various forms of contingent remuneration for which amounts were expensed during the year for financial reporting purposes. There is no requirement for a separate total column.

Release No. 33-6016, SEC Rules for Sequential Numbering of Pages of All Documents Filed, requires that all filings be numbered sequentially from the facing page of the document, including any exhibits or attachments thereto.

• Subnumbering systems (10a, 10b, 10c) must be avoided
• The total number of pages in the document should be stated on the first page
• It is not necessary to number pages of conformed copies.

The numbering system will assist in the implementation of the Commission’s Micrographic Conversion Program to put all filings on microfilm storage media.

Release No. 33-6020, Expands Use of Short Form S-16 by Subsidiaries, and Permits Alternative to Parent Guarantee. The use of Short Form S-16 has been extended to primary offerings of debt or equity securities offered for cash by subsidiaries of certain issuers.

Generally, the issuer must satisfy the rules for the use of Form S-7 and meet one of the conditions listed below:

• The aggregate market value of the voting stock held by nonaffiliates of the issuer is $50 million or more; or
• The aggregate market value of the voting stock of the issuer’s parent held by nonaffiliates is $50 million or more, the issuer is a majority-owned subsidiary and its parent has fully guaranteed the
securities as to principal and interest; or

• The aggregate market value of the voting stock of the issuer’s parent held by nonaffiliates is $50 million or more, the issuer is a majority-owned subsidiary; and
  - The issuer has outstanding registered securities held by nonaffiliates, with an aggregate principal amount or market value of at least $250 million, and
  - The issuer has at least 1,000 security holders to whom the issuer has furnished an annual report containing certified financial statements for its most recent fiscal year. An annual report of the issuer’s parent that contains separate certified financial statements of the issuer may be used to satisfy this requirement.

"Aggregate market value" is computed by reference to the price at which the stock was sold, or the average of the bid and asked prices of such stock, as of a specified date within 60 days prior to the date of filing.

Release No. 33-6027, SEC Interprets Management Remuneration Disclosure Requirements, indicates that registrants should use reasonable flexibility in determining which are the five most highly compensated executive officers and directors. Thus, for example, if one individual who does not have a considerable policy making role (1) receives in one year a very large bonus, commission or option spread which is not part of a recurring arrangement and is unlikely to continue or (2) receives considerable foreign cost of living allowances in connection with an overseas work assignment, such individual need not automatically be included in the “five most highly compensated” category. The individual should probably be excluded if his level of executive responsibility is relatively lower. The intent of the requirement is to obtain disclosure of the five most highly compensated executive officers or directors.

The release also contains guidelines as to whether accruals or distributions by defined benefit pension plans are to be included in the remuneration table.

Release No. 33-6032, Amendments of Rules 144 and 148, Safe Harbor for Sale of Beneficially Owned Restricted Securities, amends Rules 144 and 148 to relax certain restrictions on the resale of securities, and permits persons who have held securities covered by the rules for a specified period of time to sell such securities without any amount limitation, provided they are not affiliates of the issuer of the securities.

Under both rules, if the securities to be sold have been beneficially owned for a three-year period prior to sale and are listed on a national securities exchange or quoted in NASDAQ or have been beneficially
owned for four years at the date of sale, are not listed or quoted and the
issuer is in compliance with the filing requirements of Sections 13 and
15(d) of the Securities Exchange Act of 1934, then the volume limitations
on the number of shares which can be sold under each Rule do not apply.

Release No. 33-6049, Registration of Securities on Short Form S-18,
adopts Form S-18 for certain smaller offerings of securities by domestic or
Canadian corporate issuers who are not subject to the reporting
provisions of Sections 12 or 15(d) of the 1934 Act. Certain issuers are
excluded.

Form S-18 may be used for the registration of securities to be sold to the
public for cash not exceeding a total offering price of $5,000,000. The total
amount includes any securities of the issuer sold within twelve months
before commencement of the S-18 offering. Form S-18 may also be used
for secondary (resale of securities) offerings up to $1.5 million, but the
amount offered for sale is to be included in the $5 million ceiling.

The disclosure requirements of Form S-18 are generally similar to those
required for Form S-1. However, some S-1 item requirements are reduced
in scope or exempted. For example, a summary of operations for the last
five years is not required by Form S-18.

Audited financial statements required are: (1) a consolidated balance
sheet, and (2) consolidated statements of income, source and application
of funds and other stockholders' equity for two years (Form S-1 requires
three years). Interim financial statements may also be required.
Regulation S-X does not apply to the financial statements in the filing. As
a result the technical disclosures and schedules are not required.

Release No. 33-6079, Deferral of Auditors' Reporting on Oil and Gas
Reserve and Revenue Disclosures. ASR 253 established disclosure
requirements for years ending after December 25, 1979 for oil and gas
reserve quantities, estimated future net revenues and the present value of
future net revenues, within the body of the financial statements. This
information would be audited. Independent accountants would have to
use the report of reservoir engineers in the audit of the required oil and
gas data. Without such reports, no satisfactory audit could be performed.
However, since issuance of the ASR, the SEC has become aware that
certain problems exist, primarily a lack of estimating and verifying
standards which can be applied by reservoir engineers to quantify certain
oil and gas reserve information. For that reason, Release No. 33-6079
proposes deferral of the requirement that information on oil and gas
reserve quantities, the estimated future net revenues and the present
value of future net revenues be audited until years ended after December
25, 1980.
The Commission also proposes to permit any supplemental earnings summary based on reserve recognition accounting to be designated as unaudited for fiscal years ending before December 26, 1980.

**Release No. 33-6084. SEC Adopts Safe-Harbor Rule for Projections**, applicable to certain forward-looking statements. Forward-looking statements covered by the rule are limited to those listed below and disclosure of the assumptions underlying them:

- Statements containing projections of revenue, income, earnings per share, capital expenditures, dividends, capital structure or other financial items
- Statements of management’s plans and objectives for future operations
- Statements included in management’s discussion and analysis concerning future economic performance.

The safe-harbor rule protects noninvestment company issuers and outside reviewers retained by them from federal securities law liability for covered forward-looking statements made by or on behalf of the issuer which do not materialize if all the following conditions are met:

- The issuer is subject to the reporting requirements of the Exchange Act or the statement is made in an initial registration statement
- The issuer has filed its most recent annual report on Form 10-K, if applicable
- The plaintiff is unable to prove that the statement did not have a reasonable basis or was not disclosed in good faith at the time it was made or reaffirmed
- The statement is included in material filed with the Commission or the annual report to shareholders.

The interpretive release accompanying the safe-harbor rule makes clear that the Commission believes registrants have a duty to correct any material statements included in filings or otherwise which are later discovered to have been false or misleading from the outset or to have become inaccurate by virtue of intervening events.

**Release No. 34-15567, Proxy Statement Disclosure for Certain Sales of Assets Transactions**, states the Division of Corporation Finance views and practices in administering the existing disclosure requirements of the proxy rules in the context of certain sale of assets transactions. Usually, the transaction involves a cash sale of substantially all of the assets of a public company to another company, often a private company not otherwise engaged in trade or business. The purchaser expects to continue the business under the seller’s name and hires substantially all of the seller’s managers under long-term employment arrangements to
manage the business. A significant percentage of the purchase price may be borrowed by the purchaser and, if so, the assets purchased are usually directly or indirectly pledged to secure loan repayment. Although the purchaser assumes substantially all of the seller's liabilities, the seller may nevertheless be liable if those liabilities are not discharged by the purchaser in the ordinary course of business.

In some cases, the sale of assets may be followed by an issuer tender offer by the seller to repurchase its shares for cash from the proceeds received from the sale. The remaining proceeds of sale may be invested to provide tax exempt income to the remaining shareholders.

The SEC is concerned that disclosure has not in the past adequately highlighted the actual and potential conflicts of interest presented to management or its affiliates in transactions such as these. Accordingly, the SEC recommends that, in appropriate cases, a Special Factors section be included in the forepart of the proxy statement. The special factors discussed might include the following:

- Disclosure that the principal shareholders or management may have actual or potential conflicts, and descriptions of such conflicts
- Disclosure of the sale price per share compared to the net tangible book value per share
- Disclosure that the seller may remain secondarily liable with respect to liabilities assumed
- Disclosure that certain officers and directors have entered into long-term employment contracts with the purchaser and, if applicable, that they will receive increased salaries and/or the opportunity to share in future profits of the business
- Disclosure of such other factors with respect to the transaction which management believes require particular attention by shareholders in making their voting decisions.

The SEC also suggests expanded coverage in proxy materials of:

- Reasons for and effect of the transaction
- Material features of the plan or transaction
- Rights of shareholders under state law.

Release No. 34-15772, Statement of Management on Internal Accounting Control, proposes that management provide a statement on internal accounting control that provides "reasonable assurance" that transactions have been properly recorded and that the company's system safeguards assets. The requirement would be effective in two phases. In the first – December 16, 1979 through December 15, 1980 [but see the announcement below] – management's representation would apply only to conditions existing at the balance sheet date; this statement would also have to report material weaknesses that have not been corrected and the
reasons therefor. In the second phase, December 16, 1980 and after, the statement would have to cover conditions throughout the year, and the representations would have to be examined and reported on by an independent public accountant.

Touche Ross position:

We strongly oppose the SEC's proposed requirement that management publish an opinion on its system of internal controls. We are equally opposed to the proposal requiring an auditor's report on management's assessment. We think that users of financial information would receive little benefit from such information; that the FCPA makes the SEC requirements redundant; that audit costs would usually be increased, not reduced as the SEC believes; and that the requirement to disclose uncorrected material weaknesses fails to consider that determination of such weaknesses is highly subjective and that financials can be properly presented despite their existence.

SEC Announcement:

On November 26th, the Commission announced that any rule adopted with respect to its proposal to require inclusion of a statement of management on internal accounting control in annual reports on Form 10-K and in annual reports to security holders furnished pursuant to the proxy rules would not be effective for periods ending on or before December 31, 1979.

The 1979 SEC Report to Congress on the Accounting Profession and the Commission's Oversight Role. The SEC has released its second annual report to Congress regarding the accounting profession and the Commission's oversight role. As in its first report, the SEC reaffirms its position that the establishment of accounting and auditing standards should remain a private sector responsibility. The report reflects the profession's efforts and the results of the Commission's involvement and oversight during the period from July 1978 through June 1979.

The Commission continues to believe that the profession's progress in the past year has been sufficient to merit continued self-regulation and that in certain respects it is still too early to determine whether future possible legislation or regulation will be necessary.

The 700-page Commission report contains: (1) the Commission's conclusions and expectations, (2) the staff's description and analysis of the profession's progress during the past year, and (3) relevant exhibits. The report covers the following key issues: independence, regulation and oversight, the accounting standard-setting process, the auditing standard-setting process, accounting by state and local governmental units and some initiatives related to small businesses and small- and medium-sized accounting firms.
DEPARTMENT OF LABOR

ERISA Status Report: 1978 Form 5500 Series; Revised Schedule B; and Determining Whether to File Form 5500 or Form 5500C. The annual return/report Forms 5500, 5500C and 5500K, required schedules and instructions for plan years beginning in 1978 have been issued by the Internal Revenue Service, the Department of Labor and the Pension Benefit Guaranty Corporation. Also, a new annual return/report form, Form 5500G, has been issued by the Internal Revenue Service. The forms released include:

- 5500 - For plans with 100 or more participants
- Schedule A - For insurance information
- Schedule B - Actuarial information and the funding standards account
- Schedule SSA - Report of separated participants with deferred vested benefits
- 5500C - For plans with fewer than 100 participants
- 5500K - For plans of sole proprietorships and partnerships
- 5500G - A new form for government plans and certain church plans who do not elect to be covered by ERISA participation, vesting, and funding standards.

Copies of these forms should be available now from your local IRS office.

With the exception of Schedule B, the forms contain very few changes. The significant changes made this year are discussed below.

Schedule A. The form now provides a choice between two methods for reporting insurance fees and commissions. This information may be reported either as (1) payments to soliciting agents and brokers, or (2) insurance fees and commissions paid to general agents, brokers and other persons.

Schedule B. This revised schedule now requires the following:

- A uniform method – the accrued benefit cost (unit credit) method – is to be used to calculate the present value of accrued benefits
- The present value of accrued benefits is to be calculated as of the beginning of the year and classified between vested-receiving benefits, other vested and nonvested. These amounts are required for 1978 plan years only if calculated. Reporting will be mandatory for 1979 plan years
- Plans with fewer than 100 participants need not disclose the present value of accrued benefits
• The assumptions used to calculate accrued benefits are to be based on expectations relating to an ongoing rather than terminating plan
• Major assumptions are to be disclosed
• When significant, accrued benefits must be increased by the present value of any subsidized early retirement benefits, disability benefits and death benefits which are related to accrued benefits.

Permanent Waiver of Allocated Nonforfeitable Benefits. In connection with the release of Schedule B and its instructions, DOL also announced a permanent waiver of the ERISA reporting requirement (Section 103(d)(6)) that the actuarial statement must include the present value of the plan's liabilities for nonforfeitable pension benefits, allocated by termination priority categories as required in Section 4044 of ERISA. In the past, the DOL has issued temporary waivers of this reporting requirement.

**Form 5500 or Form 5500C?** Plans with 100 or more participants at the beginning of the plan year must file Form 5500; those with fewer than 100 participants may file Form 5500C. “Participants” for the purposes of this test are defined as follows according to the instructions for Item 7(b), Form 5500C:

- Active participants (vested, partially vested and nonvested)
- Retired or separated participants receiving benefits
- Retired or separated participants entitled to future benefits
- Deceased participants whose beneficiaries are receiving or are entitled to receive benefits.

The sum of the number of participants in each of the four categories above as of the **beginning of the plan year** determines which reporting form should be used and whether a plan is exempt from audit because it has fewer than 100 participants.

**DOL Issues Final Regulations for Summary Annual Reporting to Participants.** The Department of Labor has adopted final regulations which become effective June 5, 1979, specifying the form, content and procedures associated with summary annual reporting to plan participants and beneficiaries. Generally, the requirements are as follows:

- The plan administrator of plans required to file Forms 5500, 5500C, or 5500K must furnish annually to each plan participant and each beneficiary receiving benefits under the plan a summary annual report (SAR).
- The SAR must be furnished within nine months of the close of the plan year or the trust year if the trust or other entity files the annual report. When an extension of time in which to file an annual report...
has been granted by the IRS, the SAR must be furnished within two months after the close of the period for which the extension was granted.

• The regulation provides specific wording, with blanks for financial and other information of the plan to be used in preparing the SAR. The form must be tailored to fit the plan characteristics. Two formats have been provided: one for pension plans including defined contribution plans, and one for health and welfare plans. All financial data is to be taken from the most recent annual report filed with the IRS. (The regulation includes a cross reference from the 5500 series forms to the blanks in the SAR formats to assist in preparation.) The plan administrator may include additional explanatory information if he determines it is necessary to fairly summarize the annual report information.

• Participants may request a complete set of financial statements (or portions thereof) free of charge. The financial statements furnished may be items 13 and 14 of Form 5500 or the separate financial statements and notes, or both when the request is nonspecific and both are available. The accountants’ report, if any, need not be furnished unless requested. (Note the fourth item below regarding plans filing on Form 5500K.)

We have the following observations on the SAR:

• The required wording of the SAR includes an erroneous definition of unrealized appreciation or depreciation of plan assets. A DOL representative has informed us that, since the definition is incorrect, it should be deleted when the SAR is prepared. Accordingly, the phrase “that is, the difference between the value of the plan’s assets at the end of the year and the price the plan originally paid for those assets,” should be deleted (and is in the revised regulation).

• While total income is disclosed, not all individual items of income are being furnished in the SAR, so the sum of the income sources furnished will not equal the total income amount furnished.

• The regulation permits the plan administrator to furnish only portions of the financial statements when he is requested to do so.

• A SAR furnished to a plan which files Form 5500K should delete all references to the availability of financial statements and notes since the annual report Form 5500K does not require statements, and it is unlikely that separate financial statements will be prepared, since there is no requirement for audit of such plans. The DOL representative indicated that, in all cases where information is inapplicable or not available, the SAR format should be modified to exclude reference to that information.
TREASURY DEPARTMENT

The Vinson-Trammel Act, which limits profits of defense prime and subcontractors who manufacture parts for aircraft or naval vessels, became effective in September 1976, upon expiration of the Renegotiation Act. In the interim, however, neither the IRS nor DOD has issued final regulations for compliance with the Act. In October 1979, the IRS did issue proposed regulations and at the same time postponed once again the report filing date, this time to April 15, 1980. That date may be further extended, because the Congress intends to hold hearings on V/T and will probably be considering other profit-limiting legislation as well. Whatever the outcome contractors will eventually have to file for periods back to 1976.

REGULATED INDUSTRIES


Temporary regulations have been adopted effective March 10, 1979, implementing the Changes in Savings and Loan Control Act of 1978 which requires that 60 days prior notice be given to the Federal Savings and Loan Insurance Corporation when a person, or a group of persons acting in concert, will acquire control of any stock insured institution. Control is defined in the temporary regulations as “power, directly or indirectly, to direct the management or policies of an institution or to vote 25% of any class of stock or voting rights.” The existing requirements for after-the-fact notification of changes in control now apply only to mutual insured institutions.

The notice must, among other things, include financial statements of the acquiring person or persons for the past five fiscal years and for the interim period ending within 90 days of the filing date. The financial statements are to be prepared in accordance with generally accepted accounting principles, consistently applied. Since the Act is silent on the subject, we conclude that the financials are not required to be audited.

These requirements for prior notice do not apply to any transaction subject to the Holding Company Act or to other prior Bank Board approval. Thus, changes in control due to acquisitions by savings and loan holding companies and changes in control of insured institutions generally, resulting from mergers, consolidations, or other similar transactions are not affected by this Act and related regulations.
Revised Audit and Accounting Guide for Savings and Loan Associations Issued

Introduction

The AICPA Committee on Savings and Loan Associations has released its revised Audit and Accounting Guide for Savings and Loan Associations. The guide updates and supersedes the previous Industry Audit Guide. The following are the major areas of change in the new Guide.

Areas of Significant Change

• Accounting for investments in mortgage-backed securities and GNMA futures
• Application of the provisions of SFAS No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructuring"
• Methods for valuation of real estate acquired in foreclosure and for other real estate owned (fair value and net realizable value concepts)
• Accounting for real estate purchased for sale and development including the capitalization of holding costs
• Accounting for repurchase agreements, reverse repurchase agreements, federal funds and short sales
• Savings account disclosures
• Accounting for interest penalties
• Accounting and disclosure of income taxes
• Accounting for mortgage securities and subordinated debentures issued by the association
• Presentation of equity accounts
• Accounting for loan commitment fee income
• Accounting for loans in process.

FHLBB Adopts Final Regulations Regarding Forward Commitments in the Savings and Loan Industry

The FHLBB has issued final regulations, effective June 1, 1979, regarding "Forward Commitments." This regulation was promulgated as a result of the FHLBB's concern as to forward commitment activities, which resulted in a number of associations sustaining substantial losses, engaging in speculative trading, and generally operating in an imprudent fashion.

TOUCHE ROSS ACCOUNTING AND AUDITING PUBLICATIONS

Controlling Assets and Transactions – Touche Ross Accounting Control Evaluation is a concise booklet that shows corporate managements how
to review and improve their internal accounting control systems. It presents the rationale for internal control reviews, describes the responsibilities of those conducting the review, aids in evaluating specific control objectives and shows how to conduct an effective cost/benefit analysis. Much of the booklet consists of questionnaires, checklists and techniques that have been proven invaluable in establishing and carrying out a successful internal accounting control evaluation. Copies are available from your Touche Ross account representative or any Touche Ross office.

Basic Cost Accounting Considerations in Government Contracting (revised) discusses the various types of government contracts, contractors' accounting systems, government cost regulations and standards issued by the Cost Accounting Standards Board. Also covered are court cases relating to allowability and allocability of contract costs and the role of government auditors. The publication is directed primarily to nonaccountants and to accountants with limited experience in government cost accounting.

A booklet entitled Accounting for Oil and Gas – What Oil and Gas Producers Should Know, covers the SEC's and FASB's requirements for oil and gas producers, including the successful efforts method and the SEC-prescribed full cost method. Income tax allocation changes are described, and restatement checklists and worksheets are provided.
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