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Accounting and auditing developments, 1983

Touche Ross & Co.

ACCOUNTING AND AUDITING DEVELOPMENTS
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FOREWORD

This booklet summarizes most of the authoritative accounting and auditing literature issued in 1983, as well as describing certain other positions that the FASB, the AICPA, or the SEC developed during the course of the year. This collection of summaries is not to be considered definitive or complete, of course. We have generally tried to give the gist of each development in just a few paragraphs.

It is possible that more detailed advice on the application of the standards and rules described herein will be critical to the success of your operations. Touche Ross stands ready to help, to answer your questions or to suggest solutions to particular problems. Just call your Touche Ross general services partner or the Touche Ross office in your area.

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FINANCIAL ACCOUNTING STANDARDS BOARD

SFAS 72, Accounting for Certain Acquisitions of Banking or Thrift Institutions, amends APB 17 on goodwill amortization in purchase acquisitions and specifies that financial help from a regulatory agency in connection with a business combination must be accounted for as part of the combination. SFAS 72 directs post-combination banks and thrifts to amortize identified intangible assets over the estimated lives of those intangibles. Unidentifiable intangible assets (goodwill) equal to the excess of assumed liabilities over identifiable assets shall be amortized over the estimated remaining life of long-term interest-bearing assets. Any remaining goodwill shall be amortized in accordance with APB 17.

The Statement is effective for business combinations initiated after September 30, 1982 with earlier application encouraged. Retroactive application to business combinations initiated prior to October 1, 1982 is permitted but not required.

Because SFAS 72 was issued in March 1983, but is effective for transactions initiated after September 30, 1982, the FASB has provided a transition rule as follows: if, prior to March 1, 1983, an enterprise has issued financial statements in which the provisions of SFAS 72 have not been applied to a business combination initiated and consummated after September 30, 1982, those financial statements must be restated when they are first presented with financial statements for subsequent periods (or the opening retained earnings balance shall be adjusted if comparative financial statements are not presented).

SFAS 73, Reporting a Change in Accounting for Railroad Track Structures, an amendment of APB Opinion No. 20, adds to the list of exceptions under which changes in accounting principle are to be retroactively restated for all prior periods. The Statement requires that when a railroad changes from betterment to depreciation accounting for railroad track structures it should restate all prior periods presented in general purpose financial statements. The FASB felt that this change should be included among the exceptions to APB 20 because the advantages of having comparable financial statements outweigh the disadvantages related to changing previously reported results. SFAS 73 is effective for changes from betterment to depreciation accounting that take place after June 30, 1983. Earlier application is encouraged but is not required.

SFAS 74, Accounting for Special Termination Benefits Paid to Employees, requires that a company recognize special termination benefits as current period expenses. These termination benefits are commonly known as "early retirement incentives" and are typically offered to employees for a short period of time. The benefits may be in the form of lump sum payments, periodic future payments or some combination of the two.

The FASB indicated that an employer must recognize special termination benefits as a liability and as an expense at the time the employees accept the offer if the amount can be reasonably estimated. The effect of other changes in the estimated cost of other employee benefits, if reliably determinable, should also be included in measuring the expense.

This new standard is effective for benefits offered after June 30, 1983.

SFAS 75, Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Government Units (an amendment of FASB Statement No. 35), defers indefinitely the applicability of SFAS 35.

SFAS 35 (March 1980) prescribed GAAP for general-purpose external financial reports of defined benefit pension plans. At that time the standards were supposed to be effective for plan years beginning after December 15, 1980.

In subsequent months, however, the Financial Accounting Foundation, the AICPA and governmental auditor associations questioned the advisability of permitting FASB to set accounting standards for governmental entities. Statement 35's applicability was therefore deferred, first by SFAS 59, which delayed the applicability until plan years beginning after June 15, 1982, and now by SFAS 75.

This indefinite deferral of SFAS 35 has a parallel in the suspension by the National Council on Governmental Accounting of its Statement 6. SFAS 35 and the NCGA's Statement 6 differ in some respects, notably in the methods they use to measure participants' benefits and the valuation bases they use for measuring plan investments.

It is uncertain whether SFAS 35 will ever become effective. NCGA and the FASB seem to have agreed that the new Governmental Accounting Standards Board, or GASB, ought to have jurisdiction in these matters, but the establishment of the GASB has been delayed due to disagreements regarding the jurisdiction of the FASB and the GASB.

SFAS 76, Extinguishment of Debt, establishes criteria necessary to treat an in-substance defeasance as an extinguishment of debt.

Debt is to be considered extinguished if the debtor is relieved of primary liability for the debt by the creditor and it is probable that the debtor will not be required to make future payments as guarantor of the debt. SFAS 76 specifies the following conditions for considering defeasance to be extinguishment:

- assets are placed in an irrevocable trust

- the assets are essentially risk-free
- the debtor no longer has a probable future sacrifice of economic benefits in the form of interest or principal payments related to the debt.

This Statement amends APB Opinion No. 26, *Early Extinguishment of Debt,* to make it apply to all extinguishments of debt, whether early or not, other than those currently exempted from its scope, such as debt conversions and troubled debt restructurings.

SFAS 76 is effective for transactions occurring after December 31, 1983, but may be applied retroactively.

SFAS 77, Reporting by Transferors for Transfers of Receivables With Recourse, specifies that the sale of receivables with recourse is reported as a sale if the selling company gives up all future economic benefits relating to those receivables and can estimate its obligations under the recourse provisions.

The company acquiring the receivables must not have the right of return, unless in accordance with the specified recourse provisions. Gain or loss should be recognized on the sale at the time the transfer is made rather than over the period during which the receivables would be outstanding.

This Statement is effective for all transfers of receivables after December 31, 1983 including those made in accordance with earlier agreements. It amends a minor provision of SFAS 13 (Accounting for Leases).

SFAS 78, Classification of Obligations that are Callable by the Creditor, indicates that if long-term debt becomes callable as the result of the violation of a debt covenant and that violation still exists at the balance sheet date, the obligation would generally be classified as a current liability. If, however, the creditor has waived or has lost the right to demand repayment for a period in excess of one year from the balance sheet date, or the debtor expects to refinance the obligation on a long-term basis, the obligation would not be classified as current.

SFAS 78 amends ARB No. 43, Chapter 3A, "Current Assets and Current Liabilities," to specify the balance sheet classification of obligations that, by their terms, are or will be due on demand within one year (or operating cycle, if longer) from the balance sheet date.

Short-term obligations expected to be refinanced on a long-term basis, including those callable obligations discussed herein, continue to be classified in accordance with SFAS 6, *Classification of Short-Term Obligations Expected to Be Refinanced.*

This Statement is effective for fiscal years beginning after December 15, 1983.

FASB Interpretation No. 37, Accounting for Translation Adjustments Upon Sale of Part of an Investment in a Foreign Entity, an interpretation of SFAS 52, *Foreign Currency Translation,* applies to paragraph 14 of that Statement. The Interpretation indicates that when an enterprise sells part of an ownership interest in a foreign entity, a pro-rata amount of the accumulated translation adjustment component of equity which applies to that investment should be recognized in measuring the gain or loss on the sale. The Interpretation is effective for transactions entered into after June 30, 1983.

FASB Technical Bulletin 83-1, Accounting for the Reduction in the Tax Basis of an Asset Caused by the Investment Tax Credit, expresses the FASB staff's opinion that the portion of the investment tax credit that reduces the tax basis of the asset under TEFRA is in substance a timing difference. Therefore, the effect of the basis reduction should be reported as a timing difference and tax-effected as required by APB Opinion 11. It applies only to those enterprises that recognize investment tax credits by the flow-through method.

The Technical Bulletin was issued when the FASB dropped from its agenda a proposed Statement on the issue.

The FASB Task Force on Timely Financial Reporting Guidance has submitted a special report to the Board containing four general recommendations and suggested methods for implementing them. The summary of the report states:

> The Task Force... agrees with extensive input received... that indicates the Financial Accounting Standards Board generally has provided adequate guidance in a timely manner for resolution of emerging issues and implementation of FASB standards. The Task Force also received and endorses several suggestions designed to improve the FASB's ability to identify and deal with a limited number of issues more expeditiously, which some respondents believe will enhance the Board's ability to concentrate on its conceptual framework project and other major projects involving broad standards.

The Task Force's conclusions and recommendations are that the Board should:

1. Remain the sole standards-setting body for financial accounting and reporting for the private sector. Accordingly, the FASB would remain the sole body recognized by the AICPA to establish financial accounting and reporting standards subject to its Ethics Rule 203.
2. Explicitly affirm its responsibility to provide timely guidance on emerging issues and implementation of standards and its intent to

monitor and assess the state of financial reporting and to deal promptly with significant issues.

3. Broaden the scope of FASB Technical Bulletins, allowing them to address emerging and implementation issues as well as specialized industry accounting questions. Technical Bulletins should be used to address many of the narrow issues of the type that the Board has previously addressed in FASB Statements and Interpretations. Due-process procedures are in place for Technical Bulletins and need not be changed.
4. Establish an advisory group to assist the Board and FASB staff in identifying and defining financial reporting issues and to suggest solutions if possible. The composition of the advisory group should be supplemented as appropriate to include individuals with specialized knowledge for specific issues.

The Task Force believes that implementation of its recommendations will accomplish the following positive changes:

- Reduction of the amount of due process procedures required for narrow issues will allow them to be resolved more quickly and efficiently by Technical Bulletins.
- Reduction of the amount of time that Board members must spend to study and deliberate narrow issues will allow them to concentrate more on concepts and broad standards issues.
- Discussion of emerging and implementation issues by the advisory group may resolve some potential issues before diverse accounting practices become established, thereby eliminating the need for any pronouncement to address them, or help identify problems earlier and provide a definition of the problem and possible solutions if a pronouncement is needed.

AICPA

STATEMENTS ON AUDITING STANDARDS

SAS 45, Omnibus Statement on Auditing Standards – 1983, supersedes three earlier auditing standards that furnish guidance in three areas: timing of substantive tests, related-party transactions and supplementary oil and gas reserve information. Only the first of these provides additional guidance; the other two were issued in response to recently issued FASB statements on the named issues, and do not affect existing auditor's procedures and responsibilities.

Substantive Tests Prior to the Balance-Sheet Date, which supersedes SAS 1, Section 310.05-.09, provides guidance on the factors auditors should consider before applying substantive tests at interim dates. It indicates that auditors should consider

- Whether adverse business conditions or the inability of the accounting system to process information accurately increases the risk of applying tests of details at interim dates.
- Whether the effectiveness of substantive tests might be impaired by the absence of particular internal accounting control procedures.
- Whether sufficient evidential matter will be available at both the interim date and the balance sheet date and concerning the transactions that occur between those dates.
- Whether audit conclusions drawn from the interim work might not remain valid at the balance sheet date.

This Statement also provides guidance on auditing procedures that should be applied to provide a reasonable basis for extending the audit conclusions at the interim date to the balance sheet date.

Related Parties supersedes SAS 6, *Related Party Transactions,* by removing guidance on accounting considerations and disclosure standards that are now provided in SFAS 57, *Related Party Disclosures,* issued in March 1982 by the FASB. The SAS makes other appropriate changes, such as revising the discussion in certain paragraphs, including quotations from SFAS 57 and appropriately renumbering the paragraphs and footnotes of SAS 6.

Supplementary Oil and Gas Reserve Information supersedes SAS 33 (of the same name) to respond to changes in supplementary disclosures requirements specified in SFAS 69, *Disclosures about Oil and Gas Producing Activities.* It amends references to specific disclosure items to be consistent with the requirements of the FASB Statement.

SAS 45 is effective for examinations of financial statements for periods ended after September 30, 1983.

SAS 46, Consideration of Omitted Procedures After the Report Date, provides guidance on the considerations and procedures to be applied by an auditor who, subsequent to the date of his report on audited financial statements, concludes that one or more auditing procedures considered necessary in the circumstances were omitted from his examination of the financial statements, but there is no indication that those financial statements are not fairly presented.

The SAS requires that, upon concluding that an auditing procedure considered necessary in the circumstances was omitted from his examination, the auditor assess the importance of the omitted procedure to his present ability to support his previously expressed opinion on the financial statements taken as a whole. If the auditor concludes that the omission materially affects his present ability to support his opinion, the SAS requires that the auditor promptly undertake to apply the omitted procedure or alternative procedures that would provide a satisfactory basis for his opinion.

If the application of the omitted procedure or alternative procedures makes the auditor aware of facts regarding the financial statements that existed at the date of his report and that would have affected his report, had he been aware of them, the SAS refers the auditor to SAS No. 1, section 561.05-.09 that deals with notification of those relying on the report.

If the auditor is unable to apply the omitted procedure or alternative procedures, the SAS advises him to consult his attorney regarding his responsibility to notify his client, regulatory authorities and other persons relying, or likely to rely, on his report.

SAS 46 is effective October 31, 1983.

SAS 47, Materiality and Audit Risk in Conducting an Audit, provides guidance on the auditor's consideration of materiality and audit risk in planning the nature, timing and extent of audit procedures and in evaluating the results of those procedures. The major requirements of the SAS are that the auditor:

- Use a preliminary estimate of materiality for the financial statements taken as a whole to plan audit procedures.
- Plan his examination so that the audit risk will be limited to a relatively low level appropriate for expressing an opinion on the financial statements.
- After he has assessed inherent and control risks, consider to what extent audit risk needs to be limited by performing substantive tests.
- When evaluating whether the financial statements are materially misstated, aggregate likely errors so that he may consider them in relation to individual amounts or subtotals included in the financial statements.
- Include in the aggregate error any difference between an accounting estimate included in the financial statements and the closest estimate that the auditor believes is reasonable.
- Consider the risk that the financial statements might be materially misstated due to further error remaining undetected because of the imprecision inherent in audit procedures.
- Note that an error identified in a prior period that affects the current financial statements be included in the aggregate error and that such errors be considered when planning audit procedures.

The Statement recognizes that although both qualitative and quantitative factors may influence an auditor to decide that an error is material, the auditor generally plans the audit only to detect quantitatively material errors.

SAS 47 is effective for periods beginning after June 30, 1984.

Subsequent Events Procedures and Shelf Registration Statements, responds to the question, "Under what circumstances does the independent accountant have a responsibility to perform subsequent events procedures after the original effective date of the registration statement?" The accountant should perform the procedures in SAS 37, paragraphs 10 and 11, when either:

a. A post-effective amendment to the shelf registration statement, as defined by SEC rules, is filed pursuant to Item 512(a) of Regulation S-K[1] or

b. A 1934 Act filing that includes or amends audited financial statements is incorporated by reference into the shelf registration statement.

The footnote [1] describes the circumstances under which a post-effective amendment is required, as follows:

- When a new Form 10-K or 11-K is incorporated by reference into a shelf registration statement (which is then considered a new registration statement).
- When there is a subsequent "fundamental change" in the information in the registration statement.
- When there is new material information regarding the plan of distribution.

On the other hand, subsequent events procedures would not be necessary when a 1934 Act filing is incorporated by reference without the need for a post-effective amendment, for example, when a Form 10-Q or 8-K is filed and does not affect the audited financial statements in the shelf registration statement. Nor would they be required when a "sticker" supplement to the prospectus is filed. In both these cases the effective date of the registration statement is unchanged.

Form of Report on Internal Accounting Control Based Solely on a Study and Evaluation Made as Part of an Audit *(An Interpretation of SAS No. 30, Reporting on Internal Accounting Control).* This says that the auditor may modify the wording on the SAS 30 sample report on internal accounting control, provided the scope limitations of the underlying study are disclosed, and certain other SAS 30 requirements are adhered to. A sample report for this situation is offered. The Auditing Standards Division also notes that "less formal means" than SAS 30-style reports (for example, letters or memoranda) should not be used by the auditor when reporting on the basic elements of internal accounting control. These "less formal means" are appropriate for additional comments or suggestions to management concerning internal accounting control.

Reporting on Internal Accounting Control Based Solely on an Audit When a Minimum Study and Evaluation is Made *(An Interpretation of SAS No. 30).* One of SAS 30's report formats is designed for situations in which only a preliminary review of internal accounting control has been made. The Auditing Standards Division staff says that this style of report is sufficient even if the auditor has become aware of a material weakness during his evaluation. But if he so chooses, the auditor might also give a fuller description of how limited his study was.

Report Required by U.S. General Accounting Office Based on a Financial and Compliance Audit When a Study and Evaluation Does Not Extend Beyond the Preliminary Review Phase *(An Interpretation of SAS No. 30).* This Interpretation gives a report example for such a situation. The request for the Interpretation came up because certain GAO requirements state that in such an instance "the auditors must describe in their report why a study was not made."

Restricted Purpose Report Required by Law to be Made Available to the Public *(An Interpretation of SAS No. 30)* notes that the "restricted purpose" clause (paragraph 49, SAS 30) may be modified in reports to public bodies, but not omitted. The Auditing Standards Division offers a modifying paragraph noting that the report may be distributed as a matter of public record.

AUDIT AND ACCOUNTING GUIDES

Audit Sampling. This audit and accounting guide was issued to provide guidance to auditors in applying audit sampling in accordance with SAS 39, which became effective in June 1983. The guide covers statistical and non-statistical approaches for both substantive testing of details and compliance testing of internal accounting controls.

Substantive Testing. Substantive statistical sampling techniques in the guide include probability-proportional-to-size (PPS) sampling (which we call monetary unit sampling) and variables sampling. The section on PPS sampling includes the detailed techniques necessary for the auditor to perform a PPS application. The variables sampling section summarizes the different techniques, but expects the auditor to use computer programs to perform such techniques. Non-statistical sampling is discussed only in general terms. Major substantive testing topics discussed in the guide are:

- tolerable error (i.e., planning materiality)
- risk of incorrect acceptance
- sample size determination
- projecting the results of the sample
- the need for qualitative evaluation
- situations when sampling is not appropriate.

Compliance Testing. Attribute sampling is the only sampling technique described in the guide for compliance tests of internal accounting controls. Major compliance testing topics discussed in the guide are:

- tolerable rate of compliance deviations
- risk of overreliance
- sample size determination
- evaluating the results of the sample
- the need for qualitative evaluation.

Audits of Banks. This industry audit guide, which replaces the 1968 guide, is a comprehensive aid to auditors that describes the industry and its unique accounting practices, presents audit objectives and the procedures to attain them, and discusses in some detail other areas of interest to the auditor, i.e., study and evaluation of internal control, audit sampling and audit of EDP systems.

Certain issues currently under study by the AICPA or the FASB have not been addressed in the guide, but they may be included in amendments to the guide. Among the issues are acquisition and amortization of goodwill, regulatory mark-to-market accounting, loan and fee recognition, and accounting for futures and forward contracts.

The accounting provisions of the guide are effective for financial statements prepared after December 31, 1983.

Audits of Employee Benefit Plans. This audit and accounting guide provides guidance to the auditor in examining and reporting on the financial statements of defined benefit pension plans, defined contribution plans and health and welfare benefit plans. It applies both to plans subject to ERISA requirements and those that are not.

Appendices include applicable portions of ERISA and SFAS 35, internal control considerations and illustrations of financial statements for the three types of employee benefit plan. Also included in the guide are several examples of accountants' reports for standard examinations, regulatory compliance, non-GAAP basis financials and limited-scope examinations.

The guide is effective for examinations of financial statements for plan years beginning after December 31, 1982.

Personal Financial Statements Guide. This guide is an aid to accountants who compile, review or audit personal financial statements. It covers the procedures to be followed for each type of engagement and gives sample engagement and representation letters and accountants' reports. Because personal financial statements should be prepared on an estimated current value basis as set forth in SOP 82-1, the text of the SOP is reproduced in an appendix.

OTHER AICPA GUIDANCE

Accounting for ADC Loans: In the November issue of the *Journal of Accountancy,* the task force on real estate lending activities of financial institutions provided guidance on whether an acquisition, development or construction (ADC) loan is to be accounted for as an investment in the borrower's project or as a loan.

In the list of criteria indicating that the lender's risks and rewards in the arrangement are similar to those of a loan (p. 52), the second criterion states:

> "The lender has recourse to substantive net assets of the borrower other than the ADC project . . ."

The firm has interpreted this criterion to mean that, if the borrower has substantive assets (other than the project assets), a full recourse note (i.e., the lender has recourse to the borrower's assets generally) meets the intent of this criterion, and specific assets need not be pledged.

SECURITIES AND EXCHANGE COMMISSION

FINANCIAL REPORTING RELEASES

FRR 8, Adoption of Amendments to Article 6 of Regulation S-X Related to Registered Investment Companies, amends Article 6 (and certain Rules of Articles 3, 5 and 12) of Regulation S-X regarding financial statements filed by registered investment companies. The amendments (1) eliminate rules which are duplicative of generally accepted accounting principles, (2) effect changes to recognize current industry practices, and (3) integrate and simplify the rules to improve financial reporting. In addition, financial statement requirements for employee stock purchase, savings and similar plans are also being amended and transferred to a separate Article 6A. The amended rules are effective for companies and plans with fiscal years ending after June 15, 1983, with earlier implementation encouraged. Where comparative financial statements are presented, all reporting periods shall conform with the rules being adopted.

These amendments simplify the requirements of Article 6 by integrating those rules which apply to more than one type of investment company and segregating other rules which are unique to a specific type of registered investment company or plan. A number of special rules continue to apply, however, to face-amount certificate investment companies and to employee stock purchase, savings and similar plans.

In a number of instances the amended Article 6 differs from the AICPA Guide, *Audits of Investment Companies,* and related SOPs. The SEC will reexamine the rules adopted in this Release after the FASB has completed its project of extracting the specialized principles and practices from the guide and the SOPs and has issued them as FASB Statements.

FRR 9, Supplemental Oil and Gas Disclosures, announces the adoption of rules that require compliance with SFAS 69, *Disclosures about Oil and Gas Producing Activities.* The rules are effective for fiscal years beginning after December 15, 1982, with earlier application encouraged. The requirements have been added to Item 302(c) of Regulation S-K, and previous Rule 4-10(k) of Reg. S-X will be deleted when SFAS 69 is fully effective.

Under SFAS 69, *all* companies have to disclose which of the two alternative methods they are using, full cost or successful efforts. In addition, public companies must make the following disclosures as supplementary information:

- Proved oil and gas reserve quantities
- Capitalized costs
- Costs incurred in property acquisition, exploration and development
- Results of operations
- A standardized measure of discounted future net cash flows relating to proved oil and gas reserves.

The key differences between the SEC's new rules and SFAS 69 are administrative in nature, pertaining to the periods presented and the enterprises affected. Certain companies that do not meet the SFAS 69 definition of "public" are still subject to the SFAS 69 supplemental disclosures under SEC rules.

FRR 10, Accountant's Independence, revises Rule 2-01(b) of Regulation S-X by redefining the term "member" (of an independent accounting firm) as it pertains to an accountant's independence. Now, a professional employee located in an office of the firm that is participating in a significant part of the audit but who does not participate in the audit and does not have managerial responsibility, is not subject to the Rule. Presumably an employee in another office of the firm that is not involved in the audit, even if he or she does have managerial responsibilities, is likewise not subject to the Rule. All partners and principals of the firm continue to be subject to the Rule.

Accounting firms will have to weigh the meaning of "managerial responsibility" and "significant part of the audit," since the SEC has not yet furnished any guidance.

FRR 11, Financial Statements of Bank Holding Companies, amends Article 9 of Regulation S-X. The amendments eliminate rules that duplicate GAAP and simplify the remaining rules to reflect current financial reporting practices and to improve financial reporting generally. The amendments are effective for financial statements for fiscal years ending on or after December 31, 1983; earlier application is permitted.

Some of the disclosures that Article 9 previously required in the primary financial statements have been moved to the Industry Guide (Guide 3). The most significant of these relate to information about short-term borrowings, disclosure of investment concentrations, and certain details about foreign activities. The Commission concluded that these disclosures were primarily analytical and thus similar to other Guide 3 type disclosures.

The proxy rules have also been amended to require that financial statements in annual reports to shareholders conform to Regulation S-X. The interim rule requiring only substantial compliance with Article 9 has been eliminated.

For the most part, the final rules reflect current reporting practices, except for the income statement presentation of investment securities gains and losses, the disclosure requirements for loans to related parties, and parent company financial information, as described below.

Investment Securities Gains and Losses. The Commission rejected continuation of the typical "two-step" income statement format previously used; instead, investment securities gains and losses will have to be presented as a separate "subcategory" of other income.

Loans to Related Parties. In general, the final rules for related party disclosures will be consistent with the requirements of Item 404 of Regulation S-K. The rules will require disclosure of loans of more than $60,000 (loans not made in the ordinary course of business must be disclosed regardless of the amount) to directors, executive officers or principal stockholders or to any of their "associates," as defined. "Associates" includes members of the immediate family, i.e., spouse, parents, children, siblings, and any in-laws.

Disclosure is not required if loans to all such persons above, in the aggregate, do not exceed five percent of stockholders' equity. Note that this five-percent test relates to the financial statements only; no such global test is contained in Item 404 of Regulation S-K as to the related party disclosures required in the non-financial statement portion of the various filing forms.

If a significant portion of the aggregate amount of loans to all related parties relates to nonperforming loans, this fact must be disclosed, along with the dollar amount and other relevant information.

Parent Company Financial Information. Parent company financial information, previously furnished as a schedule, will now be required in a note to the financial statements and, thus, available in the annual reports to shareholders.

FRR 12, Accounting for the Costs of Internally Developed Computer Software for Sale or Lease to Others, significantly restricts the ability of SEC registrants to capitalize such costs. Only those companies that had publicly disclosed the practice of capitalizing software development costs prior to April 14, 1982 (the date the Release was issued) may continue the practice, and then only if the net amount of such costs is disclosed. The Commission also indicated that, because of the rapid change and competition in the industry, amortization periods are expected to be very short.

The new rule appears as Rule 3-21 of Regulation S-X and as Item 21(j) of Form S-18. Background and discussion are given in new Section 218 of the Codification of Financial Reporting Releases. The requirements of the rule will remain in effect until the FASB provides specific guidance on the issue.

FRR 13, Revision of Industry Guide Disclosures for Bank Holding Companies, deletes from Guide 3 the term "nonperforming loans" and adds a new section IIIC called "Risk Elements." Four categories of disclosure are specified:

1. Nonaccrual, past due and restructured loans
2. Potential problem loans – those where management believes the borrower may not, because of possible credit problems, be able to comply with the loan repayment terms
3. Foreign outstandings – disclosure is required of the country and the amount of loans to foreign borrowers that exceed 1% of total assets
4. Loan concentrations – disclosure is required of loans (that exceed 10% of total loans) to multiple borrowers that engage in similar activities that may cause them to be similarly affected by economic or other conditions.

The Release also adds a new disclosure item IIID, requiring disclosure of the nature and amount of any interest-bearing assets that would have to be disclosed if those assets were loans.

FRR 13 is effective for fiscal years ending on or after December 31, 1983, with early adoption encouraged. Disclosure of foreign outstandings is not required for any reporting periods ending before December 31, 1983 if it is impractical to do so. Nonaccrual, past due and restructured loans may be disclosed under the previous guidelines for periods ending before December 31, 1983.

FRR 14, Amendments of Rules for Exclusion of Costs from Amortization by Oil and Gas Producers on the Full Cost Method, permits the general exclusion of all unevaluated costs from immediate amortization and also adopts expanded disclosure requirements for such excluded costs. The disclosures are effective for fiscal years *ending* after December 15, 1983; however, the exclusion rules are effective for costs incurred in fiscal years *beginning* after that date, with earlier application permitted only for prior fiscal years for which annual financial statements have not yet been filed with the SEC.

STAFF ACCOUNTING BULLETINS

SAB 50, One-Bank Holding Company Reporting and Disclosure Requirements, presents the SEC staff's views on disclosures required when a bank holding company is formed and has as its only substantial asset its investment in the bank. In a series of questions and staff responses the staff presents its position with respect to disclosures required in registration Form S-14. Financial statements and Guide 3 disclosures are not required if, since the latest financial statements were furnished to shareholders, there has been no material adverse change in the bank's financial condition and if there has been no general change in stock authorized or held. In these circumstances, the bank's financial statements in the report to shareholders used to satisfy the initial Form S-14 requirements need not be audited. However, the consolidated financial statements of the bank holding company included in the next Form 10-K should be audited and the Guide 3 disclosures should be included.

SAB 51, Accounting for Sales of Stock by a Subsidiary, states that the SEC staff will permit such sales that cause a change in the parent's ownership percentage in the subsidiary to be accounted for in accordance with the 1980 AcSEC issues paper, *Accounting in Consolidation for Issuance of a Subsidiary's Stock.* They will accept the issues paper's conclusions that changes in ownership percentage should be recognized in consolidation as gains or losses, and tax effect accounting should be applied. (Before SAB 51 the SEC staff believed that such issuances should be accounted for as capital transactions, not items of income.) They also indicated that SAB 51 is permissive, not mandatory, and these issuances may continue to be accounted for as capital transactions.

SAB 52, Terminations of Overfunded Defined Benefit Pension Plans, points out that the SEC staff will not object to the recognition of a gain on termination of a company's pension plan if all obligations under the terminated plan are fully funded and the substituted employee benefit provisions under the new plan are not based on such factors as past employee service or guaranteed minimum benefits because in such circumstances the substituted plan would in substance be a continuation of the terminated plan.

If gain is recognized, the staff believes that the termination of a pension plan meets the criteria for classification as an extraordinary item under APB 30. Terminations of pension plans are unusual and infrequent. A company's expectation that it would terminate several pension plans over a few years, for example, through negotiations with employee unions, would not affect the staff's position.

Gains or losses from pension plan terminations which arise in connection with decisions to dispose of a segment of the business or close a plant should be reported in the same manner as the costs related to the discontinued operations or plant closing.

SAB 53, Financial Statement Requirements for Filings Involving Parent/Subsidiary Guarantees of Securities, adds new Topics 1G and 1H. Topic 1G gives the financial statement filing requirements when a parent guarantees securities issued by a consolidated subsidiary. Generally, if the subsidiary is wholly owned, has no independent operations and the debt is fully guaranteed, consolidated financial statements of the parent would suffice. Where the subsidiary had some independent operations, summarized financial information of the subsidiary should be included in the footnotes to the parent's consolidated financial statements. If the subsidiary is not wholly owned or the debt is not fully and unconditionally guaranteed, the subsidiary will have to file all the required financial statements as well as the parent's full financial statements. New Topic 1H discusses the infrequent situation in which the subsidiary guarantees securities issued by the parent – in that case financial statements of both subsidiary and parent would be required.

SAB 54 (new Topic 5, Section J) expresses the staff's view that "push down" accounting should be used in the separate financial statements of substantially wholly owned subsidiaries acquired by a company (or a company and related persons) in one or a series of purchase transactions. Substantially wholly owned subsidiaries are those meeting the definition of Rule 1-02(z) of Regulation S-X.

The staff's view is that, when the form of ownership is within the control of the parent, the basis of accounting for purchased assets and liabilities should be the same regardless of whether the entity continues to exist or is merged into the parent's operations. Therefore, the parent's cost of acquiring the subsidiary should be "pushed down," i.e., used to establish a new accounting basis in the subsidiary's separate financial statements.

If less than substantially all of the common stock is acquired or if the acquired subsidiary, though wholly owned, has publicly held debt or preferred stock outstanding, the staff generally would encourage, but not insist upon, use of "push down" accounting.

"Push down" accounting should be followed in:

1. Registration statements of the subsidiary when the subsidiary is registering either stock or debt.
2. Separate financial statements of the subsidiary included in its parent's 1933 or 1934 Act filings because the subsidiary is a significant unconsolidated subsidiary whose financial statements are required in these filings pursuant to Rule 3-09 of Regulation S-X.
3. Summarized financial information on unconsolidated subsidiaries included in the footnotes of their parent's consolidated financial statements.
4. Separate financial statements of a subsidiary to be included in a merger proxy at time of sale by its parent.

SAB 55, Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity; Cheap Stock, adds Topics 1B and 4D to the Staff Accounting Bulletin codification. New Topic 1B says that the separately presented income statements of subsidiaries and divisions must include all costs of doing business, including those incurred by the parent on behalf of the subsidiary. Where specific expenses cannot be identified, they should be allocated on a "reasonable" basis. Topic 4D stipulates that "cheap stock" (and potentially dilutive stock options, warrants and the like) issued to selected persons during the twelve months prior to an initial public offering at less than the public offering price, shall be given effect in earnings-per-share calculations for all reported periods.

OTHER SELECTED SEC RELEASES

Release No. 33-6441 combines in new Item 404 of Regulation S-K all non-financial statement disclosures of transactions and relationships involving a company's management. The new item consists of four parts that relate to transactions with management and certain others, relationships of directors with the company's customers, suppliers or creditors, indebtedness to the company of directors, officers or family members and transactions with promoters.

Release No. 33-6486 amends the rules governing the disclosure of executive compensation to allow companies more choice in selecting the format for disclosure while at the same time making it easier for investors to understand the information disclosed. New Item 402 of Regulation S-K is designed to eliminate the disclosure of contingent compensation by focusing on compensation actually paid or vested and improve the effectiveness of disclosure by directing attention to the compensation of management personnel who perform policy-making functions for the company.

Release No. 33-6488 revises Rule 144 of the 1933 Act to permit non-affiliates of an issuer to resell restricted securities freely after a three-year holding period by eliminating the requirement that current information about the issuer be publicly available. Accordingly, Rule 237 and Form 237 (five-year resale exemption) have been rescinded. The changes are effective October 31, 1983.

Release No. 33-6488 raises the aggregate offering price ceiling for offerings under Form S-18 from $5 million to $7.5 million. The disclosure requirements for management involvement in certain transactions have been amended to conform to the requirements of Item 404 of Regulation S-K. The increase in the aggregate offering price ceiling is effective March 31, 1984; the changes in the disclosure requirements for management involvement in certain transactions are effective December 31, 1983.

Release 34-20091 announces amended Rule 14a-8 which restricts the inclusion of shareholder proposals in the company's proxy statement. Now, a shareholder would have to own $1,000 worth of the company's stock or 1% of the company's outstanding securities, and must have held that stock for at least one year. Also, companies may now exclude proposals that are "substantially similar" to proposals rejected the previous year (unless the proposal had received at least 5% of the shares voted). The purpose of the rule is to reduce the number of "frivolous" proposals appearing in the proxy statement and requiring a vote at the annual meeting – often such proposals are advanced by a shareholder who may hold one recently purchased share.

SEC POSITIONS AND REPORTS

Junior Common Stock Plans: Early in November, in response to a question from a registrant, the SEC took the position that a proposed junior common stock plan would have to be accounted for in a way similar to that of Stock Appreciation Rights.

The amount of compensation expense to be recognized would not be determined at the inception of the plan but rather would be measured at the date the junior common stock was convertible to full common stock.

The SEC takes the position that the abovementioned accounting treatment would be required for any plans where junior common stock had not yet been issued, and for plans considering issuing additional junior common stock. The SEC has not yet decided how to handle the situations where junior common stock or JCS options are already outstanding. The SEC staff is currently looking at existing plans and may decide to force retroactive application of this accounting treatment in some cases.

Twenty-five-Year Goodwill Amortization for Mergers of Financial Institutions: At a November meeting of the AcSEC Planning Subcommittee and the SEC, SEC Chairman Clarence Sampson indicated that he did not believe that there would be any justification for an amortization period in excess of 25 years for goodwill arising from an acquisition of one financial institution by another.

A staff member later noted that Sampson was referring to the goodwill arising when the acquisition price is in excess of the fair value of the net assets acquired which could be amortized over 40 years as per APB Opinion 17. The "goodwill" arising when the liabilities of the acquired institution exceed the fair value of the tangible and identifiable intangible assets would continue to be amortized, in accordance with SFAS 72, over a period which normally ranges from 10-12 years.

The rationale for Sampson's position, a departure from the 40-year amortization period suggested in APB 17, is based on the current environment of deregulation and its impact on financial institutions.

Foreign Corrupt Practices Act – Litigation. The SEC won its first litigated decision under the accounting provisions of the Foreign Corrupt Practices Act against World-Wide Coin, a company engaged in the wholesale and retail sales of precious metals, rare coins, gold and silver coins, and units of bullion. Of the previous some 20 injunctive actions alleging violations of the accounting provisions in Section 13(b)(2), none had reached the courts. Rules adopted under Section 13(b)(2) prohibit falsification of books and records and prohibit directors or officers from misleading auditors either by statements made or withheld. Both rules obviously are of great interest to auditors, and successful litigation under these rules may, in time, impact the validity of record keeping and the validity of statements made to auditors (or the diminishment of statements withheld).

The Court cited numerous violations of the Act by the company's chief executive officer and its employees and noted many deficiencies in internal control.

The SEC Advisory Committee on Tender Offers, in its final report to the Commission, concluded that takeovers per se are neither beneficial nor detrimental to the economy or the securities markets. Some 50 recommendations were offered, the basic theme being that the SEC should maintain a neutral position toward the participants in a takeover, issuing rules only to protect all shareholders and the integrity of the securities markets. In addition, the SEC should maintain a position of flexibility in its regulations so that it may act rapidly on abuses as soon as they occur. Commissioner Shad noted that it will take about a year for the SEC and the Congress to complete action on the recommendations.

TOUCHE ROSS ACCOUNTING AND AUDITING PUBLICATIONS

The Regional Holding Companies – 1984 and Beyond, was issued in early December by the National Accounting and Auditing Staff as part of the Firm's program of service to the telecommunications industry. It offers a summary of key information contained in the massive SEC registration statement filed by AT&T in November with respect to AT&T's divestiture of certain of its operations (including local telephone service, mobile telephone service and Yellow Pages publishing) as of January 1, 1984.

This booklet provides:

- Comparative financial and operating data of the seven regional holding companies and the "new" AT&T.
- Concise descriptions of the new "post-divestiture" companies.
- Key provisions of the divestiture transaction.
- The mechanics of the stock distribution process.
- Federal income tax implications for shareholders.
- A description of the dividend reinvestment and stock purchase plans of the regional companies.