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AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

# ***AICPA Technical Practice Aids***

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Accounting and Auditing Publications  
Technical Questions and Answers

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Statements of Position  
Accounting  
Auditing and Attestation

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Practice Bulletins

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**As of June 1, 1999**

***AICPA Technical Practice Aids***  
**As of June 1, 1999**

AICPA





AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

# ***AICPA Technical Practice Aids***

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Technical Questions and Answers**

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1 2 3 4 5 6 7 8 9 0 AAP 9 9

ISBN 0-87051-278-1



## CHANGES AFFECTING THIS EDITION

### Statements of Position Recently Added

<u>Statement</u>	<u>Title</u>	<u>Addition Date</u>	<u>Section</u>
SOP 98-7	<i>Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk</i>	October 1998	10,760
SOP 98-8	<i>Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934, Rule 17Ad-18 of the Securities Exchange Act of 1934, and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission</i>	November 1998	11,340
SOP 98-9	<i>Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions</i>	December 1998	10,770
SOP 99-1	<i>Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of Its Corporate Compliance Program</i>	May 1999	11,350

In addition, conforming and editorial changes have been made throughout the literature to reflect the issuance of recent pronouncements.





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## HOW TO USE THIS VOLUME

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This volume, which is a reprint of the looseleaf edition of *Technical Practice Aids*, includes selected Accounting and Auditing Publications Technical Questions and Answers, Statements of Position—Accounting, Statements of Position—Auditing and Attestation, AcSEC Practice Bulletins, and a list of Issues Papers of the Accounting Standards Division of the American Institute of Certified Public Accountants.

### How This Volume Is Arranged . . .

The contents of this volume are arranged as follows:

Accounting and Auditing Publications Technical Questions and Answers

Introduction

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### How to Use This Volume . . .

The arrangement of material is indicated in the general table of contents at the front of the volume. There is a detailed table of contents covering the material within each major division.

The major divisions are subdivided into sections, each with its own section number. With respect to Technical Questions and Answers, within each section, each Technical Question and Answer is decimally numbered. For example, section 9430.02, *Reporting on Companies With Different Fiscal Years*, is the second Technical Question and Answer in section 9430. When a Technical Question and Answer is deleted, its number is reserved. Reserved sections are deleted permanently if no future Technical Questions and Answers are expected for a particular topic.

Authoritative pronouncements are referenced in the Technical Questions and Answers, whenever possible, to support the guidance provided. The following list explains the references and cites the publications containing the authoritative literature:

AC	An accounting section from FASB <i>Accounting Standards Current Text</i>
ACC	Statements of Position—Accounting contained in AICPA <i>Technical Practice Aids</i>
AR	Accounting and Review Services standard or interpretation contained in AICPA <i>Professional Standards</i> , vol. 2
AT	Attestation standard or interpretation contained in AICPA <i>Professional Standards</i> , vol. 1
AU	Auditing standard or interpretation contained in AICPA <i>Professional Standards</i> , vol. 1
AUD	Statements of Position—Auditing and Attestation contained in AICPA <i>Technical Practice Aids</i>
EITF	A summary of the proceedings of the Emerging Issues Task Force contained in the FASB <i>EITF Abstracts</i>
ET	Section from the Code of Professional Conduct of the AICPA contained in AICPA <i>Professional Standards</i> , vol. 2
GAFRS	An accounting section from the GASB <i>Codification of Governmental Accounting and Financial Reporting Standards</i>
PB	Practice Bulletins of the AICPA Accounting Standards Division contained in AICPA <i>Technical Practice Aids</i>

**Note:** Generally, abbreviations are not used to reference AICPA Audit and Accounting Guides. Each guide is published separately and is also included in the AICPA *Audit and Accounting Guides* subscription service.

The TIS topical index for the Technical Questions and Answers uses the key word method to facilitate reference to the inquiries. This index is arranged alphabetically by subject, with references to section numbers.

Statements of Position—Accounting are assigned section numbers in chronological order as they are issued. Each paragraph or equivalent is decimally numbered for reference purposes.

The ACC topical index for the Statements of Position—Accounting facilitates reference to the Statements. This index is arranged alphabetically by subject, with references to section and paragraph numbers.

Statements of Position—Auditing and Attestation are assigned section numbers in chronological order as they are issued. Each paragraph or equivalent is decimally numbered for reference purposes.

Practice Bulletins are assigned section numbers in chronological order as they are issued. Each paragraph or equivalent is decimally numbered for reference purposes.

A list of Issues Papers of the Accounting Standards Division, in chronological order, is included in a separate division.

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# **ACCOUNTING AND AUDITING PUBLICATIONS TECHNICAL QUESTIONS AND ANSWERS (NONAUTHORITATIVE)**

## **Introduction**

The AICPA Accounting and Auditing Publications group has been engaged in a continuing effort to improve this publication. Our goal is to provide a publication that contains relevant and accurate questions and answers that will be a source of helpful nonauthoritative guidance to our members. The existing questions and answers in this section are subjected to ongoing review for technical accuracy and relevance. A key element of this ongoing review process is the feedback that is received from practitioners. We ask for and appreciate your corrections and suggestions with regard to this publication. Please contact:

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# ACCOUNTING AND AUDITING PUBLICATIONS TECHNICAL QUESTIONS AND ANSWERS (NONAUTHORITATIVE)

## Notice to Readers

The questions and answers in this section of the AICPA TECHNICAL PRACTICE AIDS are based on selected practice matters identified by the staff of the AICPA's Technical Hotline, the Accounting and Auditing Publications group, and various other bodies within the AICPA.

This material has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the American Institute of Certified Public Accountants. **These answers are not sources of established accounting principles as described in Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, nor are they sources of authoritative generally accepted auditing standards.**

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## TIS Section 1000

# FINANCIAL STATEMENT PRESENTATION

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## Section 1100

### ***Statement of Financial Position***

#### **.03   Unclassified Balance Sheet for Venture With Limited Life**

*Inquiry*—A corporation has recently been organized with the sole purpose of constructing a shopping center which will take several years to complete, after which the company will be liquidated. The company uses the completed contract method to recognize income, and will have only one operating cycle. Would an unclassified balance sheet be appropriate?

*Reply*—An unclassified balance sheet would be more appropriate than a classified one in this situation. The sole purpose of the corporation is to construct the shopping center, and the appropriate time frame for reporting purposes, by definition, becomes the time required to complete the project, rather than an arbitrary one-year period.

#### **.06   Classification of Idle Property**

This Question and Answer is currently being revised.

#### **.07   Comparative Statement Disclosures**

*Inquiry*—When financial statements of the prior period are presented on a comparative basis with financial statements of the current period, should the notes to the comparative financial statements disclose details for the prior year?

*Reply*—Generally, in practice notes to comparative financial statements are also comparative if they present details of items on the financial statements or are otherwise pertinent. For example, details of notes payable outstanding at the end of each period are normally disclosed, but the future maturities disclosure need only be disclosed for the current year. [Amended June 1995.]

#### **.08   Classification of Outstanding Checks**

*Inquiry*—Should the amount of checks that have been issued and are out of the control of the payor but which have not cleared the bank by the balance sheet date be reported as a reduction of cash?

*Reply*—Yes. A check is out of the payor's control after it has been mailed or delivered to the payee. The balance sheet caption "cash" should represent an amount that is within the control of the reporting enterprise, namely, the amount of cash in banks plus the amount of cash and checks on hand and deposits in transit minus the amount of outstanding checks. Cash is misrepresented if outstanding checks are classified as liabilities rather than a reduction of cash.

#### **.12   Classification of Inventory Stored in a Grain Elevator**

*Inquiry*—Should the operator of a grain elevator report in its financial statements grain owned by others and stored in its grain elevator?

*Reply*—No. Grain stored for others should not be included on the balance sheet of a grain elevator operator. SAS No. 1, section 901, *Public Warehouses—Controls and Auditing Procedures for Goods Held*, paragraph 13 (AU 901.13), states that goods held for others by a warehouseman are not owned by the warehouseman and should not appear in his financial statements. The same is true for grain stored for others by a grain elevator.

**.14 Classification of Convertible Debt**

*Inquiry*—A company has debt that is convertible into common stock of the company at the option of the company. The debt by its terms is considered long-term debt in the classified balance sheet. The company intends to call the debt and issue the common stock within one year of the balance sheet date. Should this debt be classified as a current liability?

*Reply*—No. The expected call of the debt securities will not consume current assets or increase current liabilities, and accordingly should continue to be classified as a long-term obligation.

The general principle underlying the classification of debt in a debtor's principal balance sheet should be based on facts existing at the date of the balance sheet rather than on expectations. ARB No. 43, Chapter 3A, *Current Assets and Current Liabilities*, paragraph 7 (AC B05.402), states that "the term current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities."

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## Section 1200

### Income Statement

#### .01 Disclosure of Revenues of an Agent

*Inquiry*—Company A is in the business of arranging sales of used cars for which service it receives a commission based on an established fee schedule. Company A receives title to the cars sold but simultaneously transfers title to the car buyer. Company A warrants main engine components for thirty days after date of sale.

The following presentations of revenue in the income statement are being considered:

Commissions Earned	<u>\$20,000</u>
or	
Sales	\$ 300,000
Cost of Sales	<u>(280,000)</u>
Gross Profit (or Net Commissions)	\$ 20,000

What is the proper presentation of revenue?

*Reply*—Since Company A is operating as a broker, Company A should report Commissions Earned rather than Sales. However, Company A could disclose above the Commissions Earned figure, without showing a deduction, the amount of sales, as follows:

Sales Arranged	<u>\$300,000</u>
Commissions Earned	\$ 20,000
Expenses, etc.	XXX

Company A should also make proper provision for the cost of warranties.

#### .04 Statement Title When There Is a Net Loss

*Inquiry*—What title is suggested for the "Statement of Income" when a "net loss" exists in one or more years?

*Reply*—Companies included in the annual survey entitled *Accounting Trends & Techniques* ("Trends") file with the Securities and Exchange Commission. Accordingly, their annual reports include a three year statement of income. If a current year net loss is shown in the income statement, the "Trends" companies usually describe the statement of income as the "Statement of Operations." They occasionally use the title "Statement of Income (Loss)" and very rarely use the title "Statement of Loss."

Some companies always use "Statement of Operations" since the heading will be the same whether there is a "net loss" or "net income."

#### .05 Presentation of Reimbursed Payroll Expense

*Inquiry*—One company of a controlled group, in addition to its own operations, acts as a "paymaster" for the entire group. This company records the entire payroll of all members in the group on its general ledger to facilitate reconciliation with state and federal payroll tax returns. Each member of the

group reimburses the “paymaster” for its share of payroll and payroll taxes and records management fee expense while the paymaster records it as management fee income.

Should the reimbursement be classified as other income in the separate income statement of the “paymaster” company?

*Reply*—No. The reimbursement should be allocated as a reduction of payroll and payroll tax expense because this approach would more accurately present the “paymaster” company’s expenses for its own operations.

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## Section 1300

### Statement of Cash Flows

#### .03 Comparative Statements of Cash Flows

**Inquiry**—Is it necessary to provide a statement of cash flows for both the current and prior periods if comparative income statements are presented, but only the current balance sheet is presented?

**Reply**—FASB Statement No. 95, *Statement of Cash Flows*, paragraph 3, (as amended by FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*) (AC C25.101), states:

A business enterprise (except for defined benefit plans and certain other employee benefit plans or for certain investment companies), that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided.

Therefore, if a balance sheet is presented, a statement of cash flows should be presented for both current and prior periods if income statements are presented for such periods. [Amended]

#### .05 Statement of Cash Flows for Annual Report With Balance Sheet Only

**Inquiry**—When only a statement of financial position is presented, is it necessary that the auditor's opinion be qualified relative to the omission of the statement of cash flows?

**Reply**—FASB Statement No. 95, *Statement of Cash Flows*, paragraph 3, (as amended by FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*) (AC C25.101), states:

A business enterprise (except for defined benefit plans and certain other employee benefit plans or for certain investment companies), that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided.

Therefore, when a statement of financial position is not accompanied by a statement of operations, there is no need for presentation of a statement of cash flows, and no comment on the absence of such a statement is necessary. [Amended]

#### .08 Effect of Change in Depreciation Method on Statement of Cash Flows

**Inquiry**—A company which formerly depreciated its equipment on an accelerated basis has changed to the straight-line method. The cumulative effect of this change, net of tax, was a \$100,000 increase in income for the current year. How should this change be shown on the statement of cash flows?

**Reply**—The cumulative effect should be shown on the statement of cash flows under cash flows from operating activities as a reconciling item between

net income and net cash provided by operating activities, if the indirect method is used. If the direct method is used, the cumulative effect should be shown as a reconciling item on the reconciliation of net income to net cash provided by operating activities. [Amended]

## **.10 Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles**

**Inquiry**—When an entity prepares its financial statements on a comprehensive basis of accounting other than generally accepted accounting principles (GAAP), is a statement of cash flows required?

**Reply**—FASB Statement No. 95, *Statement of Cash Flows*, paragraph 3, (as amended by FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*) (AC C25.101), states:

A business enterprise (except for defined benefit plans and certain other employee benefit plans or for certain investment companies), that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided.

SAS No. 62, *Special Reports*, paragraph 7 (AU 623.07), states, in part:

Terms such as “balance sheet,” “statement of financial position,” “statement of income,” or “statement of operations,” and “statement of cash flows,” or similar unmodified titles are generally understood to be applicable only to financial statements that are intended to present financial position, results of operations, or cash flows in conformity with generally accepted accounting principles.

Interpretation 14 of SAS No. 62 (AU 9623.92) states, in part:

While a statement of cash flows is not required in presentations using the cash, modified cash, or income tax basis of accounting, if a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the entity chooses to present such a statement . . . the statement should either conform to the requirements for a GAAP presentation or communicate their substance.

## **.11 The Effect of a Prior Period Adjustment on the Statement of Cash Flows When Single Period Statements Are Presented**

**Inquiry**—How would a prior period adjustment be presented in the statement of cash flows if single period statements are presented?

**Reply**—FASB Statement No. 16, *Prior Period Adjustments*, paragraph 16a (A35.106), states that “prior period adjustments shall, in single period statements, be reflected as adjustments of the opening balance of retained earnings.” A corresponding prior period adjustment will normally result in a change in the beginning balance of an asset or liability account. FASB Statement No. 95, *Statement of Cash Flows*, paragraph 32 (AC C25.132), states, in part:

Information about all investing and financing activities of an enterprise during a period that affected recognized assets or liabilities but that did not result in cash receipts or cash payments in the period shall be reported in related disclosures.

Therefore, the difference in an account between the current balance sheet and that same account in the restated beginning balance sheet (even if not presented) that resulted from the prior period adjustment, should be reflected in the related footnote disclosures and clearly referenced to the statement of cash flows. [Amended]

### **.13 Classification of Increase in Cash Value of Officers' Life Insurance in Statement of Cash Flows**

*Inquiry*—How should the increase in cash surrender value of officers' life insurance be classified in the statement of cash flows?

*Reply*—An increase in the cash surrender value of officers' life insurance would normally be presented as an investing outflow if the increase in cash value is less than the related premium paid. If the increase in cash value exceeds the premium paid, the premium paid is an investing outflow and the remainder of the increase in cash value would be presented as a reconciling item on the reconciliation of net income to net cash provided by operating activities.

### **.15 Presentation of Cash Overdraft on Statement of Cash Flows**

*Inquiry*—A company has accounts at three separate banks. One of the bank accounts is in an overdraft position at year end, thus it is shown as a liability on the balance sheet. Does the company show as cash and cash equivalents on the statement of cash flows only the two accounts with the positive balances or does it show the net cash (the three accounts combined) at the end of the year as its cash and cash equivalents?

*Reply*—The amount that will be shown on the statement of cash flows is the two accounts with the positive balances. Per FASB Statement No. 95, *Statement of Cash Flows*, paragraph 7 (AC C25.105), "The total amounts of cash and cash equivalents at the beginning and end of the period shall be the same amounts as similarly titled line items or subtotals shown in the statements of financial position . . ." The net change in overdrafts during the period is a financing activity.

### **.16 Purchase of Inventory Through Direct Financing**

*Inquiry*—An automobile dealer purchases its inventory from a manufacturer which finances purchases through a finance subsidiary. The finance subsidiary pays the manufacturer directly on behalf of the dealer. Cash is not disbursed by the dealer until the automobiles are sold.

Under the provisions of FASB Statement No. 95, *Statement of Cash Flows* (AC C25), how should the purchases of inventory be reported by the automobile dealer in the statement of cash flows?

*Reply*—A statement of cash flows reports an enterprise's cash receipts and cash payments during the period. Transactions that do not involve cash receipts and cash payments should be excluded from the statement of cash flows. Noncash investing and financing transactions should be reported in separate disclosures.

The purchases of inventory described above do not involve a cash flow by the automobile dealer until the automobiles are sold and the dealer pays the finance subsidiary under the financing arrangement. Therefore, only the cash outflows from payments to the finance subsidiary should be included in the body of the statement of cash flows.

Payments made to the finance subsidiary of the manufacturer should be classified as operating cash outflows in accordance with FASB Statement No. 95, paragraph 23(a) (AC C25.121), which defines operating cash outflows to include principal payments on accounts and notes payable to suppliers for goods acquired for resale.

### **.17 Omission of Reconciliation of Net Income to Cash Flow From Operations**

*Inquiry*—When an accountant is requested to compile financial statements that omit substantially all of the disclosures required by GAAP, [SSARS 1, *Compilation and Review of Financial Statements*, paragraph 19 (AR 100.19)] would the omission of the schedule, “reconciliation of net income to net cash flow from operating activities” required by the direct method of reporting cash flows under FASB Statement No. 95, *Statement of Cash Flows* (AC C25), be considered a departure from GAAP?

*Reply*—Yes. Under the direct method of reporting net cash flows from operating activities, the separate schedule reconciling net income to net cash flow from operating activities is a required part of the cash flow statement. If the schedule is omitted, the accountant should modify his compilation report to disclose a departure from GAAP in accordance with SSARS 1, paragraph 40 (AR 100.40).

### **.18 Presentation on the Statement of Cash Flows of Distributions From Investees With Operating Losses**

*Inquiry*—An entity carries an investment in a limited partnership interest under the equity method of accounting. The partnership had operating losses during the year, but a positive cash flow allowed the partnership to distribute funds to its investors. Would receipt of that distribution by the entity be classified on the statement of cash flows as cash inflows from investing activities or as cash inflows from operating activities?

*Reply*—FASB Statement No. 95, *Statement of Cash Flows* (AC C25), requires dividends received (returns on investments) to be classified as cash inflows from operating activities. Receipts from returns of investments are classified as cash inflows from investing activities.

Distributions to investors from investees should be presumed to be returns on investments and be classified by the investor as cash inflows from operating activities, similar to the receipt of dividends. That presumption can be overcome based on the specific facts and circumstances. For example, if the partnership sells assets, the distribution to investors of the proceeds of that sale would be considered a return of investment and be classified by the investor as cash inflows from investing activities.

### **.19 Classification of Payments on Equipment Finance Note**

*Inquiry*—Under the provisions of FASB Statement No. 95, *Statement of Cash Flows*, paragraph 32 (AC C25.134), noncash investing and financing transactions are to be disclosed in related narrative form or summarized in a schedule. An example of a transaction of this type would be an acquisition of equipment in a transaction in which an enterprise borrows money from a financial institution for the purchase of equipment and the financial institution remits the money directly to the vendor. In a transaction of this nature, should the payments of principal be presented as an outflow in the financing or investing section of the cash flow statement?

*Reply*—Payments on the aforementioned notes would be recorded as financing outflows per FASB Statement No. 95, paragraph 20b (AC C25.118b).

### **.20 Direct vs. Indirect Method for Statement of Cash Flows**

*Inquiry*—A company has decided to present its statement of cash flows using the direct method for the current year although the indirect method was used



in the prior year. Would this change require an explanatory paragraph noting a lack of consistency in the financial statements?

**Reply**—No. A change in the presentation for the statement of cash flows from the indirect to direct method (or vice versa) is considered a change in classification rather than a consistency problem. SAS No. 1, section 420, *Consistency of Application of Generally Accepted Accounting Principles*, paragraph 16 (as amended) (AU 420.16) states:

Classifications in the current financial statements may be different from classifications in the prior year's financial statements . . . material changes in classification should be indicated and explained in the financial statements or notes. These changes . . . ordinarily would not need to be referred to in the independent auditor's report.

If the statement of cash flows is presented for the prior period, it should be restated using the direct method approach for comparative purposes. In addition, disclosure should be made indicating the prior period restatement.

## **.21 Presentation of Financing Transaction on Statement of Cash Flows**

**Inquiry**—A buyer contracts to purchase real estate. The lender gives the buyer a check made payable to the buyer for a loan to purchase the property. The buyer in turn endorses the check over to the seller. How should this financing transaction be presented on the buyer's statement of cash flows?

**Reply**—This transaction should be treated as a cash receipt by the buyer since the buyer was named as payee on the check. The amount of the check should be reported on the statement of cash flows even though the buyer did not convert the check to currency or deposit it in his or her bank account. The cash receipt belongs to the payee named on the check. The buyer should present the amount of the check as "Proceeds From Borrowings" as a cash inflow from financing transactions and "Purchase of Real Estate" as a cash outflow from investing activities.

## **.22 Negative Amortization of Long-Term Debt in Cash Flows Statement**

**Inquiry**—The cash repayments on a long-term loan are less than the interest expense for the period. The amount of the interest expense not paid becomes part of the principal balance (negative amortization). How should the negative amortization be shown on the cash flows statement?

**Reply**—FASB Statement No. 95, *Statement of Cash Flows*, paragraph 28 (AC C25.126), footnote 13, indicates:

Adjustments to [reconcile] net income to determine net cash flow from operating activities shall reflect accruals for interest earned but not received and interest incurred but not paid.

The negative amortization should therefore be treated as an adjustment to net income to remove the effect of this noncash expense. Disclosure should also be considered.

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## Section 1400

### ***Consolidated Financial Statements***

#### **.02 Consolidation of Corporation and Proprietorship**

*Inquiry*—How should the financial statements of a corporation and a proprietorship be consolidated?

*Reply*—This answer assumes that 100% of the corporation capital stock is owned by the proprietorship. If not, the proportion of the net equity of the corporation applicable to the interest of the minority should appear on the balance sheet between liabilities and equity, and on the income statement as a subtraction following the provision for income taxes.

As in any consolidation, the stockholders' equity of the subsidiary corporation should be eliminated against the investment of the parent (the proprietorship). Any net earnings of the subsidiary corporation subsequent to its acquisition and not recorded on the books of the parent should be reflected in the consolidated net equity, which, since the parent is a sole proprietorship, will be a single figure. As income taxes are assessed against the owner as an individual, rather than against the proprietorship, no provision is made for income taxes beyond those payable by the corporation. However, a footnote should disclose such omission, and if it is anticipated that funds will have to be withdrawn from the proprietorship to meet future taxes on income earned to date, this too should be disclosed, with an estimate of the amount thereof if practicable. Of course, provision should be made for elimination of profits to the extent that they may be reflected in consolidated inventories or in other consolidated assets.

#### **.06 Combined and Separate Financial Statements**

*Inquiry*—Company A and Company B are new car dealers with A selling an American made car and B selling a foreign made car. One individual owns 100% of the outstanding stock of both companies.

Both companies A and B are at the same location with separate buildings for sales staffs. Company A maintains the parts and service departments for both companies with the parts inventory, warranty and service receivables of Company B on Company A's books. In return, Company B pays Company A a per car fee for services to be performed on each new car sold by B.

Company A maintains the only used car inventory on the lot adjacent to Company B's building. Each time B receives a used car in trade, it is sold to Company A at the wholesale fair market value.

Although there is a differentiation in sales staffs, management, accounting, secretarial, and other related services are performed by the same staff out of both buildings, and Company B pays a monthly fee for services performed.

Company A has income for the year, but Company B has a loss for the period. Combined financial statements will be prepared, but is it also necessary to provide combining statements for the individual companies?

*Reply*—ARB No. 51, *Consolidated Financial Statements*, paragraph 22 (AC C51.121), states in part:

There are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate statements. For example, combined financial statements would be useful where one individual owns a controlling interest in several corporations which are related in their operations.

Combined financial statements of the companies would be appropriate, and there is no necessity for presenting separate statements for the companies.

Unfortunately, Accounting Research Bulletin No. 51 (AC C51) makes no statement as to appropriate presentation of the stockholder's equity section of a combined balance sheet. Appropriate disclosure, therefore, may depend upon the circumstances. Either on the statement of financial position, or in a note, there should be disclosure for each company of their number of shares of stock that are authorized and outstanding, and the par value. While under some circumstances it might not be necessary to disclose the allocation of retained earnings between the two companies, other circumstances may exist under which such disclosure would be required—e.g., if the losses of either company have been so severe that an insolvent condition might be anticipated.

#### **.07 Reporting on Company Where Option to Acquire Control Exists**

*Inquiry*—Corporation A acquired debentures from Corporation B convertible into common voting stock within ten years at \$1 per share. Corporation A also has an option to purchase additional shares at \$1 per share upon conversion to bring A's holdings in B up to 51% of the total outstanding shares. Corporation A also has the right to appoint a majority of Corporation B's Board of Directors and has done so. Other intercompany transactions are negligible.

May each company issue separate financial statements, or are consolidated statements required? What disclosures would be necessary?

*Reply*—At present there is no ownership of one company by the other, and consolidation would not be proper. Further, since intercompany transactions (other than interest on the debentures) are negligible, combined statements would probably not be particularly useful.

Corporation A should disclose in its financial statements the terms under which it may obtain controlling stock ownership of Corporation B, the amount of interest received, that no other intercompany transactions are significant, and that it presently has the right to and does appoint a majority to Corporation B's Board of Directors. It should also present summarized information as to the assets, liabilities, and operating results of Corporation B, or include B's financial statements with its report.

Corporation B, in addition to disclosing the interest rate and maturity of the convertible debentures, should disclose Corporation A's conversion and option privileges and should disclose that Corporation A has the right to and has appointed a majority to Corporation B's Board of Directors.

#### **.19 Consolidation of Limited Partnerships**

*Inquiry*—Company A, a privately held real estate developer and operator, conducts a portion of its business through limited partnerships in which it is a general partner. The limited partnerships are structured so that Company A,

the general partner, has a 5 percent interest in profits and losses, shares in two-thirds of the cash flow from operations after the limited partners receive their guaranteed payments, and has full authority to operate, manage, refinance, and sell. Should Company A consolidate the limited partnerships?

*Reply*—SOP No. 78-9, *Accounting for Investments in Real Estate Ventures*, paragraph 9, (ACC 10,240.09), states that consolidation is appropriate “only if the substance of the partnership or other agreements provide for control by the general partners.” Since the general partner has full authority to operate, manage, refinance, and sell, the general partner controls the operations of the limited partnerships and should consolidate the limited partnerships.

## **.21 Minority Interest Guarantee**

*Inquiry*—Company A is the majority shareholder and Company B the minority shareholder in Company C. B has guaranteed the debt of C by irrevocable letters of credit. B's share of the net losses of C exceeds its share of C's net assets. Since B guaranteed C's indebtedness, should this be reported as an asset in the consolidated financial statements of A and C?

*Reply*—B's guarantee is similar to a contingent asset and should not be included in the consolidated financial statements of A and C other than through note disclosure. Accordingly, there would be no amount reflected in the consolidated balance sheet for the minority interest, since B's share of the net losses of C exceeds its share of C's net assets. (See ARB No. 51, *Consolidated Financial Statements*, paragraph 15 (AC C51.116).)

If the creditor of C requires B to perform on its guarantee, then B, for accounting purposes, would have a claim against C. After this takes place, a liability to B would be reported in the consolidated financial statements of A and C. [Amended]

## **.22 Intervening Intercompany Transactions Between Subsidiary's and Parent's Year-End**

*Inquiry*—A parent company has a December 31 year-end and its wholly owned subsidiary has a November 30 year-end. The two companies generally have substantial intercompany sales and purchases which are recorded by each company as they occur. The parent uses the subsidiary's November 30 year-end statement to prepare the consolidated financial statements.

The intervening intercompany transactions, which occur between December 1 and December 31, create intercompany account balances which do not eliminate upon consolidation due to the difference in year-ends of the parent and its subsidiary. How should these intervening transactions be accounted for in the consolidated financial statements?

*Reply*—In discussing differences in fiscal periods, ARB No. 51, *Consolidated Financial Statements*, paragraph 4 (AC C51.107), states, “where the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's statements for its fiscal period; when this is done, recognition should be given by disclosure, or otherwise, to the effect of intervening events which materially affect the financial position or results of operations.”

When a subsidiary's fiscal year differs from that of the parent, intercompany accounts may not agree. Transactions in the interval between the subsidiary's year-end and the parent's year-end must be analyzed and appropriate consolidation entries prepared.

A practical approach to preparing these consolidation entries would be to reverse the intervening intercompany transactions in the parent company's accounts but not in the subsidiary's accounts. A summary of these intervening transactions could then be disclosed in a note to the consolidated financial statements.

### **.23 Conforming Subsidiary's Inventory Pricing Method to Its Parent Company's Method**

*Inquiry*—A parent company uses the first-in, first-out (FIFO) cost assumption to price its inventory, while its subsidiary uses the last-in, first-out (LIFO) cost assumption to price its inventory. Must the subsidiary's inventory method be changed to conform to the FIFO method used by its parent company in consolidated financial statements?

*Reply*—There is no requirement under generally accepted accounting principles for the subsidiary to conform its inventory pricing method with the parent company's method. Consolidated statements may be presented with the subsidiary using LIFO and the parent using FIFO. Also, separate subsidiary only statements may be presented on the LIFO basis.

### **.24 Classification of Minority Interest**

*Inquiry*—Where should minority interest be classified in a consolidated balance sheet?

*Reply*—The authoritative literature does not provide definitive guidance on the classification of minority interest. In practice, minority interest is presented as a liability, a component of stockholders' equity or as a separate category between liabilities and stockholders' equity.

The AICPA's *Accounting Trends & Techniques* is a compilation of data obtained by a survey of 600 annual reports to stockholders, undertaken for the purpose of analyzing the accounting information disclosed in such reports. Most companies included in the survey that reflected a minority interest caption presented it as part of noncurrent liabilities or between liabilities and stockholders' equity.

### **.25 Issuance of Parent Company Only Financial Statements**

*Inquiry*—FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, paragraph 15 (AC 182.102), precludes preparation of parent company financial statements for issuance to stockholders as the financial statements of the primary reporting entity. Are there any circumstances under which parent company financial statements may still be prepared?

*Reply*—Yes. ARB No. 51, *Consolidated Financial Statements*, paragraph 24 (AC C51.123), states: "In some cases parent company statements may be needed, in addition to consolidated statements, to indicate adequately the position of bondholders, other creditors, or preferred stockholders of the parent. Consolidated statements, in which one column is used for the parent company and other columns for particular subsidiaries or groups of subsidiaries often are an effective means of presenting the pertinent information."

### **.26 Consolidated Versus Combined Financial Statements**

*Inquiry*—S Corporation has 2000 common shares and 1000 preferred shares outstanding. The preferred shareholders have the same rights as the common shareholders, except the right to vote. Of the 2000 common shares outstanding,

1000 shares are owned by P Corporation and 1000 shares are owned by I (an individual) who also owns all of the outstanding common shares of P Corporation. The preferred shares of S Corporation are owned by an outside party. Should P Corporation consolidate S Corporation for financial reporting purposes?

*Reply*—ARB No. 51, *Consolidated Financial Statements*, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* (AC C51), states that to “justify the preparation of consolidated statements, the controlling financial interest should rest directly or indirectly in one of the companies included in the consolidation.” In this situation P does not control S directly or indirectly and therefore consolidation is not appropriate. Combined financial statements could be presented if the circumstances are such that combined financial statements of S Corporation and P Corporation are more meaningful than separate financial statements.

## **.27    Subsidiary Financial Statements**

*Inquiry*—FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, paragraph 61 (AC C51.101), indicates that “consolidated rather than parent-company financial statements are the appropriate general-purpose financial statements.” May subsidiary-only financial statements be issued without consolidated financial statements?

*Reply*—Yes. Generally accepted accounting principles do not preclude issuance of subsidiary-only statements. Care should be taken to include all disclosures required by FASB Statement No. 57, *Related Party Disclosures* (AC R36), FASB Statement No. 109, *Accounting for Income Taxes*, paragraph 49 (AC C51.108A), and other relevant pronouncements (AC R36.105-106).

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**[The next page is 301.]**





## Section 1500

### ***Financial Statements Prepared Under An Other Comprehensive Basis Of Accounting (OCBOA)***

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For nonauthoritative guidance about OCBOA financial statements, consult the AICPA's publication entitled, *Preparing and Reporting on Cash- and Tax-Basis Financial Statements*. This book is intended to alert the reader to some of the most frequently-encountered issues faced by accounting professionals in dealing with cash- and tax-basis financial statements and provides suggestions and insight into how these issues are resolved in practice. To order this publication, call the AICPA at 1-888-777-7077.

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#### **.04 Terminology for OCBOA Financial Statements**

*Inquiry*—(1) If an entity presents financial statements under an other comprehensive basis of accounting, may GAAP financial statement titles be used?

(2) What should be the caption for “net income” or “net loss,” and may the corporation use “retained earnings”?

*Reply*—(1) No. SAS No. 62, *Special Reports*, paragraph 7 (AU 623.07), states that unmodified GAAP financial statement titles are not acceptable for use in OCBOA financial statements. The paragraph contains a few examples of appropriate financial statement titles (for example, *Statement of Assets and Liabilities Arising from Cash Transactions* and *Statement of Income—Statutory Basis*). However, the examples presented in the authoritative literature were not meant to be all-inclusive and are not the only acceptable titles. Equally acceptable titles would be *Balance Sheet—Cash Basis* or *Statement of Operations—Income Tax Basis*. The selection of specific financial statement titles is a matter of judgment; any modified title would fulfill the requirements of SAS No. 62 (AU 623) as long as it is clear that the financial statements are not prepared in accordance with GAAP.

(2) The authoritative literature is silent regarding the captions to be used within OCBOA financial statements. Therefore, there is no requirement to modify standard GAAP financial statement captions in OCBOA financial statements. If modifications are desired, common examples for cash basis financial statements are *Excess of revenue collected over expenses paid*, *Excess of expenses paid over revenue collected*, and *Accumulated excess of revenue over expenses paid*. For tax-basis financial statements, acceptable modifications include *Retained earnings—income tax basis* and *Net income—tax basis*. [Amended February 1995.]

#### **.05 Substantial Support for Modifications in Cash Basis**

*Inquiry*—Many nonprofit organizations, partnerships, and small businesses prepare their financial statements on a modified cash basis of accounting. Which modifications of the cash basis of accounting have “substantial support” under SAS No. 62, *Special Reports*, paragraph 4c (AU 623.04c)?

*Reply*—The cash basis of accounting and modifications of the cash basis are not formalized in accounting literature. Modifications have evolved through common usage and practice.

Modifications of the cash basis of accounting to record depreciation on plant and equipment and to accrue income taxes were recognized in SAS No. 62, paragraph 4c (AU 623.04c). Ordinarily a modification would have “substantial support” if the method is equivalent to the accrual basis of accounting for the particular item and if the method is not illogical. For example, generally income tax accruals are derived from the tax payable or receivable on the entity’s income tax return(s). An illogical method would be recording revenue on the accrual basis and recording purchases and other costs on the cash basis.

If modifications to the cash basis of accounting do not have substantial support, the auditor should include an explanatory paragraph in his or her report (preceding the opinion paragraph) and should include in the opinion paragraph the appropriate modifying language and a reference to the explanatory paragraph.

If the modifications are so extensive that the modified “cash-basis” statements are, in the auditor’s judgment, equivalent to financial statements on the accrual basis, the statements should be considered GAAP basis. The auditor should use the standard form of report (SAS No. 58, *Reports on Audited Financial Statements*, paragraph 8 (AU 508.08)), modified as appropriate because of departures from generally accepted accounting principles (SAS No. 58, paragraphs 49 through 54 (AU 508.49–54)). For example, financial statements that are presented in conformity with generally accepted accounting principles, except that material leases are not capitalized (FASB Statement No. 13, *Accounting for Leases* (AC L10), are considered GAAP-basis financial statements containing a GAAP departure. [Amended February 1995.]

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[The next page is 451.]

## Section 1600

### ***Personal Financial Statements***

#### **.03 Social Security Benefits—Personal Financial Statements**

*Inquiry*—Do social security benefits to be received based on the future life expectancy of an individual qualify as an asset in personal financial statements?

*Reply*—No. Statement of Position (SOP) 82-1, *Accounting and Financial Reporting for Personal Financial Statements*, paragraph 26 (ACC 10,350.26), indicates that nonforfeitable rights to receive future sums must meet certain criteria to be accounted for as assets. One of these criteria is that the rights must not be contingent on the individual's life expectancy or the occurrence of a particular event, such as disability or death. In this example, because the social security benefits are contingent on the individual's life expectancy, they do not qualify as a recognizable asset for the personal financial statements.

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[The next page is 551.]



## Section 1800

### ***Notes to Financial Statements***

#### **.03 Disclosure of Change in Fiscal Year**

*Inquiry*—What disclosure in the financial statements is necessary when a company changes its fiscal year?

*Reply*—Generally accepted accounting principles do not specifically require disclosure of a change in the fiscal year. However, disclosure of such a change is generally considered necessary to make the financial statements meaningful to users. [Amended]

#### **.04 Derivatives**

*Inquiry*—FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (AC F25), requires certain disclosures for investments made in derivative financial instruments. Some entities have indirect investments in derivatives because they invest in mutual funds that include derivatives in their portfolios. Do these disclosure requirements apply only to direct investments in such instruments or do they apply to indirect investments as well?

*Reply*—No. FASB Statement No. 119 (AC F25) does not require disclosure of indirect investments in derivatives. This topic was specifically addressed by the FASB during the preparation of FASB Statement No. 119 (AC F25). The FASB's position differs from the GASB's conclusion in GASB Technical Bulletin No. 94-1, *Disclosures about Derivatives and Similar Debt and Investment Transactions*, paragraph 4, which states: "... the disclosures ... are applicable if the entity is exposed to risk by indirectly ... holding ... derivatives, such as through participation in a mutual fund. ..."

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# TIS Section 2000

## ASSETS

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## Section 2110

### Cash

#### .02 Checks Held at Balance Sheet Date

*Inquiry*—It is the practice of a company to eliminate its recorded accounts payable balance at the end of each month by writing checks to all of its trade vendors prior to the end of the month. To prevent overdrafts that would result from this practice, the company retains possession of the checks and only mails them to the vendors after the end of the month, when sufficient funds are available to satisfy them.

How should these held checks be accounted for by the company at month end?

*Reply*—At month end the aggregate dollar amount of held checks should be added back to cash and accounts payable. Checks which have not left the custody of the company should not reduce the company's recorded cash or accounts payable balances because they have not been tendered to the vendor to satisfy the debt.

#### .06 Disclosure of Cash Balances in Excess of Federally Insured Amounts

*Inquiry*—Should the existence of cash on deposit with banks in excess of FDIC-insured limits be disclosed in the financial statements?

*Reply*—The existence of uninsured cash balances should be disclosed if the uninsured balances represent a significant concentration of credit risk. Credit risk is defined in FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, paragraph 7 (AC F25.107), as "the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract." As a result, bank statement balances in excess of FDIC-insured amounts represent a credit risk.

A concentration of credit risk exists if an entity has exposure with an individual counterparty or groups of counterparties. For example, a material uninsured cash balance with a single bank should generally be disclosed. In contrast, numerous immaterial uninsured cash balances on deposit with several banks may not require disclosure. The threshold for "significance" is a matter of judgment and will vary with individual circumstances.

An example of disclosure for this circumstance might be:

The Company maintains its cash accounts primarily with banks located in Alabama. The total cash balances are insured by the FDIC up to \$100,000 per bank. The Company has cash balances on deposit with two Alabama banks at December 31, 1996 that exceeded the balance insured by the FDIC in the amount of \$1,100,000.

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[The next page is 761.]



## Section 2120

### Temporary Investments

#### .05 Depreciation on Building Held for Investment

*Inquiry*—A corporation purchased a building and intends to sell it within six months. It is accounted for as an investment rather than a fixed asset. Should the building be depreciated?

*Reply*—No. Depreciation is the systematic allocation of an asset's cost over the asset's service period. Because the building will be recovered through sale rather than through operations, accounting for the building is a process of valuation rather than allocation. FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (AC 108.122), concludes that long-lived assets to be disposed of should not be depreciated during the period they are held for disposal. The asset should be reported at the lower of carrying amount or fair value less cost to sell.

The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. The cost to sell an asset to be disposed of are generally the incremental direct costs to transact the sale of the asset, such as broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred. Costs generally excluded for cost to sell an asset to be disposed of are insurance, security services, utility expenses, and other costs of maintaining the asset.

#### .06 Accounting for Preferred Dividends Received on Investments in Common Stock

*Inquiry*—A company received dividends on its investment in common stock of another company in the form of preferred stock. How should the dividend be recorded?

*Reply*—The assets and related dividend income should be recorded at fair value. APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, paragraph 18 (AC N35.105), states that in general, accounting for nonmonetary transactions should be based on the fair values of the assets or services involved which is the same basis as that used in monetary transactions and that a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received. (ARB No. 43, chapter 7B, *Stock Dividends and Stock Split-ups* (AC C20), discusses accounting for stock dividends by the recipient; however, the scope of that pronouncement specifically excludes distributions of a different class of shares from that owned.) [Amended June 1995.]

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[The next page is 811.]



## Section 2130

### *Receivables*

#### **.05 Out-of-Pocket Costs Incurred by a Law Firm**

*Inquiry*—A law firm incurs certain out-of-pocket costs on behalf of its clients. If the law firm's efforts on behalf of the client are successful, these costs are recovered from the client in addition to the legal fees. If the case is lost, the costs are absorbed by the law firm. How should these costs be treated by the law firm?

*Reply*—These out-of-pocket costs should be reported as an asset in the financial statements of the law firm (for example, in an account called "client costs receivable"). At each balance sheet date, the law firm should apply the criteria in FASB Statement No. 5, *Accounting for Contingencies*, paragraph 3 (AC C59.104) to determine whether a loss contingency should be accrued.

If an asset is recorded, an allowance for unrecoverable client disbursements should be established representing the estimated amount of such costs that will not be realized. If these out-of-pocket costs become uncollectible because a case is lost, they should be written off against the allowance. [Amended June 1995]

#### **.07 Requirement for Doubtful Accounts Allowance**

*Inquiry*—Do generally accepted accounting principles require an enterprise to establish an allowance for doubtful accounts even though management, based on analysis of the receivables and past charge-off experience, believes that no accounts are uncollectible at the balance sheet date?

*Reply*—FASB Statement No. 5, *Accounting for Contingencies*, paragraph 22 (AC C59.128), states that "the conditions under which receivables exist usually involve some degree of uncertainty about their collectibility, in which case a contingency exists . . ." FASB Statement No. 5, paragraph 8 (AC C59.105), would require an accrual of a loss by a charge to income if both of the following conditions exist:

- a. "Information available prior to issuance of the financial statements indicates that it is probable that an asset has been impaired . . . at the date of the financial statements." and
- b. "The amount of loss can be reasonably estimated."

If both conditions are not met, an allowance for doubtful accounts would not be required. Further, there is no requirement to disclose the absence of a loss accrual. If the conditions are met, an accrual for the loss should be recognized even though the specific receivables that are uncollectible may not be identifiable.

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[The next page is 861.]





## Section 2140

### *Inventories*

#### **.01 Warehousing Included in Cost of Inventory**

*Inquiry*—A client deals in wholesaling and retailing automotive tires for foreign cars. Most of the inventory is imported, and it is valued on the company's records at the actual inventory cost plus freight-in. At year-end, the warehousing costs are prorated over cost of goods sold and ending inventory. The company's auditor believes the warehousing costs should not be capitalized to inventory, but the entire amount should be expensed in the year the costs are incurred. Are warehousing costs considered to be product costs or period costs?

*Reply*—Statement 3 of Chapter 4, ARB No. 43 states in part:

As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location.

Kieso and Weygandt, *Intermediate Accounting*, 9<sup>th</sup> Edition states:

Product costs are those costs that "attach" to the inventory and are recorded in the inventory accounts. These costs are directly connected with the bringing of goods to the place of business of the buyer and converting such goods to a saleable condition. Such charges would include freight charges on goods purchased, other direct costs of acquisition and labor, and other production costs incurred in processing the goods up to the time of sale. It would seem proper also, to allocate to inventories a share of any buying costs or expenses of a purchasing department, storage costs, and other costs incurred in storing or handling goods before they are sold (i.e., warehousing costs). Because of the practical difficulties involved in allocating such costs and expenses, however these items are not ordinarily included in valuing inventories.

Costs of delivering the goods from the warehouse would be considered a selling expense and should not be allocated to the goods that are still in the warehouse.

#### **.02 Obsolete Items in Inventory—I**

*Inquiry*—A client purchased in bulk various inventories of stock material. This material is used to produce various specialized parts used in electronic equipment. The bulk purchase took place some eighteen months ago, and less than ten percent of these inventories have been used. The client claims that there may be some obsolete stock on hand from this bulk purchase, but an eighteen months period is not enough time to effectively determine the complete degree of obsolescence because the highly specialized nature of the product line may not lead to renewed orders until periods beyond one or more operating cycles. Based on the information available to the client, about one-third of the original bulk purchase will be written off because of obsolescence. For the remaining inventories, the client will present a representation letter indicating that he believes the remaining inventory not to be obsolete.

There may be more obsolete inventory than the client is willing to admit. The poor turnover of such items is the chief reason for concern. Pricing the inventory at the lower of cost or market will be difficult. The nature of the inventory (many small items at low unit cost) and its poor turnover make obtaining market prices difficult.

What is the responsibility of auditors, not being inventory experts, in determining the extent of obsolescence?

*Reply*—Sections 331.09 to 331.13 of Statement on Auditing Standards No. 1 discuss evidential matter for inventories. These sections of SAS No. 1 do not define the auditor's responsibility for quality of inventory. However, the third standard of field work would require the auditor to obtain sufficient competent evidential matter regarding inventory quality in connection with determining whether or not the inventories are presented in accordance with generally accepted accounting principles. This evidential matter might include the opinion of other experts, for example an electronics engineer, with respect to the quality of the inventories in this case.

Over the eighteen-month period since the inventories were purchased, less than ten percent have been utilized. Such a usage rate indicates that the client has close to an estimated fifteen year supply of these inventories. This would indicate that little or no value should be assigned to these inventories.

### **.03 Obsolete Items in Inventory—II**

*Inquiry*—Accounting Research Bulletin No. 43, Chapter 4, "Inventory Pricing," Statement 1 defines inventory as,

"The aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale."

Is it correct to assume that obsolete items which are not currently consumed in the production of "goods or services to be available for sale," are not classified as inventory?

*Reply*—It is correct to conclude that obsolete items are excludable from inventory. Cost attributable to such items is "nonuseful" and "nonrecoverable" cost (except for possible scrap value) and should be written off if a perpetual inventory is maintained or simply excluded from the inventory count if cost of sales is derived solely by means of taking a physical inventory count at the end of a period.

### **.04 Airplanes Chartered While Held for Sale**

*Inquiry*—A company purchases airplanes for sale to others. However, until they are sold, the company charts and services the planes. What would be the proper way to report these airplanes in the company's financial statements?

*Reply*—The primary use of the airplanes should determine their treatment on the balance sheet. Since the airplanes are held primarily for sale, and chartering is only a temporary use, the airplanes should be classified as current assets. However, depreciation would not be appropriate if the planes are considered inventory. ARB No. 43, Chapter 4, *Inventory Pricing*, states in part that the term inventory "excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified."

If the use period were to exceed one year, reclassification to fixed assets and recognition of depreciation expense would be appropriate under generally accepted accounting principles (GAAP). [Amended]

### **.05 Valuation of Rebuilt Airplane Parts Inventory**

This Question and Answer is currently being revised.

## .06 Inventory of Meat Packer

**Inquiry**—A client engaged in the meat packing business uses the “National Provisioner Daily Market Service” quotations in valuing its inventories. The client contends that these quotations, adjusted for freight differentials, reflect an accurate approximation of actual costs and, in lieu of a complete cost accounting system, should be considered as cost for inventory valuation. Is this method of inventory valuation acceptable for meat packers?

**Reply**—Meat packing companies generally value their work in process and finished goods inventories at market price less cost to bring to market in accordance with ARB No. 43, Chapter 4 (AC I78), *Inventory Pricing*. Live animals and whole carcasses are carried at lower of cost or market. Many companies use quoted costs such as the National Provisioner quotations which are estimated costs of producing a particular cut of meat adjusted for the fluctuating daily livestock prices and other factors. These quoted prices must be further adjusted by the individual meat packers to take into account individual factors such as freight and storage.

## .08 Valuing Precious Metals Inventory Used in Manufacturing Applications

**Inquiry**—Should inventories of precious metals used in manufacturing applications (for example, diamonds used in drill bits, plutonium or uranium used in steel fabrication, or titanium used in paint manufacturing) be valued at market or at the lower of cost or market?

**Reply**—These inventories should be valued at the lower of cost or market in accordance with ARB No. 43, Chapter 4, *Inventory Pricing*, Statement 5, paragraph 8 (AC I78.109). The excess of market value over cost may be disclosed.

The exception to “lower of cost or market” that allows precious metals to be recorded at market on the balance sheet does not apply to these industrial applications because the metals will be used in the manufacturing process rather than held for immediate sale and do not meet the other conditions specified in ARB No. 43, Chapter 4, Statement 9 (AC I78.119), which states:

Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Where goods are stated above cost, this fact should be fully disclosed.

[Amended June 1995.]

## .09 Standard Cost for Inventory Valuation

**Inquiry**—A client uses standard costs for valuing inventory. What disclosure is necessary in the financial statements regarding inventory valuation?

**Reply**—Ordinarily, standard costs should be adjusted to a figure which approximates the lower of cost or market. If this is done, then it is appropriate to use standard costs for financial reporting purposes. This is usually the case where standards are currently and frequently adjusted.

ARB No. 43, Chapter 4, *Inventory Pricing*, states in the footnote to paragraph 6:

Standard costs are acceptable if adjusted at reasonable intervals to reflect current conditions so that at the balance sheet date standard costs reasonably approximate costs computed under one of the recognized bases. In such cases, descriptive language should be used which will express this relationship, as, for instance, "approximate costs determined on the first-in first-out basis," or, if it is desired to mention standard costs, "at standard costs, approximating average costs."

Accordingly, if in this particular case standard costs do in fact approximate the lower of cost or market, then disclosure along the lines indicated in the above reference is adequate.

On the other hand, if the difference between standard costs and the lower of cost or market is material, then mere footnote disclosure will not cure the known statement imperfection.

### **.11 Average Cost Method for Subsidiary**

*Inquiry*—Company A and all of its subsidiaries, except one, determine the cost of inventories by the last-in, first-out method (LIFO). The one subsidiary uses an average cost method. Is the average cost method acceptable for determining the cost of inventory? Is it acceptable for one subsidiary to use the average cost method and Company A and the other subsidiaries to use the LIFO method?

*Reply*—The average cost method is an acceptable method for determining the cost of inventory. An entity may use more than one method to determine the cost of inventory provided the methods are disclosed.

### **.12 Classification of Replacement Parts Under a Maintenance Agreement**

*Inquiry*—Company A has entered into a maintenance agreement with Company B, an unrelated party, to provide maintenance and service for specialized computer equipment leased by Company B to third parties. The maintenance contract between A and B requires that A maintain a spare/replacement parts inventory for the equipment. Company A has no use for these parts other than to fulfill the obligation under its contract with Company B. The term of the contract between Company A and Company B is for several years.

Most of the spare parts (i.e., circuit boards) are of a repairable nature, and it is expected that as A replaces a part, A will have the removed part refurbished, at its own cost. The refurbished parts will be available for future use as necessary.

Should Company A classify the refurbished replacement parts as inventory? Should Company A's investment in the parts be amortized?

*Reply*—Company A should classify the refurbished replacement parts as inventory. Inventory costs should not be amortized; a loss in their utility should be reflected as a charge against revenues of the period in which it occurs, as discussed in ARB No. 43, Chapter 4, *Inventory Pricing*, paragraph 8.

### **.13 Classification of Slow-Moving Inventory**

*Inquiry*—A client, engaged in an oil field related industry, has slow-moving products that are not considered obsolete. The inventory is properly stated at the lower of cost or market. The client plans to continue selling the inventory

on hand but will cease manufacturing the specialized product. Based on current sales estimates and demand for the product, it appears likely that the client will be able to sell all of the items in the inventory over a period of about four years. Is it correct to classify a portion of the slow-moving inventory as a long-term asset in the client's classified balance sheet?

**Reply**—The portion of the slow-moving inventory not reasonably expected to be realized in cash during the client's normal operating cycle should be classified as a long-term asset in the company's classified balance sheet. ARB No. 43, chapter 3A, *Working Capital*, paragraph 4, states that the term "current assets" is used to designate cash or resources commonly identified as those that are reasonably expected to be realized in cash or sold during the normal operating cycle of the business.

#### **.14 Disclosure of LIFO Reserve**

**Inquiry**—Should a company using the last-in, first-out (LIFO) method of inventory valuation be required to disclose the LIFO reserve in its financial statements or in the accompanying footnotes?

**Reply**—Yes. The Accounting Standards Division Issues Paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories*, addresses this matter in section 2, paragraphs 24 through 28. Paragraph 28 indicates that the task force voted (9 yes, 0 no) that either the LIFO reserve or replacement cost and its basis for determination should be disclosed. Paragraph 26 states that the Securities and Exchange Commission (SEC) requires companies whose securities trade publicly to disclose this information [Regulation S-X, section 210.5-02.6(c)] and that many nonpublic companies also disclose this information.

SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, paragraph 11 (AU 411.11), states that in the absence of a pronouncement covered by Rule 203 of the Rules of Conduct of the AICPA Code of Professional Conduct or another source of established accounting principles, the auditor may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example, AICPA Issues Papers, FASB Statements of Financial Accounting Concepts, International Accounting Standards of the International Accounting Standards Committee; GASB Statements, Interpretations, and Technical Bulletins; Technical Information Service Inquiries and Replies included in AICPA *Technical Practice Aids*; pronouncements of other professional associations or regulatory agencies, and accounting textbooks, handbooks, and articles. [Amended June 1995.]

#### **.16 Accounting and Reporting for Changes in Inventory Policy**

**Inquiry**—In 19X4, a health care entity capitalizes in inventory supplies that in previous years were expensed. What is the proper accounting and reporting treatment for this event?

**Reply**—The accounting treatment of capitalizing supplies is in conformity with the guidance provided in the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*, paragraph 8.04. This paragraph states that supplies for a health care entity should be accounted for in a manner similar to methods used by other business organizations. When material, this amount should be capitalized and, when immaterial, judgment for the proper accounting treatment should be exercised.

If the amounts of unrecorded supplies inventory in prior years were immaterial, the entity need not report the capitalization of supplies inventory in 19X4 as a change in accounting principle. APB Opinion No. 20, *Accounting Changes*, paragraph 8(a) (AC A06.106) states, "... neither (a) initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect ... is a change in accounting principle."

However, if unrecorded supplies inventories in the prior years were material, and therefore should have been capitalized, an error has occurred, and the guidance in APB Opinion No. 20, paragraphs 36 and 37 (AC A35.105), concerning prior period adjustments should be followed.

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## Section 2210

### ***Fixed Assets***

#### **.01 Settlement of Mortgage Installment on Real Estate Between Buyer and Seller**

*Inquiry*—A company purchased an office building subject to the seller's assumable mortgage. The closing of the transaction occurred in the middle of a month which was between payment dates on the mortgage. The closing statement reflected a credit from the seller to the buyer for the interest that accrued on the mortgage from the last payment date until the date of the closing. How should this credit be accounted for by the buyer?

*Reply*—The buyer would treat the accrued interest credit as a reduction of interest expense for the first month of ownership. When the buyer makes the first interest payment after the closing, the credit will offset the full month's interest paid and thus reduce the buyer's net interest expense to the amount attributable to the period that the property was owned by the buyer. [Amended June 1995.]

#### **.02 Broker's Commission Received by Purchaser of Property as Purchase Price Concession**

*Inquiry*—A corporation ("purchaser") is engaged in negotiations to purchase real property. During the negotiations, the purchaser was unwilling to accept the seller's best offer. To induce the purchaser to agree to the sale, the broker agreed to rebate a portion of the seller-paid commission to the purchaser.

Would this rebate be considered income to the purchaser or a reduction of the cost of the property acquired?

*Reply*—The "rebate" received from the broker should be accounted for as a reduction of the cost of the property rather than as income. Income should not be recognized on a purchase. The receipt of the rebate was part of the acquisition of the real estate and, when netted against the purchase price, reflects the amount the purchaser was willing to pay for the property. [Amended June 1995.]

#### **.06 Valuation of Cattle Herd**

*Inquiry*—A client, in the business of raising and selling cattle, has not been in business long enough to develop enough cost information to reliably value the cattle raised by them. Each cow costs \$2,000 or more and has an estimated salvage value of about \$300 at the end of its productive breeding life. The client has adopted a life of seven years for its breeding herd based on the various ages of the cows.

The client proposes to price the cattle raised as follows:

##### *Purchased calves*

When a cow is purchased with a "calf at side," twenty percent of the purchase price is allocated to the calf. An additional \$50 is allocated to the calf every six months for the first eighteen months. At eighteen months of age, the cows are considered mature enough for breeding and are then either sold or placed in the breeding herd and depreciated.

*Raised calves*

Since the mother is maintained principally for breeding and is expected to produce one calf each year, the calf birthed and raised is allocated one year's depreciation of the mother, plus \$50 at birth. An additional \$50 is allocated every six months for the first eighteen months.

The problem of valuing the cattle is compounded by the fact that cattle purchased for breeding and those purchased for sale are not separated, and any cow may be sold at any time. What improvements could be made in the pricing scheme, and how should the breeding herd and the herd held for sale be shown on the balance sheet?

*Reply*—Rather than setting an average breeding life of seven years for the breeding herd, it would appear more reasonable to set an estimated age at which a cow should be fully depreciated and to depreciate the cost of each cow over the remaining estimated years of life. Also, instead of allocating twenty percent of the purchase price of the cow to the calf "at side," it would be better to determine the percent applicable to the calf on the basis of the number of expected additional calves for that cow.

In valuing the calves, if the \$50 figure is a reasonable estimate of six months of costs, the method seems reasonable. However, instead of allocating one year's depreciation of the mother plus \$50 at birth, it might be better to allocate only the depreciation plus the direct expenses of birth such as veterinarian's fees, etc.

Since it is difficult to determine which of the cattle are "inventory" and which are "fixed assets," it might not be appropriate in this case to classify the assets and liabilities as current or long-term in the balance sheet.

**.07 Costs of Ski Slopes and Lifts**

*Inquiry*—A company has developed a piece of land into a skiing resort. The company has cut the trees, cleared and graded the land and hills, and constructed ski lifts and platter pulls.

Should the tree cutting, land clearing, and grading costs of constructing the ski slopes be capitalized to land? If so, are these costs amortizable?

Should the clearing and grading costs connected with the construction of the ski lifts and platter pulls be capitalized to this equipment and depreciated?

*Reply*—All expenditures incurred which are made for the purpose of making the land suitable for its intended use or purpose (whether that use be for the construction of a ski lodge, lifts, slopes, platter pulls, or other facilities) are properly capitalizable as land costs, and land is not subject to depreciation. During the course of clearing the land to make it useful for the purpose acquired, salable timber may be recovered, and since the clearing costs are capital items, amounts realized from the sale of the timber may properly be credited to the land account. Recurring maintenance of right-of-way (i.e., the slope and ski-lift areas) would be properly treated as a period cost. [Amended]

**.08 Restaurant Dishes and Silverware**

*Inquiry*—Should a base stock inventory of silverware and dishes be shown on the balance sheet of a restaurant as a fixed asset? In the base stock method, the base stock is recorded at an unchanging amount and additions to the stock



are charged to expenses for the period. Inasmuch as fixed assets are specific items which are subject to depreciation (except land), and the base stock is an approximate figure for many items and is not depreciated, it would seem that the base stock should not be classified as a fixed asset.

**Reply**—Various publications recommending treatment for large stocks of short-lived, replaceable assets such as silverware and dishes indicate that the assets should be valued on the basis of physical inventories at year-end, with used equipment being valued at 50% of current cost, and unused equipment valued at full cost. This, in effect, assigns an average useful life of two years for the equipment. It is recommended that such assets be included in fixed assets.

The classification in the balance sheet should not depend upon the method of valuing the assets. Therefore, regardless of the method of valuation, the assets should be included in fixed assets. If the valuation differs materially from the depreciated cost of individual goods on hand at year-end, the presentation is not in accordance with generally accepted accounting principles.

### **.09 Appraisal Value for Mailing Lists**

This Question and Answer is currently being revised.

### **.13 Effect of Future Transfer on Accounting for Land**

**Inquiry**—A nonprofit health care corporation has agreed to a future transfer of title in its operating property (land and a hospital) to the city in which the property is located. The transfer will occur in 30 years. Under such circumstances, is it appropriate to amortize the cost of land over a period of 30 years?

**Reply**—APB Opinion No. 17, *Intangible Assets*, paragraph 22, states in part:

Accounting for the cost of a long-lived asset after acquisition normally depends on its estimated life. The cost of assets with perpetual existence, such as land, is carried forward as an asset without amortization, and the cost of assets with finite lives is amortized by systematic charges to income.

Accordingly, the cost of land should not be amortized.

The agreement between the corporation and the city should be disclosed in notes to the corporation's financial statements.

### **.15 Capitalization of Cost of Dredging Log Pond**

**Inquiry**—Corporation A operates a log pond and dredged the pond during the year at a cost of \$350,000. Thus, the useful life of the log pond was extended several years. Should the dredging cost be expensed or capitalized?

**Reply**—FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, paragraph 89, states, in part, "... many assets yield their benefits to an enterprise over several periods . . . . Expenses resulting from their use are normally allocated to the periods of their estimated useful lives (the periods over which they are expected to provide benefits) by a 'systematic and rational' allocation procedure, for example, by recognizing depreciation or other amortization."

Since the dredging cost will benefit future periods, Corporation A should capitalize the cost and amortize it in a systematic and rational manner over the estimated period of benefit. [Amended]

### **.18 Revaluation of Assets**

**Inquiry**—Company A acquired a material amount of treasury stock resulting in a stockholders' equity deficit. Since state law (where Company A is in-

corporated) prohibits the impairment of legal capital, Company A revalued certain of its assets at fair market value. Should Company A record depreciation for the revalued assets based on historical cost or fair market value?

*Reply*—APB Opinion No. 6, *Status of Accounting Research Bulletins*, paragraph 17 (AC D40.102), states:

The Board is of the opinion that property, plant and equipment should not be written up by an entity to reflect appraisal, market or current values which are above cost to the entity. This statement is not intended to change accounting practices followed in connection with quasi-reorganizations or reorganizations. This statement may not apply to foreign operations under unusual conditions such as serious inflation or currency devaluation. However, when the accounts of a company with foreign operations are translated into United States currency for consolidation, such write-ups normally are eliminated. Whenever appreciation has been recorded on the books, income should be charged with depreciation computed on the written up amounts.

An opinion expressed on the financial statements of Company A should be qualified or adverse because the write-up of assets is a departure from generally accepted accounting principles.

## **.20 Compounding Capitalized Interest**

*Inquiry*—Company A is constructing a building for its own use. The company capitalized interest cost on the average amount of accumulated expenditures for the asset during the current year end. The building was completed in the next year. Should the company capitalize interest on the average amount of expenditures for the assets that were made during the current period only or the average amount of accumulated expenditures for the asset during the period including the expenditures made in the prior period, which already includes capitalized interest cost?

*Reply*—FASB Statement No. 34, *Capitalization of Interest Cost*, paragraph 13 (AC I67.110), states in part, the amount capitalized in an accounting period shall be determined by applying an interest rate to the average amount of accumulated expenditures for the asset during the period. Paragraph 57 further states, “the Board concluded that compounding is conceptually consistent with its conclusion that interest on expenditures for the asset is a cost of acquiring the asset.” Accordingly, the rate should be applied to the average of all the accumulated expenditures.

## **.22 Fixed Asset Partially Acquired With Grant Funds**

This Question and Answer is currently being revised.

## **.25 Capitalization of Interest Costs Incurred by Subsidiary**

*Inquiry*—A subsidiary with an asset qualifying for interest capitalization under FASB Statement No. 34, *Capitalization of Interest Cost* (AC I67), incurs its entire interest cost from a loan from its parent.

What is the extent of interest that may be appropriately capitalized?

*Reply*—FASB Statement No. 34, paragraph 13 (AC I67.111), states in part, that the amount capitalized in an accounting period shall be determined by applying an interest rate to the average amount of accumulated expenditures for the asset during the period. FASB Statement No. 34, paragraph 15 (AC I67.113), further states that in separately issued financial statements of a parent company, consolidated subsidiary, or unconsolidated subsidiary, the amount of interest cost that may be capitalized is limited to the total amount of interest cost (including interest on intercompany debt) incurred by the separate entity.

Such financial statements should disclose related party transactions as required by FASB Statement No. 57, *Related Party Disclosures* (AC R36). [Amended]

**.27 Construction of Asset—Foreign Currency Transaction Gains/Losses**

*Inquiry*—A company is constructing a building in the United States for its own use. In order to finance the cost of the building, a loan denominated in a foreign currency is obtained from a bank in a foreign country. The company is appropriately capitalizing interest incurred as part of the cost of the building in accordance with FASB No. 34, *Capitalization of Interest Cost* (AC I67). However, the company wants to also capitalize as part of the cost of the building any foreign currency transaction gains or losses it incurs as a result of the loan with the bank in the foreign country. The company's rationale is that the transaction gains or losses relate specifically to the building and therefore should be considered part of the cost of the building. Is this appropriate?

*Reply*—No. According to FASB Statement No. 52, *Foreign Currency Translation*, paragraph 15 (AC F60.122):

Foreign currency transactions are transactions denominated in a currency other than the entity's functional currency. Foreign currency transactions may produce receivables or payables that are fixed in terms of the amount of foreign currency that will be received or paid. A change in exchange rates between the functional currency and the currency in which a transaction is denominated increases or decreases the expected amount of functional currency cash flows upon settlement of the transaction. That increase or decrease in expected functional currency cash flows is a foreign currency transaction gain or loss that generally shall be included in determining net income for the period . . . .

Thus, even though the loan was obtained to construct the building, the transaction gains and losses are not part of the cost of the building, but are a result of the change in the exchange rate and are included in income each period in which the exchange rate fluctuates. [Amended]

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## Section 2220

### Long-Term Investments

#### .01 Equity Method When Current Direct Ownership Less Than Twenty Percent

*Inquiry*—Company A purchased a 19% stock ownership interest in B. The company also made a loan to B which is convertible into stock of B and is secured by shares of C (B's subsidiary). For as long as the loan is outstanding, Company A will have several seats on B's board. The company also has options to purchase shares of C.

Is the company required to report its investment in B under the equity method?

*Reply*—APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, paragraph 17, states that the ability to exercise the type of influence contemplated in the Opinion may be indicated in several ways such as representation on the board of directors and investment (direct or indirect) of 20% or more in the voting stock of an investee.

The company would own only 19% of the outstanding voting stock. Although it is not indicated whether the conversion feature of the loan may result in ownership of 20% or more, or whether the board seats would allow A to significantly influence the voting at meetings of B's board of directors, the overall impact of the proposed transaction could demonstrate that the company has the ability to exercise significant influence over the investee. Therefore, the equity method should be followed in accounting for the investment.

#### .03 Equity Method for Investee Following Completed Contract Method

*Inquiry*—A client, a contractor who follows the percentage of completion method for income recognition, has entered into a joint venture. The joint venture follows the completed contract method in its financial statements. The client accounts for his investment in the joint venture on the equity basis. May the client recognize his share of the venture's income (determined on the percentage of completion method) even though the venture will not recognize income until the contract is completed?

*Reply*—APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, paragraph 3f, states:

"Earnings or losses of an investee" and "financial position of an investee" refer to net income (or net loss) and financial position of an investee determined in accordance with accounting principles generally accepted in the United States.

Both the completed contract method and the percentage of completion method are generally accepted, and the investor should not change the investee's method of accounting from completed contract to percentage of completion in applying the equity method. If the investee's financial statements are prepared on a comprehensive basis of accounting other than GAAP, the investor

should eliminate material variances from GAAP in applying the equity method, in accordance with SOP No. 78-9, *Accounting for Investments in Real Estate Ventures*, paragraph 24. [Amended]

#### **.05 Assuming Pro Rata Share of Venture's Revenues and Expenses**

*Inquiry*—A company has entered into a joint venture with another venturer. Would it be permissible for the company to include in its income its pro rata share of each of the revenue and expense accounts of the venture?

*Reply*—APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, paragraph 19c, states:

The investment(s) in common stock should be shown in the balance sheet of an investor as a single amount, and the investor's share of earnings or losses of the investee(s) should ordinarily be shown in the income statement as a single amount except for the extraordinary items as specified in (d) below.

However, AICPA Interpretation No. 2 of APB Opinion No. 18, "Investments in Partnerships and Ventures" relating to accounting for investments in unincorporated joint ventures states in part:

... because the investor-venturer owns an undivided interest in each asset and is proportionately liable for its share of each liability, the provisions of paragraph 19-c may not apply in some industries. For example, where it is the established industry practice (such as in some oil and gas venture accounting), the investor-venturer may account in its financial statements for its *pro rata* share of the assets, liabilities, revenues, and expenses of the venture.

Terminology such as "should ordinarily" contained in the above reference indicates that picking up the share of the joint venture on a line by line item, while it may be unusual, would not necessarily be prohibited. Guidance for transactions of this type relating to real estate can be found in SOP No. 78-9, *Accounting for Investments in Real Estate Ventures*, paragraph 11 (ACC 10,240.11). [Amended]

#### **.08 Acquisition of Subsidiaries by Exchange of Assets With No Book Value**

*Inquiry*—A client, a computer services company, acquired fifty percent of the capital stock of a corporation in exchange for rights to computer programs. The cost of these programs had been expensed by the client. Another party acquired the remaining fifty percent of the stock for \$150,000. The client recorded this transaction as a debit to investments in subsidiaries and a credit to earnings of \$150,000.

A similar transaction, an exchange of rights to computer programs for capital stock with a stated value of \$200,000, occurred later. Investments in subsidiaries was debited and earnings was credited for \$200,000.

The subsidiaries are accounted for under the equity method.

Can the earnings recorded on the exchange of expensed computer programs for common stock be reflected in parent company financial statements, or do generally accepted accounting principles require elimination?

*Reply*—APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, paragraph 19 (AC 182.109) states in part, "The difference between consolidation and the equity method lies in the details reported in the financial statements. Thus, an investor's net income for the per-

iod and its stockholders' equity at the end of the period are the same whether an investment in a subsidiary is accounted for under the equity method or the subsidiary is consolidated . . . ." Intercompany profit eliminations under the equity method is discussed in AICPA Interpretation No. 1 of APB Opinion No. 18, "Intercompany Profit Elimination Under Equity Method (AC I82.501)," and states in part, "All intercompany transactions are eliminated in consolidation, but under the equity method intercompany profits or losses are normally eliminated only on assets still remaining on the books of an investor or an investee."

Both APB Opinion No. 18, paragraph 19 (AC I82.109), and AICPA Interpretation No. 1 of APB Opinion No. 18 (AC I82.501), indicate that the intercompany gain (\$150,000 and \$200,000) recorded by the investor company would be eliminated under the equity method.

In the second case, measuring the value of the computer programs by the \$200,000 stated value of the stock may not be appropriate, and the auditor should try to satisfy himself concerning the estimated values assigned to the tangible and intangible assets contributed by the other stockholders. (See APB Opinion No. 18, paragraph 19n and APB Opinion No. 16, *Business Combinations*, paragraph 88.)

#### **.09 Market Value of Unregistered Stock**

*Inquiry*—A company needs a monthly valuation of its securities at market. Among the securities to be valued are some lettered securities that contain a three-year restriction against sale. These lettered securities consist of 7 1/2% convertible debentures maturing in five years and common stock which had to be purchased as a unit. Common stock which is unrestricted is being freely traded and is presently selling at three times the cost of the restricted common.

What is the generally accepted accounting method of valuing the lettered securities?

*Reply*—The valuation of unregistered stock is discussed in the SEC's Codification of Financial Reporting Policies, Sec. 404.04.a (ASR 113).

In general the valuation of such stock is difficult. The relationship between the current value of unregistered stock and of similar stock which is available for sale on the exchanges or over the counter will vary for many reasons, including particularly the period for which it may be expected to remain unregistered, and the volatility and thinness of market of stock being traded.

Methods of valuation are not, strictly speaking, accounting functions. The valuation of securities is primarily a function of appraisers and stockbrokers. A broker knowledgeable as to the company involved will frequently be in a position to suggest a discount percentage appropriate to the restrictions imposed upon sale of a particular security. Such percentage will vary with the type of restriction and with the nature of the market for the unrestricted security of that issuer.

In determining how much credibility to assign to evidence of valuation of an asset, it is necessary to evaluate the competence and experience of the individual appraiser, his knowledge of the field, and the individual asset involved.

#### **.11 Equity Method for Investments in Limited Partnerships and Unincorporated Joint Ventures**

*Inquiry*—Corporation A owns investments ranging from 20% to more than 50% in several limited partnerships and unincorporated joint ventures. Is Cor-

poration A required to use the equity method to account for its investments? If Corporation A uses the equity method for its investments, should the auditors of Corporation A examine the financial statements of each separate investee?

**Reply**—AICPA Interpretation No. 2 of APB Opinion No. 18, "Investments in Partnerships and Ventures," states:

APB Opinion No. 18 applies only to investments in common stock of corporations and does not cover investments in partnerships and unincorporated joint ventures (also called undivided interests in ventures). Many of the provisions of the Opinion would be appropriate in accounting for investments in these unincorporated entities, however, as discussed below.

Partnership profits and losses accrued by investor-partners are generally reflected in their financial statements as described in paragraphs 19-c and 19-d. Likewise, most of the other provisions of paragraph 19 would be appropriate in accounting for a partnership interest, such as the elimination of intercompany profits and losses (see paragraph 19-a).

\* \* \*

Generally, the above discussion of partnerships would also apply to unincorporated joint ventures, particularly the elimination of intercompany profits and the accounting for income taxes. However, because the investor-venturer owns an undivided interest in each asset and is proportionately liable for its share of each liability, the provisions of paragraph 19-c may not apply in some industries. For example, where it is the established industry practice (such as in some oil and gas venture accounting), the investor-venturer may account in its financial statements for its *pro rata* share of the assets, liabilities, revenues, and expenses of the venture.

AICPA Interpretation No. 2 of APB Opinion No. 18, seems to imply that the same factors (a controlling financial interest, the ability to exercise significant influence over operating and financial policies, or the lack of control or ability to exercise significant influence) that determine the method used by an investor to account for its investments in corporate common stock would also determine the method used by an investor to account for its investments in unincorporated entities. The one exception stated in AICPA Interpretation No. 2 of APB Opinion No. 18, that an investor may account for its *pro rata* share of the assets, liabilities, revenues, and expenses of an unincorporated joint venture, is based on industry practices. Accordingly, Corporation A's method of accounting for its investments would depend on the circumstances.

SAS No. 1, section 332, *Long-Term Investments*, paragraph 5 (AU Section 332.05), relates to investments accounted for by either the cost method or the equity method and states, in part, that:

Evidential matter pertaining to the carrying amount of long-term investments, income and losses attributable to such investments, and capital and other transactions of the investee may be available in the form of audited financial statements, unaudited financial statements, market quotations, or other evidential matter.

## **.12 Investor's Share of Losses in Excess of Its Investment**

**Inquiry**—Company A's share of the losses of a real estate venture exceeds its investment in the venture. How should Company A account for its investment?



*Reply*—SOP No. 78-9, *Accounting for Investments in Real Estate Ventures* (ACC section 10,240), recommends that the equity method be used to account for investments in corporate or noncorporate real estate ventures. APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, paragraph 19i (AC I82.109), states:

An investor's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by the equity method plus advances made by the investor. The investor ordinarily should discontinue applying the equity method when the investment (and net advances) is reduced to zero and should not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee.\* If the investee subsequently reports net income, the investor should resume applying the equity method only after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended.

Accordingly, the investor should reflect its investment at a zero amount and disclose in a note to the financial statements the amount of its share of investee losses in excess of the zero amount.

If the investor is committed to provide further financial support to the investee, the investor should show the excess of its share of investee losses over its investment and advances as a liability up to the amount of its commitment.

### **.13 A Change in Circumstances Using the Equity Method of Accounting for an Investment**

*Inquiry*—An investor had guaranteed obligations of an investee and the investor's share of losses of this investee have exceeded the carrying amount of the investment on the investor's book in a prior year. This procedure is in accordance with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, paragraph 19i (AC I82.109). In the current year, the investee fully paid the obligation which was guaranteed by the investor; accordingly, the investor will no longer guarantee the obligations of the investee and, therefore, will not record its share of the investee's losses.

- (1) Does this constitute a change of accounting principles?
- (2) How should the liability recorded on the investor's books be accounted for?

*Reply*—(1) This is not a change in accounting principles. According to APB Opinion No. 20, *Accounting Changes*, paragraph 8 (AC A06.106), an "adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring" is not a change in accounting principles. The situation described is a change in circumstances and not a change in accounting principles.

(2) The liability recorded on the investor's books should be reversed in the current year and reported in the income statement with appropriate footnote disclosure.

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\* An investor should, however, provide for additional losses when the imminent return to profitable operations by an investee appears to be assured. For example, a material, nonrecurring loss of an isolated nature may reduce an investment below zero even though the underlying profitable operating pattern of an investee is unimpaired. [APB Opinion No. 18, paragraph 19i, footnote 10 (AC I82.109, footnote 11).]

#### **.14 Equity Method—Effect of Unrecorded Equity in Losses on Additional Investment**

*Inquiry*—Company A purchased 40 percent of Company B for \$100,000. Company A did not guarantee the debt of Company B. Subsequent to the investment by A, B incurred large operating losses and A ceased to record equity in B's losses after its investment in B was reduced to zero. A few years later, A purchased an additional 5 percent interest in B. Should Company A offset the amount of this additional investment by the unrecorded equity in losses of Company B?

*Reply*—No. Company A's additional investment would not be offset by the unrecorded equity in Company B's losses because A's unrecorded equity in those losses is not attributable to the block of shares in comprising the additional 5 percent interest.

#### **.15 Accounting for Distribution From Joint Venture**

*Inquiry*—A corporation invests in a joint venture which is involved in real estate. The joint venture is a corporation and it is not controlled by the corporate investor. It accounts for this investment in accordance with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (AC I82). The joint venture incurred losses over the next few years. That resulted in the investment account on the corporation's books to decline to zero. At this point, the joint venture paid the corporation a cash distribution. How should the corporation account for this distribution?

*Reply*—APB Opinion No. 18 (AC I82), states that the investor ordinarily shall discontinue applying the equity method when the investment (and net advances) is reduced to zero and shall not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide financial support for the investee.

In this situation, the corporate investor in the joint venture should account for the cash distributions received as income if the distribution is not refundable by agreement or by law and the investor is not liable for the obligations of the joint venture and is not otherwise committed to provide financial support to the joint venture.

#### **.17 Tax Basis Accounting—Use of Equity Method**

*Inquiry*—Can an investor who prepares its financial statements in accordance with U.S. generally accepted accounting principles (GAAP) use the equity method of accounting for an investment in the common stock of an investee that presents its financial statements on the income tax basis of accounting if the investment would otherwise qualify for the equity method?

*Reply*—APB Opinion No. 18, *Equity Method of Accounting for Investments in Common Stock*, paragraph 10 (AC I82), states, "Under the equity method, an investor recognizes its share of earnings or losses of an investee in the periods for which they are reported by the investee in its financial statements." APB Opinion No. 18, paragraph 3 (AC I82.404), defines the earnings or losses of an investee as the "net income (or net loss) . . . of an investee determined in accordance with accounting principles generally accepted in the United States."

If the investment qualifies for equity method accounting, the investor must adjust the investee's tax basis financial statements to GAAP basis to determine its share of earnings or losses. If the adjustment cannot be determined, and the amounts are material, it would be considered a GAAP exception.

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[The next page is 1361.]

## Section 2230

### ***Noncurrent Receivables***

#### **.02 Balance Sheet Classification of Deposit on Equipment to Be Purchased**

*Inquiry*—What is the appropriate balance sheet classification of a deposit on machinery which is to be purchased within one year?

*Reply*—ARB No. 43, Chapter 3A, *Current Assets and Current Liabilities*, paragraph 6, states, "This concept of the nature of current assets contemplates the exclusion from that classification of such resources as: (a) cash and claims to cash that are restricted as to withdrawal or use for other than current operations, are designated for expenditure in the acquisition or construction of noncurrent assets, or are segregated for the liquidation of long-term debts." Accordingly, the deposit on equipment should be classified as a noncurrent asset even though the equipment will be purchased within one year.

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[The next page is 1391.]



## Section 2240

### **Cash Surrender Value of Life Insurance**

#### **.01 Balance Sheet Classification of Life Insurance Policy Loan**

*Inquiry*—A company has secured a short-term loan from an insurance company against the cash surrender value of its life insurance policies.

In paragraph 6(d), Chapter 3A of ARB No. 43, cash surrender value of life insurance policies is excluded from the classification of a current asset. This reference does not appear to recommend a different classification if the cash value may have been fully borrowed from the insurance company.

Is it proper to classify a readily liquid asset as noncurrent and simultaneously show the related borrowings as a current liability?

*Reply*—Paragraph 6 of Chapter 3A of Accounting Research Bulletin No. 43 states in part:

This concept of the nature of current assets contemplates the exclusion from that classification of such resources as . . . (d) cash surrender value of life insurance policy.

Note 3 to paragraph 7 of this Chapter states:

Loans accompanied by pledge of life insurance policies would be classified as current liabilities when, by their terms or by intent, they are to be repaid within twelve months. The pledging of life insurance policies does not affect the classification of the asset any more than does the pledging of receivables, inventories, real estate, or other assets as collateral for a short-term loan. However, when a loan on a life insurance policy is obtained from the insurance company with the intent that it will not be paid but will be liquidated by deduction from the proceeds of the policy upon maturity or cancellation, the obligation should be excluded from current liabilities.

Paragraph 7-1 of Accounting Principles Board Opinion No. 10 states:

It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists.

Therefore, if a company takes out policy loans from the insurance company on life insurance policies which it owns and if there is no intention to repay the loan during the ensuing operating cycle of the business, such loan may be excluded from current liabilities. Furthermore, as the owner of a policy normally has the right to offset the loan against the proceeds received on maturity or cancellation of the policy, it is appropriate to apply the amount of the loan in reduction of the cash surrender value, with disclosure of the amount so offset.

#### **.02 Disclosure of Life Insurance on Principal Stockholders**

*Inquiry*—A client corporation maintains life insurance policies on its principal stockholders which will provide for the repurchase of the stock in the event of a stockholder's death. The cash surrender value of these policies appears on the balance sheet. Is further disclosure necessary?

*Reply*—The rule of informative disclosure requires that the essential facts respecting firm commitments for purchase of a corporation's own stock pursuant to a buy-sell agreement, be set forth in a footnote to the financial statements.

Below is an example of a footnote describing such a situation which might appear on the balance sheet in reference to the cash surrender value account:

The company is the owner and beneficiary of key-man life insurance policies carried on the lives of X, Y, and Z bearing face value amounts of \$500,000, \$500,000 and \$450,000 respectively. No loans are outstanding against the policies, but there is no restriction in the policy regarding loans.

The life insurance contracts are accompanied by mandatory stock purchase agreements to the amount of the proceeds of the life insurance. In the event of the insured's death, the "fair market value" of the stock will, by previous action, be established by the X Appraisal Company. The insured's estate will be obligated to sell, and the company will be obligated to purchase the insured's stock up to the appraisal value of the stock or the proceeds of insurance, whichever is the lesser. The purpose is to protect the company against an abrupt change in ownership or management.

### **.03 Omission of Cash Surrender Value of Life Insurance from Assets**

*Inquiry*—Clearly, cash surrender values of life insurance may be included among the assets in the balance sheet of an enterprise. Is this mandatory, or may management elect to omit this item from the assets on the theory that its inclusion will be misleading since the insurance is carried for the purpose of covering the loss it is anticipated will be sustained as a result of the death of a key official?

*Reply*—If the enterprise retains all valuable contract rights incident to ownership of the life insurance policy, then it is mandatory from the standpoint of full accountability to reflect the asset status of the cash surrender value of the policy. Not to reflect the cash surrender value would be tantamount to creating a hidden reserve which would be contrary to generally accepted accounting principles.

### **.04 Corporation's Policy on Life of Debtor Corporation's Officer**

*Inquiry*—A client took out a straight life insurance policy on the life of an officer of another corporation which is indebted to the client. The client corporation hopes to receive the proceeds of the insurance policy tax free and has not deducted the yearly premium payments as expenses. The officer is over 65 years old, and, therefore, there is a great possibility he will die prior to the full payment of the outstanding balance of the corporation's debt. The prior CPA reported the accumulated premium payments on the Balance Sheet as "Investment in Life Insurance."

Is it proper to show total premiums paid as an investment under these circumstances?

*Reply*—Where a corporation takes out a life insurance policy on the life of a debtor corporation's officer (assuming that there is an insurable interest), the manner of accounting for the premiums should not differ from the manner of accounting for premiums paid on the life of the corporation's own officer. The premiums should be broken down between the expense and the cash surrender value elements. Accordingly, the accumulated premiums account should be analyzed to determine the cash surrender value as at the balance sheet date, the expense portion for the period under audit, and the remaining portion which should be treated as a correction of prior period earnings. See Accounting Principles Board Opinion No. 20, *Accounting Changes*, for a discussion of correction of an error.

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## Section 2250

### *Intangible Assets*

#### **.02 Change in Amortization Period for Contingent Consideration Carried as Goodwill**

*Inquiry*—A company in a purchase transaction acquired a service business at a purchase price in excess of identifiable tangible and intangible assets. The excess purchase price, paid for customers' lists, going concern value, goodwill, etc., is reflected on the balance sheet. The original purchase agreement provided for additional payments which were dependent upon the operations of the acquired company in subsequent years. An additional \$100,000 became due three years from the date of the original purchase.

Because of the nature of the service business, the purchaser tentatively decided on the date of acquisition to adopt a ten year life for amortization purposes. The ten-year write-off period originally chosen does not represent the actual life of the excess but only a judgmental estimate. The additional \$100,000 is payable only because the acquired company has demonstrated continued earning power. Because of this evidence as to the continued value of the excess purchase price, the company determined to write off the excess (comprising the unamortized balance of the original amount plus the \$100,000) over a term of fifteen years from the date of payment of the additional \$100,000.

Is the amortization of goodwill and other intangible assets, in accordance with generally accepted accounting principles?

*Reply*—Paragraph 80 of Accounting Principles Board Opinion No. 16 states as follows:

Additional consideration may be contingent on maintaining or achieving specified earnings levels in future periods. When the contingency is resolved and additional consideration is distributable, the acquiring corporation should record the current fair value of the consideration issued or issuable as additional cost of the acquired company. The additional costs of affected assets, usually goodwill, should be amortized over the remaining life of the asset.

Paragraph 31 of APB Opinion No. 17 states in part:

A company should evaluate the periods of amortization continually to determine whether later events and circumstances warrant revised estimates of useful lives. If estimates are changed, the unamortized costs should be allocated to the increased or reduced number of remaining periods in the revised useful life but not to exceed forty years after acquisition.

This also is in accordance with paragraph 31 of APB Opinion No. 20.

It is appropriate to adjust the estimate of the period benefited by the intangible assets at the date the contingent consideration is determined. Such amortization period may not exceed forty years from the date of the original acquisition. The revised life should be applied to the unamortized balance of the originally recorded intangible, as well as to the additional payment being

made, on a straight line basis in accordance with paragraph 30 of APB Opinion No. 17. If the intangibles can be broken down between general "goodwill" and other intangibles, the estimated lives for the various intangible assets may differ.

#### **.04 Appraisal Value of Intangible Assets**

*Inquiry*—A client who operates several Community Antenna Television systems wishes to value the CATV systems in the statement of financial position at an appraisal value based on a fixed amount per subscriber. Could such a value be properly presented on the financial statements?

*Reply*—APB Opinion No. 6, *Status of Accounting Research Bulletins*, paragraph 17, states in part, "The Board is of the opinion that property, plant and equipment should not be written up by an entity to reflect appraisal, market, or current values which are above cost to the entity." APB Opinion No. 17, *Intangible Assets*, paragraph 25, states in part, "Intangible assets acquired singly should be recorded at cost at date of acquisition."

Therefore, whether the assets involved are tangible or intangible, it would not be in accordance with generally accepted accounting principles to state such assets at appraised values in excess of cost. [Amended]

#### **.05 Reporting Write-Off of Unamortized Goodwill**

*Inquiry*—Corporation A has reviewed the estimated life of goodwill, which is being amortized, and decided that the unamortized balance of goodwill should be written off in the current year. The write-off is caused by significant changes in manufacturing techniques and other circumstances which indicate that the unamortized goodwill has no future benefits. How should the write-off be reported?

*Reply*—In accordance with APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, paragraph 23(a), which refers specifically to the write-down or the write-off of intangibles, the write-off of goodwill would not be reported as an extraordinary item. Assuming that the amount of the write-off is material, the write-off should be reported in accordance with APB Opinion No. 30, paragraph 26. Paragraph 26 states:

A material event or transaction that is unusual in nature or occurs infrequently but not both, and therefore does not meet both criteria for classification as an extraordinary item, should be reported as a separate component of income from continuing operations. The nature and financial effects of each event or transaction should be disclosed on the face of the income statement or, alternatively, in notes to the financial statements. Gains or losses of a similar nature that are not individually material should be aggregated. Such items should not be reported on the face of the income statement net of income taxes or in any manner inconsistent with the provisions of paragraphs 8 and 11 of this Opinion or in any other manner that may imply that they are extraordinary items. Similarly, the earnings per share effects of those items should not be disclosed on the face of the income statement.

#### **.06 Accounting Treatment of Agreements Not to Compete**

*Inquiry*—A company enters into an agreement with an outgoing officer whereby the company will make future periodic payments to the officer in return for the officer's agreement not to compete with the company for the period coinciding with the payments.



Would it be appropriate for the company to record a liability for the total future payments to the former officer and a corresponding intangible asset for the covenant?

**Reply**—The authoritative literature does not provide specific guidance for the treatment of executory contracts, which require future consideration upon the occurrence of certain events.

FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 36, specifies that a characteristic of a liability is that “the transaction or other event obligating the entity has already happened.” Since the event that gives rise to the company’s obligation is the former officer’s forbearance from competition, many accountants believe that the transaction should be recorded prospectively, as the payments are “earned” by the former officer. They would disclose the contractual obligation as a commitment in the company’s notes to its financial statements.

Concepts No. 6, paragraph 26 provides that a characteristic of an asset is that “it embodies a probable future benefit. . . .” Accordingly, the company would only record an intangible asset if the payment to the former officer preceded the period of forbearance.

#### **.07 Write-Off of Goodwill on Date of Purchase**

**Inquiry**—An investor purchased a significant interest in an equity investee and at the same time guaranteed its obligations. The subsequent share of the investee’s losses plus advances exceeded the carrying amount of the investment. The investor purchased the remaining interest and assumed responsibility for the obligations of the investee. The purchase price of the remaining interest was in excess of the sum of the fair values of the identifiable assets acquired less liabilities assumed, which implied goodwill. If the parent determines that the goodwill has no value can it immediately be written off?

**Reply**—No. Goodwill is defined as the excess of the purchase price over the fair value of the identifiable assets acquired. APB Opinion No. 17, *Intangible Assets*, requires goodwill to be capitalized and amortized over its useful life. To reduce the carrying amount of goodwill, it is usually necessary to establish that the economic conditions and factors which gave rise to the goodwill no longer exist, or that the period benefited by such factors and conditions has expired. Since sufficient time has not elapsed to demonstrate either of these conditions, it would be improper to write off the goodwill.

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[The next page is 1501.]



## Section 2260

### ***Other Assets***

#### **.03 Legal Expenses Incurred to Defend Patent Infringement Suit**

*Inquiry*—A company is sued for patent infringement. Should the cost to defend the patent be capitalized or expensed?

*Reply*—The choice of capitalizing or expensing depends on the outcome of the lawsuit. FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 247 (AC V18.401), states "... the legal and other costs of successfully defending a patent from infringement are 'deferred legal costs' only in the sense that they are part of the cost of retaining and obtaining the future economic benefit of the patent."

If defense of the patent lawsuit is successful, costs may be capitalized to the extent of an evident increase in the value of the patent. Legal costs which relate to an unsuccessful outcome should be expensed.

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# TIS Section 3000

## LIABILITIES AND DEFERRED CREDITS

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## Section 3100

### **Current Liabilities**

#### **.01 Estimated Liability for Unemployment Claims**

*Inquiry*—Under state law, a corporation has a choice of the method to pay unemployment insurance contributions. The corporation may pay a percentage of gross wages or may reimburse the state employment commission directly for actual unemployment claims. A client chose to reimburse the state for the actual claims which may arise. If no claims against the client are filed, may the client record an expense and a liability for unemployment claims?

*Reply*—The estimated unemployment insurance costs should be accrued currently based on the client's estimated or past history of unemployment. Unemployment insurance cost should be related to the period worked by the employees. Not recording unemployment costs until claims are actually filed would result in a mismatching of revenues and expenses. Such an approach would be unacceptable under generally accepted accounting principles.

#### **.03 Accounting for Possible Refunds of Leasing Fees**

*Inquiry*—A company franchises distributorships for home and office oxygen inhalator units. The licensees lease the units from the company and pay an initial leasing fee for each unit before receipt of the unit. As stipulated in the franchise agreement, the licensee is entitled to a refund, upon termination of the franchise agreement and return of the units, of a specified amount of the initial leasing fee depending on the period of time that the units are leased out. When units are returned they can usually be redistributed with little or no repair. Is there a liability for the return of a portion of the initial leasing fees?

*Reply*—The returned units can usually be redistributed with little or no repair. Therefore, accounting for these units would be similar to accounting for returnable containers. Because the licensee pays the initial leasing fee prior to delivery of the units, there is no receivable to be offset by an "allowance account" for the estimated refunds, and so the amounts for estimated refunds should be shown as a liability.

#### **.04 Date for Accrual of Tax Penalties**

*Inquiry*—A company has received certain billings from the federal government for interest and penalties for late filing of federal withholding taxes. Some of these notices were received prior to the balance sheet date, while other notices were received after the balance sheet date, but in either case they apply to periods prior to the balance sheet date. Should liabilities for the interest and penalties be shown on the balance sheet?

*Reply*—SAS No. 1, section 560, *Subsequent Events*, paragraph 3 (AU 560.03), states in part:

All information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.

Therefore, provision should be made for any billings received for penalties on late filing of federal withholding taxes which were required to be filed prior to the balance sheet date. Similarly, any such interest should be provided for up to the balance sheet date. Interest accrued subsequent thereto would be an expense of the following period.

### **.08 Reporting Accrued Compensation Cost**

*Inquiry*—An entity, which will be presenting comparative financial statements, failed to implement FASB Statement No. 43, *Accounting for Compensated Absences* (AC C44), until the current year. (It was required to have been adopted for fiscal years beginning after December 15, 1980.)

According to the entity's management, the condition of the books and records makes restating the earlier of the two years presented impracticable. Instead, it intends to include the cumulative effect in net income in the current year.

Management represents that the accounting treatment should parallel that of APB Opinion No. 20, *Accounting Changes*, paragraph 20 (AC A06.116), which states, "... The amount shown in the income statement for the cumulative effect of changing to a new accounting principle is the difference between (a) the amount of retained earnings at the beginning of the period of a change and (b) the amount of retained earnings that would have been reported at that date if the new accounting principle had been applied retroactively for all periods which would have been affected and by recognizing only the direct effects of the change and related income tax effect."

The auditor states that this should be treated as the correction of an error, and, as such, must result in the restatement of the earlier year of the comparative presentation.

Is the auditor correct?

*Reply*—Assuming that the amounts of unaccrued compensation costs were material in prior years, so that prior year statements were in error, the auditor is correct. If, however, the matter became material for the first time in the current year, then application of APB Opinion No. 20 (AC A06 and A35), i.e., a cumulative effect adjustment, would be appropriate.

The transition guidance in FASB Statement No. 43 (AC C44) permitted the cumulative effect to be included in net income in the year in which the Statement was first applied if it was not practicable to restate any prior year. However, the first year of application would have to have been for fiscal years beginning after December 15, 1980. The exception would not apply to initial application after that date.

### **.09 Accrual for Employer Co-Insurance Arrangements**

*Inquiry*—A company pays for the medical expenses of its active employees but purchased "stop-gap" or "excess of loss" insurance to cover medical expenses exceeding \$10,000, lifetime benefit, per employee. What amount, if any, should the company accrue to cover its liability?

*Reply*—Although FASB Statement No. 5, *Accounting for Contingencies* (AC C59), excludes employment-related costs, that accounting guidance may be appropriate for this situation. FASB Statement No. 5, paragraph 8 (AC C59.105), states that an accrual for a loss contingency is required if the loss is probable and the amount of the loss can be reasonably estimated. Medical expenses incurred by the employee during the reporting period should be ac-



crued. This includes expenses incurred during the reporting period but submitted after the balance sheet date. The accrual should be based on all relevant data (including statistical data), the company's historical experience, and its expectations of the future. Some of this data may be available from insurance administrators or actuaries.

## **.10 Compensated Absences**

*Inquiry*—A company with a June 30 year end has a sick pay policy that states that an employee employed for at least three months is entitled to ten sick days annually. The employee is entitled to these days as of January 1 and any unused sick days as of December 31, are paid to these workers. Should the company accrue a liability as of June 30 for the unused sick days of these workers?

*Reply*—Yes. FASB Statement No. 43, *Accounting for Compensated Absences* (AC C44), indicates that sick pay that is customarily paid even though the absence from work is not actually the result of an illness, should not be considered sick pay in applying the provisions of paragraph 7 (AC C44.105) of that Statement. In considering necessity for making an accrual, the four criteria in paragraph 6 (AC C44.104) should be considered.

In determining the amount of the accrual, the guidance in FASB Statement No. 5, *Accounting for Contingencies* (AC C59), concerning the probability of future payment should be considered. Specifically, the company should consider its payment history and employee turnover in calculating the accrual.

In this example, if an employee had taken three days through June 30, the remaining accrual would be seven days. If this example were modified, and the days were earned on a pro rata basis throughout the year, the company would record a liability for the expected payment to be made to the employee for only the accumulated right through June 30. With the same three days taken through June 30, the company would have an accrual for the remaining two days in the June 30 financial statements.

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[The next page is 2021.]



## Section 3200

### Long-Term Debt

#### .06 Amortization Period for Placement Fee When Mortgage Refinanced

*Inquiry*—A company paid a \$100,000 mortgage placement fee for an eighteen year mortgage. Ten months later, it became apparent that a refinancing of a significantly larger mortgage would be needed. The company negotiated a commitment with a bank for a larger mortgage to be placed one year from the date of this agreement. At the time of the commitment, in accordance with APB Opinion No. 17, paragraph 31 (AC I60.112), which deals with intangible assets, the company reduced the amortization period of the placement fee to the expected remaining period of the original mortgage.

Two months before the closing date of the original mortgage, at which time almost the entire prepaid mortgage fee had been amortized, the bank was unable to make the loan and exercised an option to extend the closing date of the old mortgage and the placement date of the new mortgage for six more months.

Should the amortization period now be extended to the new settlement date?

*Reply*—The mortgage placement fee should not be viewed as an intangible asset but as a deferred charge under APB Opinion No. 21. It is an amortizable cost incurred to secure the mortgage.

The unamortized amount of the fee at the time when the bank exercises the option should be amortized over the remaining six month period. The reasons for the exercise of the option do not change the fact that the period benefited has been extended. The change should be treated as a change in accounting estimate, in accordance with APB Opinion No. 20 (AC A06). If the new mortgage is placed before the end of the six month option period, any balance of the fee should then be written off in accordance with APB Opinion No. 26 (AC D14) and FASB Statement No. 4 (AC D14) which deal with early extinguishment of debt. [Amended]

#### .09 Financial Statement Presentation of "Pay Any Day" Loans

*Inquiry*—Corporation A finances its purchases of equipment through "pay any day" loans. Under this type of financing arrangement, the borrower signs a note and security agreement which sets forth the amount financed, the finance charge, and the amount of monthly payment. This instrument differs from a conditional sales contract or "add-on" loan. The "add-on" loan is a contract calling for a specified number of payments, including interest, and therefore the liability is the total amount to be repaid over the life of the contract; whereas, the "pay any day" loan, or note and security agreement is a simple interest loan and the agreement shows the finance charge in order to disclose the amount of interest that will be paid if each installment payment is made on its exact due date.

What is the appropriate financial statement presentation of "pay any day" loans?

*Reply*—A "pay any day" loan can be recorded and reported in the financial statements at its face amount plus accrued interest because it is in effect a term loan with interest charged at the current rate. The amount of the loan, if any, expected to be paid within one year would be shown as a current liability.

### **.10 Determining the Allocation for Lease Payments for a Lease Capitalized at Fair Market Value**

*Inquiry*—According to FASB Statement No. 13, *Accounting for Leases*, paragraph 10, a lessee accounting for a capital lease, records an asset and an obligation equal to the present value of the minimum lease payments at the beginning of the lease term, excluding any portion of the payments which represent executory costs (e.g., insurance and taxes) which will be paid by the lessor. However, if this amount is greater than the fair market value of the leased property, the amount recorded as the asset and obligation should be fair market value. When the asset and obligation are recorded at the fair market value, since the interest rate is not known, how should the amount for the lease payments be recorded?

*Reply*—FASB Statement No. 13, paragraph 12, states in part, during the lease term, each minimum lease payment shall be allocated between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the obligation. This is the “interest” method described in the first sentence of APB Opinion No. 21, *Interest on Receivables and Payables*, paragraph 15, and in APB Opinion No. 12, *Omnibus Opinion*—1967, paragraphs 16 and 17.

When the asset to be recorded based on the present value of the minimum lease payments exceeds the fair market value of the asset, it is usually because the incremental borrowing rate used to determine present value is lower than the interest rate implicit in the lease.

### **.11 Effect of Sales Taxes on the Determination of Present Value of Minimum Lease Payments**

*Inquiry*—A company leases a machine for \$14,000 a month for 72 months. The monthly invoice received from the lessor includes the stipulated monthly rent plus a charge for state sales taxes. The lease does not meet the 90 percent criterion of a capital lease (i.e., the present value of the minimum lease payments excluding executory costs equals or exceeds 90 percent of the fair value of the leased property) if sales taxes are excluded from minimum lease payments. The criterion is met if both the rent and sales taxes are included as minimum lease payments.

Should the minimum lease payments include sales taxes?

*Reply*—Practice in this area varies. FASB Statement No. 13, *Accounting for Leases*, paragraph 5(j)(i) defines, in part, minimum lease payments as the payments that the lessee is obligated to make or can be required to make in connection with the leased property. However, “. . . the lessee’s obligation to pay (apart from rental payments) executory costs such as insurance, maintenance, and taxes in connection with leased property shall be excluded.” Many accountants interpret this to mean that all taxes, including sales taxes, levied on lease payments are considered executory costs since the lessor is merely acting as a collection agent for the taxing authority.

Other accountants believe that only taxes other than sales taxes (such as property taxes) should be excluded from the minimum lease payments because sales taxes are often capitalized as part of the cost of purchased assets. FASB Statement No. 13, paragraph 60 states that the provisions of this Statement derive from the view that a lease that transfers substantially all of the benefits and risks incident to ownership should be accounted for as the acquisition of an asset and the incurrence of an obligation.

Because the authoritative pronouncements do not specifically address whether sales taxes should be included as part of minimum lease payments, practice varies and should be determined by the company's general policy for accounting for sales taxes on purchased assets.

Regardless of which approach is used, in order to properly apply the 90 percent test referred to in FASB Statement No. 13, paragraph 7(d) (AC L10.103), the components of the numerator and denominator should be the same. For example, if the sales taxes are included as part of the minimum lease payments (the numerator) then the sales taxes should be included in the fair value of the leased asset (the denominator).

## **.12 Balance Sheet Classification of Revolving Line of Credit**

*Inquiry*—A company has a revolving line of credit with a bank. The company is only required to make monthly interest payments. No principal payments are required. In the event the credit line is terminated, the principal is due 12 months after the date of termination.

Should the principal amount be classified as current or long-term in a classified balance sheet?

*Reply*—ARB No. 43, Chapter 3A, *Current Assets and Current Liabilities*, paragraph 7 (AC B05.402), states that liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually 12 months, are intended for inclusion in the current liability classification. If the line of credit has not been terminated at the balance sheet date, the principal amount should be classified as long-term, unless the company intends to repay the outstanding debt within 12 months.

## **.13 Uncertainty Arising From Violation of Debt Agreement**

*Inquiry*—At the end of 19X1, a company was in violation of its long-term debt covenant and was unable to obtain a waiver from the bank. It therefore reclassified its debt to current and appropriate footnote disclosures were made. During 19X2, the violation was cured. What is the proper classification of the debt in the company's 19X2 comparative financial statements?

*Reply*—FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor* (AC B05), states that the current liability classification is intended to include long-term obligations that are or will be callable by the creditor because the debtor either violates the debt agreement or does not cure a violation within a specified grace period. Accordingly, such callable obligations should be classified as current liabilities unless the creditor waives or loses the right to demand payment.

Since the violation was cured in 19X2, the debt should be classified as long-term in the 19X2 financial statements. The debt should not be reclassified to long term in the 19X1 financial statements because it was a current liability based on the facts existing at the 19X1 balance sheet date.

## **.15 Disclosure of Five-Year Maturities on Long-Term Debt**

*Inquiry*—A company entered into a 10-year loan agreement with a lender. The mortgage note contains a variable interest rate based on prime plus one percent. In accordance with FASB Statement No. 47, *Disclosure of Long-Term Obligations* (AC C32), the company will disclose the maturities on the debt for each of the next five succeeding years. Should the disclosure include principal and interest?

*Reply*—No. The required disclosure of the amount of scheduled repayments for each of the five succeeding fiscal years relates only to principal repayments and should not include interest. Disclosure is also called for when interest rates vary with the prime rate.

**.16 Amortization of Premium or Discount in Investment Securities With an Early Call Date**

*Inquiry*—Investment securities may be acquired at par value, at a premium, or at a discount. If the investment securities have an earlier call date, how should the amortization of premium or accretion of discount be recorded?

*Reply*—FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases* (AC L20), applies to the accounting for discounts, premiums, and commitment fees associated with the purchase of loans and other debt securities such as corporate bonds. In accordance with FASB Statement No. 91, paragraph 19 (AC L20.118), “the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principles shall not be anticipated to shorten the loan term.” Accordingly, the period of amortization or accretion is from the purchase date to the maturity date. As provided by FASB Statement No. 91, paragraph 19 (AC L20.118), in order to amortize the premium or accrete the discount to an early call date, the enterprise must hold a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated.

**.17 Disclosure of Covenant Violation and Subsequent Bank Waiver**

*Inquiry*—At the balance-sheet date, an entity was in violation of certain provisions of the loan covenant associated with its long-term debt. Under the terms of the loan agreement, the obligation is now callable by the creditor. Subsequent to the balance-sheet date, the bank waived its right to demand repayment for more than one year from the balance-sheet date. Therefore the loan remained classified as long-term, per FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor*, paragraph 5 (AC B05.109A). Does the covenant violation and subsequent bank waiver need to be disclosed in the financial statements?

*Reply*—The authoritative literature applicable to nonpublic entities does not address disclosure of debt covenant violations existing at the balance-sheet date that have been waived by the creditor for a stated period of time. Nevertheless, disclosure of the existing violation(s) and the waiver period should be considered for reasons of adequate disclosure. If the covenant violation resulted from nonpayment of principal or interest on the debt, inability to maintain required financial ratios, or other such financial covenants, that information may be vital to users of the financial statements even though the debt is not callable. If the lender has waived the right for greater than one year but retained the future covenant requirements (i.e., covenant requirements will have to be met at interim dates during the next 12 months), the accounting and disclosure provisions of EITF Issue No. 86-30, *Classification of Obligations When a Violation Is Waived by the Creditor*, apply.

For SEC registrants, Regulation S-X, Article 4, Section 210.4-08(c), requires disclosure of the amount of the obligation and the period of waiver whenever a creditor has waived its right to call the debt for a stated period of time.

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[The next page is 2471.]

## Section 3400

### Contingent Liabilities

#### .01 Contested Liability

*Inquiry*—A company acquired the entire outstanding stock of another company several years ago. The acquired company was reorganized under IRS Code Section 334(b)(2) causing its building and equipment to be written up in value. Inventory was later written down.

An unpaid portion of the original purchase price is claimed by the former owners of the acquired company, but this is contested by the acquiring company on the grounds that the value of the acquired company's stock was misrepresented.

The acquired company's shareholders intend to sue the acquiring company for the unpaid balance, but a suit has not yet been filed. How should the amount due under the original purchase contract and the possible suit be reflected on the acquiring company's financial statements?

*Reply*—Because the possibility of a suit exists, footnote disclosure describing the entire dispute should be made, including legal counsel's comment that no suit is pending at this time. The amount due under the original purchase contract, plus accrued interest, should still be reported as a liability. No adjustments should be made in the acquiring company's financial records until the dispute is settled or legal counsel advises that a statute of limitations effectively bars filing of the suit in question and the company is not legally liable to pay the debt.

#### .02 Disclosure of Agreement Between Corporation and Its Shareholders

*Inquiry*—Corporation A, a closely held entity, has an agreement with its shareholders under which Corporation A could become obligated to purchase a certain number of shares of stock of deceased shareholders at book value. Should Corporation A disclose this agreement in its financial statements?

*Reply*—Corporation A should disclose the terms of the agreement in a note to its financial statements since it is a contingent liability.

#### .04 Accounting for Issuance of Cents Off Coupons

*Inquiry*—A client includes with its consumer product a coupon for cents off on the next purchase of the product. Should the coupon be accounted for as a reduction of the selling price when the second product is sold?

*Reply*—FASB Statement No. 5, *Accounting for Contingencies*, paragraph 4(f), would consider the possible future coupon claims as a loss contingency to be evaluated as a future event. More than likely, the redemption of some or all of the coupons would be considered a probable event under FASB Statement No. 5, paragraph 3. The amount to be accrued and charged to earnings at the time the first product is sold should be based on a reasonable estimate of the amount of coupons expected to be presented for redemption. This estimate could be based on experience in previous promotions.

**.06 Change in Accounting Estimate for Discounted Receivables**

*Inquiry*—A company is contingently liable under guarantees of discounted receivables upon their default for nonpayment. In the past year the volume of defaults has increased. If the company increases its allowance for defaults as a result of such experience, how should the increase in the allowance be reflected in the financial statements?

*Reply*—The increase in the allowance represents a change in accounting estimate and should “be accounted for in . . . the period of change,” in accordance with APB Opinion No. 20, *Accounting Changes*, paragraph 31. Prior periods should not be restated, nor should pro forma information be presented.

APB Opinion No. 20, paragraph 33, states that disclosure “is not necessary (but) is recommended if the effect of a change in the estimate is material.”  
[Amended]

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[The next page is 2571.]



## Section 3500

### Commitments

#### .01 Accounting for Contract to Cut Timber

*Inquiry*—A corporation is engaged in the forest products industry and purchases timber under both “pay as cut” (specifies a rate the buyer will pay per unit of volume cut) and “lump sum” (buyer pays a fixed amount for the right to cut timber on a specific tract of land). The corporation agrees to purchase timber on land which is identified in the contract. The exact amount of timber purchased can vary in total footage as well as species due to the nature of the goods. Is it proper to recognize the transactions as assets and liabilities on the balance sheet?

*Reply*—It would be improper to recognize a contract to cut timber as an asset and a liability unless the contract, at the time it was entered into, resulted in the purchase of the timber.

A distinction must be made between a contract that is executory in nature and one in which a sale and a purchase of lumber has occurred. Evidence of a purchase would be the transfer of title to the lumber at the time the contract is signed. Such a transfer usually occurs with lump sum contracts and may occur under pay as cut contracts if they include performance guarantees or risk of monetary damages if not performed. Therefore, those contracts would generally be recognized as assets and liabilities.

Receiving title at the time the timber is cut rather than at the time the contract is signed makes the contract executory. It is generally accepted practice to adequately disclose the nature and amounts of commitments relating to executory contracts in the notes to financial statements. Therefore, pay as cut contracts without performance guarantees or risk of monetary damages would generally not be recognized as assets and liabilities until performance occurs. [Amended]

#### .02 Liability Under Foreign Bank's Letter of Payment Guarantee

*Inquiry*—A client, an import-export firm, agreed to purchase goods from a foreign manufacturer. The agreement calls for advance payment with the goods being delivered over the twelve-month period following the date of the agreement. The client arranged to make this advance payment through a letter of credit issued by a U.S. bank. The U.S. bank has received a letter of payment guarantee issued by a bank in the foreign country. If the supplier fails to make shipments under the terms of the agreement, the U.S. bank will look to the foreign bank for any unpaid advances owed to the U.S. bank by the client. The U.S. bank will look to the client for payment of all amounts represented by shipments to the client under the terms of the agreement.

Is the client directly liable for the amount advanced by the U.S. bank through its letter of credit, or does the client become liable only as the goods are received and payment is due the U.S. bank?

*Reply*—The client is directly liable for the amount advanced to the foreign supplier. It appears from the description of the transactions that the foreign

bank is contingently liable if the supplier does not perform under the agreement. The offsetting asset would be classified as an "Advance to Suppliers." Additional footnote disclosure of the financial arrangements would also be required.

#### **.04 Recognition of Losses on Purchase Commitments**

*Inquiry*—ARB No. 43, Chapter 4, *Inventory Pricing*, Statement 10 (AC I78) states: "Accrued net losses on firm purchase commitments for goods for inventory, measured in the same way as are inventory losses, should, if material, be recognized in the accounts and the amounts thereof separately disclosed in the income statement."

Does this statement mean that the measurement of losses cannot be done on an item by item basis but must only be done if there is an overall net loss on purchase commitments?

*Reply*—Net losses apply to specific purchase commitments and contracts, and not necessarily to components of major categories of inventories, as discussed in ARB No. 43, Chapter 4, Statement 7 (AC I78).

#### **.05 Letters of Credit**

*Inquiry*—Should a company report its outstanding letters of credit as a liability in the financial statements?

*Reply*—FASB Statement No. 5, *Accounting for Contingencies*, paragraphs 18 (AC C59.120) and 19 (AC C59.120), requires disclosure of unused letters of credit. They are commitments and should not be reported as a liability in the financial statements. [Amended]

#### **.06 Covenants Imposed by Loan Agreements**

*Inquiry*—Restrictive covenants under certain loan agreements of Company A require the Company to maintain a special level of working capital, limit the amount of additional debt that it can incur, and restrict the amount of retained earnings available for dividend payments. Should the restrictive covenants be disclosed?

*Reply*—FASB Statement No. 5, *Accounting for Contingencies* (AC C59), SAS No. 32, *Adequacy of Disclosure of Financial Statements* (AU 431), and ATB No. 1, paragraph 69(4) require the disclosure of restrictive covenants. The discussion of disclosure of restricted retained earnings in ARS No. 7, page 203, states: "When there is more than one type of restriction, disclosure of the amount of retained earnings, so restricted, may be based on the most restrictive covenants likely to be effective in the immediate future. In other words, restrictions seldom, if ever, pyramid in amount." By analogy, disclosing only the most restrictive covenants applying to dividend distributions would also apply to other restrictive covenants. [Amended]

#### **.07 Disclosure of Unused Lines of Credit**

*Inquiry*—Should nonpublic companies disclose the existence of unused lines of credit that are available as of the balance sheet date?

*Reply*—Although public companies are required [pursuant to SEC Regulation S-X, section 210.5-02.19(b)] to disclose significant unused lines of credit for short-term financing in the notes, there is no such explicit requirement for nonpublic companies under generally accepted accounting principles. However, under certain circumstances, disclosure by nonpublic companies may be advisable based on the general principle of adequate disclosure.

SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, paragraph 4 (AU 411.04), states that the notes, as well as the financial statements, should be "... informative of matters that may affect their use, understanding, and interpretation." In addition, SAS No. 32, *Adequacy of Disclosure in Financial Statements*, paragraph 2 (AU 431.02), emphasizes:

An independent auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which he is aware at the time.

[Amended June 1995.]

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[The next page is 2671.]



## Section 3600

### ***Deferred Credits***

#### **.01 Balance Sheet Presentation of Unearned Revenue**

*Inquiry*—A client, a motor club with an insurance company subsidiary, has annually contended that unearned insurance premiums and membership dues should be presented on the consolidated balance sheet as deferred income immediately preceding the members' equity and should not be included in the amount for total liabilities. The client recognizes the revenues on the insurance premiums and membership dues on a pro rata basis over the period covered by the insurance policy and the memberships, therefore, the auditors have maintained that the unearned portion of the insurance premiums and membership dues represent a liability on the part of the client to render services in the future.

Is it appropriate to show these unearned premiums and dues outside the liability section of the balance sheet?

*Reply*—FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 84, indicates that amounts received for goods or services in advance are not treated as revenue of the period in which they are received but as revenue of the period or periods in which they are earned. These amounts are carried as "unearned revenue"—that is, liabilities to transfer goods or render services in the future—until the earning process is complete. Therefore, the unearned portions of the insurance premiums and membership dues represent liabilities to provide services in the future. While the description of the liabilities might vary, to present the unearned premiums and membership dues outside of the liability section of the balance sheet would be inappropriate.

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# TIS Section 4000

## CAPITAL

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## Section 4110

### *Issuance of Capital Stock*

#### **.01 Expenses Incurred in Public Sale of Capital Stock**

*Inquiry*—A closely held corporation is issuing stock for the first time to the public.

How would costs, such as legal and accounting fees, incurred as a result of this issue, be handled in the accounting records?

*Reply*—Direct costs of obtaining capital by issuing stock should be deducted from the related proceeds, and the net amount recorded as contributed stockholders' equity. Assuming no legal prohibitions, issue costs should be deducted from capital stock or capital in excess of par or stated value.

Such costs should be limited to the direct cost of issuing the security. Thus, there should be no allocation of officers' salaries, and care should be taken that legal and accounting fees do not include any fees that would have been incurred in the absence of such issuance. [Amended]

#### **.02 Stock Issued for No Consideration**

*Inquiry*—A corporation issued stock without receiving any consideration and set up goodwill to offset the credit to capital stock. Was this transaction properly recorded?

*Reply*—This is primarily a legal rather than an accounting question, and it would be advisable to obtain legal advice as to the effect of such issuance. If such stock were legally issued, the appropriate entry would be to show the offset as discount on capital stock issued. Goodwill should only be recognized when acquired, in accordance with paragraphs 24 through 26 (AC I60.105–107) of Accounting Principles Board Opinion No. 17. [Amended]

#### **.03 Stock Issued for Accounting and Management Services**

*Inquiry*—A newly formed corporation is going public and wishes to issue shares of stock for certain services, such as accounting, legal, underwriting, printing, etc.

How should the value for these services be set up on the books of the corporation?

*Reply*—It would be appropriate to record the stock issued at the fair value of the stock or services rendered, whichever is the more clearly evident. The recipients should be able to furnish evidence as to such fair value. Since the amounts the Securities and Exchange Commission might consider to be fair value cannot be predicted, a consultation with the staff of the Commission might be advisable before formal submission of the financial statements. [Amended]

#### **.07 Expenses Incurred in Withdrawn Public Offering**

*Inquiry*—What is the proper accounting for the costs of a public offering that was withdrawn?

*Reply*—Accounting Research Study No. 15, *Stockholders' Equity*, page 23, discusses accounting for stock issue costs. The Study states that such costs are usually deducted from contributed portions of equity, that is, capital stock or capital in excess of stated or par value, as a reduction in the proceeds from the sale of securities.

Since there were no proceeds from a sale of securities to offset the costs, the costs should be charged to current year's income, but not as an extraordinary item.

#### **.08 Balance Sheet Presentation of Mandatory Redeemable Preferred Stock**

*Inquiry*—Should mandatory redeemable preferred stock be reflected in the equity section of the balance sheet?

*Reply*—The Securities and Exchange Commission has addressed this question in Regulation S-X, section no. 210.5-02.28. This regulation states that mandatory redeemable preferred stock is not to be included in amounts reported as stockholders' equity.

Although nonpublic companies are not required to follow Regulation S-X, it would be appropriate for them to do so in most cases. However, practice varies.

FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 62, states all classes of equity depend to some extent on enterprise profitability for distribution of enterprises assets, and no class of equity carries an unconditional right to receive future transfers of assets from the enterprise except in liquidation, and then only after liabilities have been satisfied.

This characteristic of equity is generally not found in mandatory redeemable preferred stock. If the stock is redeemable at a specific date or at the option of the holder, debt classification as suggested by Regulation S-X seems most appropriate. Some financial statements present mandatory redeemable preferred stock in a category between liabilities and equity. However, facts and circumstances in nonpublic entities (e.g., certain stock issued for estate planning purposes) may justify equity classification of certain mandatory redeemable preferred stock. [Amended]

#### **.09 Costs Incurred to Acquire Treasury Stock**

*Inquiry*—A company has incurred legal and accounting costs arising from the acquisition of treasury stock. How should the costs be classified in the company's financial statements?

*Reply*—There is no authoritative literature on this particular subject. Some accountants believe that costs associated with the acquisition of treasury stock should be treated in a manner similar to stock issue costs. Stock issue costs are usually accounted for as a deduction from the gross proceeds of the sale of stock. Costs associated with the acquisition of treasury stock may be added to the cost of the treasury stock.

#### **.10 Costs Incurred in Shelf Registration**

*Inquiry*—A public company incurs legal and other fees in connection with an SEC filing for a stock issue it plans to offer under a shelf registration. How should the company account for these costs?

*Reply*—The costs should be capitalized as a prepaid expense. When securities are taken off the shelf and sold, a portion of the costs attributable to the securities sold should be charged against paid in capital. Any subsequent costs

incurred to keep the filing “alive” should be charged to expense as incurred. If the filing is withdrawn, the related capitalized costs should be charged to expense.

#### **.11 Default on Stock Subscribed**

*Inquiry*—A company entered into a stock subscription agreement to sell its stock. The agreement called for three monthly payments of \$10,000 after which the stock would be issued. Although the first payment was received by the company, the subscriber subsequently defaulted on the remaining two payments. According to the agreement, any payments made by the subscriber towards the stock subscription are not refundable. How should the company account for the retention of the first \$10,000 payment?

*Reply*—The payment should be recorded as an addition to shareholders' equity (i.e., a credit to paid-in capital). According to APB Opinion No. 9, *Reporting the Results of Operations*, paragraph 28, capital transactions shall be excluded from the determination of net income or the results of operations.

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**[The next page is 3121.]**



## Section 4120

### ***Reacquisition of Capital Stock***

#### **.03 Repurchase of Stock in Excess of Retained Earnings and Additional Paid-in Capital**

*Inquiry*—A corporation has contracted to repurchase, over a period, some of its own stock. The corporation does not have sufficient retained earnings and additional paid-in capital from which to charge the excess of amounts paid over par value. How should this repurchase be reflected in the company's financial statements?

*Reply*—In many states, it would not be legal for a corporation to repurchase shares of its own stock at a cost greater than the amount of retained earnings of the corporation. Competent legal advice as to the effect of the agreement should be obtained. This may be an executory contract, with only amounts currently being paid for considered as repurchases. If this be the case, only amounts disbursed are to be recognized in the accounts, with an offset to treasury stock. There should of course be disclosure in a note to the financial statements of the date, number of shares, and amounts of future payments under the contract. Such future payments would thus include the interest factor, which would be an additional cost of the stock, rather than being interest expense.

However, if legal counsel advises that this is in fact a completed contract and enforceable, the full amount should be shown (excluding interest) as treasury stock, with an offsetting liability. Again, there should be footnote disclosure of the nature of the liability and of the interest rate and maturity dates. Under these circumstances, the interest would be included as a current expense. [Amended]

#### **.05 Purchase of Treasury Shares for an Amount in Excess of Market Price**

*Inquiry*—A corporation enters into an agreement to purchase a major block of its shares from one of its shareholders at a price in excess of its current market price. These shares represent the controlling interest in the corporation. The purchase price of the treasury stock does not include any other rights or privileges. At what value should the corporation record the treasury stock?

*Reply*—FASB Technical Bulletin 85-6, *Accounting for a Purchase of Treasury Shares and Costs Incurred in Defending Against a Takeover Attempt* (AC C23), states that transactions do arise in which an acquisition of an enterprise's stock may take place at prices different from routine transactions in the open market. A block of shares representing a controlling interest will generally trade at a price in excess of market, and a large block of shares may trade at a price above or below the current market price depending on whether the buyer or seller initiates the transaction. A company's acquisition of its shares in those circumstances is solely a treasury stock transaction and is properly accounted for at the purchase price of the treasury shares.

In this situation, since the purchase price does not include amounts attributable to items other than the shares purchased, the entire purchase price should be accounted for as the cost of treasury shares.

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**[The next page is 3201.]**

## Section 4130

### ***Warrants***

#### **.03 Warrants Reacquired**

*Inquiry*—Company A issued, in a prior year, stock warrants with a subordinated note. The value of the warrants as determined at the date of issuance was added to capital in excess of par value and recorded as deferred loan costs to be amortized over the term of the loan. Company A plans to reacquire the warrants for \$110,000. Should the \$110,000 be:

- (a) accounted for as additional cost of the loan and amortized over the remaining term of the loan, or
- (b) accounted for as a capital transaction and deducted from capital in excess of par value, or
- (c) accounted for in some other manner?

*Reply*—The purchase price of the warrants should be deducted from either capital in excess of par value or retained earnings.

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[The next page is 3341.]





## Section 4150

### ***Stock Dividends and Stock Splits***

#### **.01 Stock Dividends of Closely-Held Corporation**

*Inquiry*—A corporation has about two hundred stockholders with the board of directors controlling about 80% of the stock. There is virtually no buying or selling of the company's stock and the price of trades has been constant at a level suggested by management.

The company has followed a policy of issuing stock distributions (usually 10 or 20%) and capitalizing them at par because there is not sufficient retained earnings to capitalize at estimated market value. The issuance of stock distributions is an integral part of the company's philosophy and policy with regard to employee morale and maintaining a relatively fixed trading value for the stock in the absence of a market.

Earnings have been increasing at 10% to 20% per year and cash dividends have remained constant. Stock distributions provide a means for returning earnings to stockholders without the tax impact of cash dividends.

Accounting Research Bulletin No. 43 states that stock dividends in amounts of less than 20% to 25% or of a recurring or frequent nature should be accounted for by capitalizing the estimated market value of the stock. The Bulletin also states that in cases of closely-held companies, it is to be presumed that the intimate knowledge of the corporation's affairs possessed by the shareholders would preclude any such implications as referred to in paragraph 10 of Chapter 7, Section B (AC C20.103), and that there is no need to capitalize earned surplus other than to meet legal requirements.

Under these circumstances, is it required that the stock dividends be capitalized at the estimated market value of the stock?

*Reply*—Since only 20% of the corporation's stock is not controlled by the board of directors, it is likely that these minority shareholders would not have intimate knowledge of the corporation's affairs, as contemplated in paragraph 12, Chapter 7, Section B (AC C20.105) of Accounting Research Bulletin No. 43, which excludes closely-held corporations from the provisions of paragraph 10 (AC C20.103). Accordingly, the requirements of paragraph 10 would apply. The stock dividends should be capitalized at the selling price of the stock with a corresponding charge to retained earnings. [Amended]

#### **.02 Stock Dividend Affecting Market Price of Stock**

*Inquiry*—A company issued a 10% stock dividend. May the dividend be treated as a stock split if the dividend resulted in a drop in the market price of the stock?

*Reply*—Paragraph 13 in Chapter 7, Section B of Accounting Research Bulletin No. 43 (AC C20.106) states, in part, "On the basis of a review of market action in the case of shares of a number of companies having relatively recent stock distributions, it would appear that there would be few instances involving

the issuance of additional shares of less than, say, 20% or 25% of the number previously outstanding where the effect would not be such as to call for the procedure referred to in paragraph 10 (AC C20.103)." Paragraph 10 (AC C20.103) requires a transfer from retained earnings to the category of permanent capitalization in an amount equal to the fair value of the additional shares issued.

In order to treat the 10% "stock dividend" as a "split-up effected in the form of a dividend," the company would have to demonstrate that the additional shares issued is "large enough to materially influence the unit market price of the stock" as indicated in paragraph 13 (AC C20.106).

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**[The next page is 3401.]**

## Section 4160

### ***Contributed Capital***

#### **.01 Payment of Corporate Debt by Stockholders**

*Inquiry*—Three shareholders own stock in Corporations A and B. They agree to personally pay a debt of Corporation A by giving the creditor stock in Corporation B. How should this transaction be recorded on the books of Corporation A?

*Reply*—The payments by the three stockholders of Corporation A's debt would represent an additional contribution by the stockholders to Corporation A. This can be recorded as a credit to "additional capital." [Amended]

#### **.02 Forgiveness of Debt by Principal Owner**

*Inquiry*—The sole owner of a corporation forgives a loan that the corporation owes to him. What is the appropriate accounting treatment for this transaction?

*Reply*—APB Opinion No. 26, *Early Extinguishment of Debt*, deals with debt extinguishments which are ordinarily treated as extraordinary items. APB Opinion No. 26, paragraph 20, footnote 1 (AC L35.105, footnote 2) states, however, that extinguishment transactions between related enterprises may be in essence capital transactions.

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[The next page is 3501.]



## Section 4200

### ***Retained Earnings***

#### **.01 Foreign Currency Translation—Retained Earnings**

*Inquiry*—A parent company is translating a foreign subsidiary's financial statements for consolidation purposes. It is the second year of operation for the subsidiary. How should retained earnings be translated?

*Reply*—For assets and liabilities, FASB Statement No. 52, *Foreign Currency Translation*, paragraph 12, requires the use of the exchange rate at the balance sheet date. For revenues, expenses, gains, and losses, the exchange rate at the dates on which those elements are recognized shall be used. However, an appropriately weighted average exchange rate for the period may be used to translate the income statement.

In year two, net income or loss would be translated at the weighted average exchange rate for the current year and accumulated with the historical opening translated retained earnings. It should be noted there may be a number of other transactions that may affect the subsidiary's retained earnings including the declaration of dividends.

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[The next page is 3551.]



## Section 4210

### Dividends

#### .01 Write-off of Liquidating Dividends

*Inquiry*—Quite a few years ago, cash dividends were distributed to stockholders in excess of earnings. The company would now like to “clean up” the stockholders’ equity section of the balance sheet by removing the account “Prior Years’ Liquidation Dividends” which is shown as a reduction of the capital stock account. Can the liquidating dividends account be written off against “retained earnings” or “paid in capital in excess of par value”?

*Reply*—Essentially, this question is a legal one as to whether cash distribution to stockholders in excess of earnings in prior years may be charged to earnings in subsequent years. When liquidating dividends are declared, the charge is made to accounts such as “capital repayment,” “capital returned,” or “liquidating dividends” which appear on the balance sheet as offsets to paid-in capital. By this treatment, the amount of capital returned as well as the amount of capital originally paid in can be disclosed. Perhaps the wisest thing to do under the circumstances is to consult legal counsel to determine whether the write-off proposed is legal under the corporate statutes of the state. Perhaps it is legally permissible, under the laws of incorporation, to reduce the par or stated value of the corporation’s stock, thereby creating a reduction surplus which may then be used retroactively to absorb the original deficit, on the ground that the excess payments were dividends in partial liquidation.

#### .04 Accrual of Preferred Dividends

*Inquiry*—A corporation has cumulative preferred stock. It has not paid any dividends on this stock in the last three years. Should the corporation accrue the preferred dividends in arrears?

*Reply*—Generally, preferred stock contains a cumulative provision whereby dividends omitted in previous years must be paid prior to the payment of dividends on other outstanding shares. Since dividends do not become a corporate liability until declared, no accrual is needed. FASB Statement No. 129, *Disclosure of Information about Capital Structure* (AC C24), requires entities to disclose within its financial statements (either on the face of the statement of financial position or in the notes thereto) the aggregate and per-share amounts of arrearages in cumulative preferred dividends. Furthermore, FASB Statement No. 128, *Earnings per Share*, paragraph 9 (AC E11.104), states that dividends accumulated for the period on cumulative preferred stock (whether or not earned) should be deducted from income from continuing operations and also from net income when computing earnings per share. If there is a loss from continuing operations or a net loss, the amount of the loss should be increased by those preferred dividends. Preferred dividends that are cumulative only if earned should be deducted only to the extent that they are earned.

If preferred dividends are not cumulative, only the dividends declared should be deducted. In all cases, the effect that has been given to preferred dividends in arriving at income available to common stockholders in computing basic earnings per share should be disclosed for every period for which an income statement is presented. [Amended September 1997]

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[The next page is 3631.]





## Section 4230

### ***Capital Transactions***

#### **.02 Exchange of No Par Common Shares for Par Value Preferred Shares**

*Inquiry*—The shareholders of Corporation A exchanged their no par common shares for preferred shares with a par value to “freeze” the value of stock ownership for estate tax purposes. How should the difference between the carrying basis of the preferred shares and the carrying basis of the common shares be accounted for?

*Reply*—The difference should be charged or credited to additional paid-in capital. If there is no additional paid-in capital, any “debit” balance should first be charged to retained earnings and any remaining “debit” balance should be described in the financial statements as a discount on preferred stock. However, in many states the law requires that issued stock must be fully paid and nonassessable and therefore, if the par value of the preferred shares exceeds the market value of the common shares this exchange may have legal implications that should be considered. [Amended]

#### **.03 Use of Stockholder’s Assets to Repay Corporate Loan**

*Inquiry*—The sole owner of a corporation agreed to collateralize the company’s bank loan with personal assets. As a result of financial difficulties, the company’s bank loan was called and its owner agreed to sell his personal assets collateralizing the company’s loan, to repay the bank debt. What is the appropriate accounting of this transaction?

*Reply*—The monies used to repay the bank loan are in substance a further capital infusion by the individual, which increases his investment in the company. The company would eliminate its liability to the bank and credit paid-in capital.

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# TIS Section 5000

## REVENUE AND EXPENSE

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## Section 5100

### Revenue Recognition

#### .01 Equipment Sales Net of Trade-Ins

*Inquiry*—A Client who deals in heavy equipment records all sales at net of trade-ins. Is this an acceptable accounting practice?

*Reply*—Support for the accounting treatment for trade-ins which this client follows could not be found. Sales should be credited with the nominal or stated contract price, and the difference between (a) the trade-in allowance and (b) the amount determined by pricing the trade-in at net realizable value minus normal profit margin should be treated as a sales allowance or discount. The traded-in equipment should be set up in inventory at an amount which, when reconditioning costs are added, will allow a margin approximating a normal profit when the sale is made.

#### .02 Rights to Broadcast Time Received for Services

*Inquiry*—An advertising agency creates and sells jingles and station identifications to radio and television stations. The agency receives broadcast time credit as part payment. This broadcast time is then resold by the agency to its clients. Should this broadcast time be recognized by the advertising agency:

1. when the agency bills the radio or television station, or
2. when it is subsequently sold to advertisers?

*Reply*—The broadcast time credit should be recognized as income when the services are billed to the station. It may be necessary to estimate the value of the credits. A corresponding asset account should be charged. This asset would be relieved as the broadcast time is sold by the advertising agency. [Amended]

#### .04 Discounts on Prepaid Funeral Arrangement Plans

*Inquiry*—An incorporated mortuary sells pre-need funeral plans in addition to rendering current mortuary services. These pre-need funeral plans are sold at a discount in order to be attractive to the public. All monies received from the sale of these plans are placed in a trust fund which has been set up at a local bank. The bank is the trustee of the trust and makes investments as it sees fit. The pre-need funeral plan agreements stipulate that all income earned by the trust belong to the mortuary, and withdrawals of such income from the trust may be made by the mortuary periodically. In return for the feature of the agreements calling for the mortuary's entitlement to the trust fund income, purchasers of the pre-need plans are permitted to buy the plans at a substantial discount. The agreements also provide for fully-covered funeral benefits in certain cases, although the plans may not be fully paid at time of death. Another advantage to the purchasers is that the costs of their funerals will not be influenced by increases in the cost of living index.

Certain expenses are met by the mortuary in the selling of its pre-need funeral plans; these are recorded monthly in a separate expense account in its general ledger. Trust fund income earned is also recorded monthly in the mortuary's general ledger, in a separate income account. As pre-need plans are

utilized by persons who had purchased them earlier, the special discounts mentioned in the preceding paragraph are recorded in a separate expense account in the mortuary's general ledger. It should be emphasized here that such discounts are not reflected as an expense in the mortuary's operations until such time the plans are actually used, whereas the expenses of the sales of the plans and the income earned by the trust affect operations currently, with no dependency whatsoever on the deaths of the purchasers or holders of the plans.

In order to achieve a better matching of expenses with revenues accruing from the sales of plans, could the trust fund income or the excess of trust fund income over the expenses of selling the plans be deferred until the plans are utilized? Or could the special discounts be charged to income at some date prior to the utilization of the plans?

*Reply*—It would be more acceptable to currently accrue or recognize selling expenses, fees and commissions, and trust fund income rather than use the “completed contract” or deferral accounting approach. If it is a fact that costs of furnishing services commonly exceed the trust funds expended at time of utilizing a plan, current provision should be made on an estimated basis for the potential or possible losses (more accurately, estimated excess of future servicing costs over monies to be released from trust to defray same) on plans not utilized as yet at the balance sheet date.

The special discounts are more in the nature of sales adjustments rather than costs or expenses.

**.07 One-Cent Sales**

*Inquiry*—A client in the fast food business has a “one-cent sale” once a week. For example, the sale might be two cheeseburgers for the price of one (60¢) plus one cent. The company would record the transaction as follows:

Cash (.60 + .01) .....	\$ .61
Advertisement Expense .....	.59
Sales (.60 × 2) .....	\$1.20

The company makes this entry so that their “food costs” are not distorted, but should an adjustment be made at the end of the year for financial reporting purposes eliminating this advertising expense against sales?

*Reply*—The practice of crediting sales and charging advertising expense for the difference between the normal sales price and the “bargain day” sales price of merchandise is not acceptable for financial reporting. Realization of the full sales price cannot properly be imputed under such conditions. To do so would seem to imply that the same quantities would have been sold if the price had not been reduced.

It might however be appropriate to adjust the cost of sales and charge advertising for the cost of the one-cent hamburger. Such cost of sales should include only out-of-pocket expenses.

**.08 Life Membership Fees in a Club**

*Inquiry*—A company is engaged in a service club enterprise. What is the proper accounting for life membership fees?



*Reply*—The life membership fees should be allocated over the time the individual may be expected to require the services of the club.

#### **.10 Members of Country Club Assessed for Debt Retirement**

*Inquiry*—A country club has voted to impose a special yearly assessment on its membership for ten years. The proceeds are to be used to retire a first mortgage on the property of the club.

The assessment is being imposed on all members including voting certificate holders and nonvoting associate members.

Is the proper accounting treatment of this transaction a contribution to capital, or are dues to be reflected in the annual income statement?

*Reply*—When billing the assessments each year, the receivables from the members can be shown as an asset with a credit to income for the special assessment. Such amounts might then be appropriated to a special membership equity, perhaps entitled “appropriation for retirement of debt.” The financial statements should disclose that the directors had voted a special assessment for ten years and the amount of assessment per year. The first or the last year for the assessment, or both, should also be disclosed.

#### **.11 Excise Tax on Club Dues**

*Inquiry*—The members of certain private clubs must pay a federal excise tax in addition to their annual dues. Should the clubs record, as revenues, the dues net of the excise tax, or should revenues include both dues and taxes?

*Reply*—A club, in collecting excise taxes on dues, is acting as no more than an agent or conduit for the federal government. The amounts paid to the club by members to be turned over as excise taxes should not be construed as dues, and to show them as such on the income statement is erroneous.

#### **.14 Recognition of Fees Earned on Construction Mortgage Placements**

*Inquiry*—A client is in the business of bringing lenders and borrowers together for a fee. When a construction mortgage has been arranged and agreed to, it would appear that the client has earned its fee. However, because of the terms of the fee arrangement, there is some doubt as to when the income should be recognized.

The following is a summary of the types of transactions involved:

##### **1. Negotiable Note**

The company receives a negotiable note in payment of its fees. Generally the note is unsecured and non-interest-bearing and is payable over the same period as the construction draws on the related mortgage are to be made.

##### **2. Nonnegotiable Note**

The terms of the nonnegotiable note are comparable to the negotiable note.

##### **3. Commitment Letter, Not Contingent on Future Events**

The company receives a letter from the borrower indicating that the lender and the borrower have agreed on the terms of the mortgage. In addition, the letter states that the borrower agrees to pay the company a fixed fee by a specified date for services rendered in arranging the loan.

4. Commitment Letter, Contingent on Future Draws

The company receives commitment letters from the borrower as described in No. 3 above. However, the commitment letters state that a certain amount of the fee will not be paid unless or until certain construction draws are received from the lender.

When should revenue be recognized as earned by the client?

*Reply*—Revenue recognition is discussed in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraphs 83 and 84.

Applying the guidelines of Concepts No. 5, paragraphs 83 and 84, to the specific situations, revenue would be recognized as follows:

1. Negotiable Note

Income would be recognized when the services have been performed and billed which may be prior to receipt of the negotiable note.

2. Nonnegotiable Note

The terms of the nonnegotiable note are comparable to the negotiable note, and revenue would be recognized in a similar manner.

3. Commitment Letter, Not Contingent on Future Events

Such a letter would be evidence that the services have been rendered and are now "billable"; therefore, the fee has been earned and income should be recognized.

4. Commitment Letter, Contingent on Future Draws

From the description, it appears that the agreement between the client, borrower, and lender in this case is such that the parties do not consider all the services rendered until actual borrowings take place even though the client need not physically do anything else. In such a situation, a portion of the fees should be deferred until the stipulated draw provisions have been met.

## .16 Rental Revenue Based on Percentage of Sales

*Inquiry*—A supermarket built an addition to its store to house a liquor store. The rent to the liquor store is to be a percent of its sales. On its income statement, would it be proper for the supermarket to include the liquor store sales as though they were their own sales? The rent would then appear as a gross margin.

*Reply*—No. In accordance with FASB Statement No. 13, paragraph 1 (AC L10.101), this transaction meets the definition of a lease, which is "... the right to use property, plant, or equipment (land or depreciable assets or both) usually for a stated period of time."

The revenue received from the liquor store represents rental income to the supermarket and it would be inappropriate for the supermarket to include as its sales the sales of the liquor store. However, it would be appropriate for the supermarket to include the rental income as part of its gross revenues. [Amended June 1995.]

## .20 Payment for Termination of License Agreement

*Inquiry*—A research and development company holds numerous patents. The company derives its income from the sale of products which utilize its pa-

tents as well as from the licensing of the patents, for which it receives royalties, and also from the sale of patent rights, for which it receives a single payment for the term of the license.

A licensee desired to terminate its license, since it was no longer using the technology contained in the company's patent, and paid to the company a lump sum termination payment. This payment approximated the amount the company would have earned during the remaining years of the license agreement. How should the termination payment be reflected in the company's financial statements?

*Reply*—The transaction is similar to sale of a license for the remaining life of a patent and should be accounted for in the same manner. If this is the sole license for a patent, any remaining unamortized cost of such patent should be written off at this time. If the license represents only a portion of the use of the patent, an appropriate portion of the remaining unamortized cost should be written off. The proceeds should be included in this year's current operations, and there should be disclosure that a major source of income from licensing agreements is being terminated.

## **.25 Finished Parts Held by Manufacturer for Customers**

*Inquiry*—Corporation A, a subcontractor, manufactures precision parts to customers' specifications. Parts produced by Corporation A are inspected by a customer's quality control representative and then held in a secured area in Corporation A's plant. Corporation A is entitled to full contract payment on parts inspected and held in the secured area. Historically, there has been a short time span between completion date and scheduled shipment date, but recently production efficiency has improved to the extent that contracts are completed significantly in advance of scheduled shipment dates. Based on the recent experience of Corporation A, what is the proper date for revenue recognition?

*Reply*—FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 83, states in part:

"Revenues are not recognized until earned. An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues . . . ."

Revenue should be recognized at the time of inspection and delivery to the secured areas, since the realization criteria have been met. Corporation A should disclose the method followed for income recognition as part of its disclosure of accounting policies.

## **.28 Revenue From Private Label Sales**

*Inquiry*—Corporation A produces certain products that are sold under Corporation B's label. Corporation B reimburses Corporation A for all direct costs of raw material, ingredients, and packaging plus 10¢ per pound processing fee. Corporation A prepares an invoice for each shipment which itemizes the various direct costs plus 10¢ per pound processing fee. Should Corporation A record the total invoice amount as a sale or should it record the processing fee as revenue and the reimbursed direct costs as a reduction of expenses?

*Reply*—Corporation A should probably record the total invoice amount as a sale. Accounting for contracts of this type would be treated similar to cost-plus-fixed-fee contracts discussed in ARB No. 43, Chapter 11A, *Cost-Plus-Fixed-Fee Contracts*. [Amended]

**.31 Accounting for Zero Coupon Bonds**

*Inquiry*—A client purchased a 20-year zero coupon treasury bond for \$189, with a maturity value of \$1,000, at an 8½% yield to maturity.

- (1) What authoritative pronouncement would provide guidance for this transaction?
- (2) How is the interest income computed for financial reporting purposes?

*Reply*—(1) APB Opinion No. 21, *Interest on Receivables and Payables*, would apply. APB Opinion No. 21, paragraph 2, states that, “The principles discussed in this Opinion are applicable to receivables and payables which represent contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates, whether or not there is any stated provision for interest . . . Examples are secured and unsecured notes, debentures, bonds . . .”

(2) APB Opinion No. 21, paragraph 15, states that, “the difference between the present value and the face amount should be amortized to reflect the interest income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period.” This is the “interest” method described in APB Opinion No. 12, *Omnibus Opinion*, paragraphs 16 and 17. However, other methods of amortization may be used if the results obtained are not materially different from those which would result from the “interest” method.

The following is an example of the application of the interest method. To calculate the semi-annual amount, multiply the purchase price by 4¼% (half of 8½%) to arrive at the adjusted cost basis for the first six-month period. Then repeat this calculation for the next six-month period using the adjusted cost basis. The total amount of income (accrual) in the first year will be \$16.40. Each year the cost basis is increased by the amount of income (accrual) reported in the previous year, as indicated in the following example:

<i>Semi-Annual Period</i>	<i>Your Purchase Price or Adjusted Cost Basis</i>	<i>½ Purchase YTM</i>	<i>Accrual During Period</i>	<i>Adjusted Cost Basis at End of Period</i>
1	\$189.00	4.25%	\$8.03	\$197.03
2	197.03	4.25%	8.37	205.40
3	205.40	4.25%	8.73	214.13
4	214.13	4.25%	9.10	223.23

The interest income would be reported annually for financial reporting purposes. If the bond is held to maturity, there will be no gain or loss. If sold prior to maturity any gain or loss is determined by the difference between the adjusted cost basis and the selling price.

**.33 Operating Lease With Rental Payments Rebated Against Purchase Price**

*Inquiry*—A lessor corporation leases construction equipment for periods of six to eighteen months under short-term cancellable leases. The leases provide

that during the first six months, 100 percent of the rentals paid may be applied toward the purchase price of the equipment if the lessee decides to purchase the equipment; during the next three months the percentage drops to 80 percent, and after nine months 60 percent may be applied toward the purchase price. The leases do not qualify as capital leases. How should the lessor account for the leases and the respective rebates?

*Reply*—The authoritative literature does not address this matter. The lessor should record rental income until the lessee decides to purchase the equipment. The lessor should then record the sale of the equipment net of the applicable rebate. The amount recorded as rental income should not be reclassified as sales proceeds.

### **.35 Involuntary Conversion—Recognition of Gain**

*Inquiry*—A tornado virtually destroys a company's building on June 12, 19X0. The company has insurance and expects to be reimbursed for costs incurred to refurbish the building. The company's fiscal year-end is June 30, 19X0. On August 15, 19X0, prior to the issuance of the financial statements, the company receives a check in excess of the carrying amount of the building. Should the company recognize the gain on the involuntary conversion in the June 30, 19X0 financial statements?

*Reply*—No. Since the company was reimbursed for an amount in excess of the carrying amount of the building there was no loss to record on June 30, 19X0. The gain, which was received on August 15, 19X0, was a gain contingency on June 30, 19X0. Per FASB Statement No. 5, *Accounting for Contingencies*, paragraph 17, contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.

### **.36 Sales of Investment to Minority Stockholder**

*Inquiry*—A corporation enters into an agreement to sell an investment accounted for on the equity method to a minority stockholder in return for his shares in the corporation. The fair value of the investment exceeds its book value. Would the corporation recognize a gain on this transaction or would the excess be credited to equity?

*Reply*—APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, paragraph 18, states that a transfer of a nonmonetary asset to a stockholder or to another entity in a nonreciprocal transfer should be recorded at the fair value of the asset transferred, and that a gain or loss should be recognized on the disposition of the asset. APB Opinion No. 29, paragraph 18 also indicates that the fair value of an entity's own stock reacquired may be a more clearly evident measure of the fair value of the asset distributed in a nonreciprocal transfer if the transaction involves acquiring stock for the treasury or retirement.

The corporation should recognize as a gain, in the year in which the transaction occurs, the excess of the fair value of the investment transferred over its carrying amount.

### **.37 Sales Price Based on Future Revenue**

*Inquiry*—A company sold one of its direct-mail catalog offices for cash plus a percentage of revenue to be earned over the next five years. The sales agreement limits the percentage of revenue to a stipulated maximum. Management believes the maximum will be earned within the five-year period. When should revenue from this transaction be recorded?

*Reply*—According to FASB Statement No. 5, *Accounting for Contingencies*, paragraph 17, revenues from “Contingencies that might result in gains usually are not (recognized) prior to (their) realization.”

Unless it is assured that adequate revenue will be earned to cause payment of the contingent portion of the sales price, the contingent portion of the sales price should only be accrued as earned. The accuracy and reasonableness of management’s projections must be ascertained. If realization is assured, which would be relatively infrequent, revenue should be recorded as of the date of the sale using the present value of the projected cash receipts in accordance with APB Opinion No. 21, *Interest on Receivables and Payables*.

### **.38 Subsequent Event Related to Vendor-Specific Objective Evidence for Software Revenue Recognition**

*Inquiry*—Vendor-specific objective evidence (VSOE) of fair value may be established by management after the balance sheet date but before the issuance of the financial statements, either by separate sales or by establishment of a price by a pricing committee. May an entity use such evidence to recognize revenue at the balance sheet date in accordance with SOP 97-2, *Software Revenue Recognition* (ACC 10,700)?

*Reply*—No. Establishment of VSOE after the balance sheet date is a Type II subsequent event, as discussed in SAS No. 1, section 560, *Subsequent Events* (AU 560). As a result, revenue should be deferred at the balance sheet date in accordance with paragraph 12 of SOP 97-2 (ACC 10,700.12), as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions* (ACC 10,770). However, if subsequent to the balance sheet date, management merely compiles evidence that existed at the balance sheet date, that evidence should be used to assess whether there is sufficient VSOE (in accordance with paragraph 10 of SOP 97-2 [ACC 10,700.10]) to recognize revenue at the balance sheet date.

### **.39 Software Revenue Recognition for Multiple-Element Arrangements**

*Inquiry*—Software vendors may execute more than one contract or agreement with a single customer. Should separate contracts or agreements be viewed as one multiple-element arrangement when determining the appropriate amount of revenue to be recognized in accordance with SOP 97-2, *Software Revenue Recognition* (ACC 10,700)?

*Reply*—A group of contracts or agreements may be so closely related that they are, in effect, parts of a single arrangement. The form of an arrangement is not necessarily the only indicator of the substance of an arrangement. The existence of any of the following factors (which are not all-inclusive) may indicate that a group of contracts should be accounted for as a single arrangement:

- The contracts or agreements are negotiated or executed within a short time frame of each other.
- The different elements are closely interrelated or interdependent in terms of design, technology, or function.
- The fee for one or more contracts or agreements is subject to refund or forfeiture or other concession if another contract is not completed satisfactorily.

- One or more elements in one contract or agreement are essential to the functionality of an element in another contract.
- Payment terms under one contract or agreement coincide with performance criteria of another contract or agreement.
- The negotiations are conducted jointly with two or more parties (for example, from different divisions of the same company) to do what in essence is a single project.

#### **.40 Software Revenue Recognition Related to Year 2000 Compliant Software**

*Inquiry*—Is a commitment to deliver in the future a Year 2000 compliant version of a software product to an existing customer or to a customer that is acquiring a non-Year 2000 compliant version considered an upgrade right or specified upgrade in accordance with SOP 97-2, *Software Revenue Recognition* (ACC 10,700)?

*Reply*—Yes. The criteria of SOP 97-2 (ACC 10,700) related to specified upgrades apply whether or not the commitment is contained under a warranty provision. Given the ramifications of non-Year 2000 compliant software, special attention should be given to paragraphs 13 and 14 of SOP 97-2 (ACC 10,700.13 and .14). Further, the Securities and Exchange Commission released an Interpretation in August 1998 titled, *Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisors, Investment Companies, and Municipal Securities Issuers*. Part of that Interpretation states, “Year 2000 issues may affect the timing of revenue recognition in accordance with (SOP 97-2 [ACC 10,700]). For example, if a vendor licenses a product that is not Year 2000 compliant and commits to deliver a Year 2000 compliant version in the future, the revenue from the transaction should be allocated to the various elements—the software and the upgrade. Entities should also consider FASB Statement No. 48, *Revenue Recognition When the Right of Return Exists* (AC R75), relating to any product return issues such as for products containing hardware and software, including whether the necessary conditions have been met to recognize revenue in the period of sale, whether that revenue should be deferred, or whether an allowance for sales return should be provided.” In such situations, a vendor generally would be required to defer all revenue until it delivers the upgraded (compliant) version.

#### **.41 Effect of Prepayments on Software Revenue Recognition**

*Inquiry*—Paragraph 29 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.29), states that if a fee on a software arrangement with extended payment terms is not fixed or determinable at the outset of an arrangement revenue should be recognized as payments become due. Should a vendor recognize revenue for amounts (related to an arrangement with extended payment terms) received directly from customers (without the software vendor's participation in its customers' financing arrangements) in advance of scheduled payments?

*Reply*—Yes, provided all other requirements of revenue recognition in SOP 97-2 (ACC 10,700) are met.

**.42 Extended Payment Terms and Software Revenue Recognition**

*Inquiry*—A software vendor with a fiscal year ending September 30 enters into a licensing arrangement and simultaneously delivers its product to a customer on September 29. Payment terms are as follows: \$600,000 due thirty days from September 29; \$400,000 due thirteen months from September 29. The licensing fee is not fixed or determinable because a significant portion of the fee is due more than one year after delivery of the software and the vendor cannot overcome the presumption in paragraph 28 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.28). How much revenue should the vendor recognize during the current fiscal year ending September 30?

*Reply*—None. Paragraph 29 of SOP 97-2 (ACC 10,700.29) requires that the vendor recognize revenue as payments from customers become due (assuming all other conditions for revenue recognition in the SOP are met). In this situation, \$600,000 should be recognized as revenue on October 29 when the payment becomes due and the remaining \$400,000 should be recognized twelve months later on October 29 of the following fiscal year.

**.43 Corrections of Errors in Computer Software (Bug Fixes)**

*Inquiry*—A software vendor licenses software products to customers. Customers may elect to obtain postcontract customer support (PCS) from the software vendor as an element of the software arrangement, or customers may choose not to obtain PCS. In order to satisfy its warranty obligations, the software vendor provides bug fixes (free of charge) that are necessary to maintain compliance with published specifications to those customers that do not obtain PCS from the software vendor.

Paragraph 31 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.31), states, "...obligations related to warranties for defective software, including warranties that are routine, short-term, and relatively minor, should be accounted for in conformity with FASB Statement No. 5." However, the SOP's glossary (ACC 10,700.149) indicates that PCS may include services such as the correction of errors (for example, bug fixing). If a software vendor provides bug fixes (under warranty obligations) free of charge that are necessary to maintain compliance with published specifications, should the software vendor account for the estimated costs to correct the bugs in accordance with FASB Statement No. 5, *Accounting for Contingencies* (AC C59), or should the vendor consider the practice of providing bug fixes free of charge part of PCS (which may result in the deferral of revenue)?

*Reply*—In this situation, the software vendor should account for the estimated costs to provide bug fixes (that are necessary to maintain compliance with published specifications) in accordance with FASB Statement No. 5 (AC C59).

**.44 Postcontract Customer Support During the Deployment Phase of Computer Software**

*Inquiry*—A software vendor enters into an arrangement with a customer to deliver its software product and to provide postcontract customer support (PCS). The product will be deployed in stages. The stipulated term of the PCS period begins six months after delivery of the product, though the vendor has



a history of regularly making available to all customers the services or unspecified upgrades/enhancements normally associated with PCS as soon as its products are delivered. (That is, the customer receives any upgrades/enhancements released by the vendor during the six-month period after product delivery.) The PCS rate inherent in the licensing fee increases over time based on the customer's deployment of the product. After three years, the predetermined renewal rate for PCS for a fully deployed license is set at a stipulated rate multiplied by the aggregate list price (as established at the inception of the arrangement) of the licensed product, regardless of the status of the deployment efforts. The vendor does not have vendor-specific objective evidence (VSOE) of fair value of the PCS when the product is less than fully deployed because the only PCS sold separately is the renewal of PCS (that is, the predetermined renewal rate). Is PCS considered to commence at the date of product delivery or six months after delivery? Should the vendor consider the PCS predetermined renewal rate to be VSOE of fair value for PCS?

*Reply*—In this situation, the PCS arrangement commences upon product delivery because the customer receives any upgrades/enhancements released by the vendor during the six-month period after product delivery. In addition, the predetermined renewal rate is the only indicator of fair value because it is the only arrangement under which PCS is sold separately, and therefore, it should be used to establish VSOE of fair value of the PCS. In this situation, the vendor should initially defer the portion of the arrangement fee related to the three and one-half years of PCS provided under the arrangement based on the predetermined renewal rate.

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[The next page is 4121.]



## Section 5210

### ***Depreciation and Depletion***

#### **.02 Disclosure of Depreciation Expense**

*Inquiry*—APB Opinion No. 12 states that the financial statements should disclose depreciation “expense” for a period. Does “expense” mean the total amount of depreciation accrued (i.e. credited to the allowance for depreciation account) for the period or the amount actually expensed after allowing for depreciation included in overhead apportioned to inventories?

*Reply*—In concerns such as public utilities and trading or commercial enterprises, determination of the total provision for depreciation is usually simple since the amounts of depreciation are generally identified in the expense accounts. In manufacturing concerns, however, there are difficulties in determining the amount of depreciation to be disclosed. Depreciation is usually included in overhead which in turn is distributed over a number of departments and products and finds its way ultimately into cost of sales through inventory accounts. To determine the amount of depreciation which is included as a part of the cost of merchandise sold may require an extensive and usually impracticable, if not impossible, analysis of cost accounts. The auditor usually solves the problem by suggesting that the amount of depreciation charged to manufacturing costs and to expense accounts be taken as representing the amount charged to income. Obviously, this method does not correctly state the depreciation charge which was recovered through sale of goods in which depreciation was an element of cost. From a practical standpoint, in view of the indicated difficulty, if not impossibility, of determining the exact amount of depreciation included in cost of sales, it has become recognized practice to report the amount of depreciation charged in the statement of income as that which has been charged to manufacturing costs and to expense accounts, even when amounts of depreciation included in inventories at the beginning and end of the period vary sufficiently to affect depreciation included in cost of sales. Such practice also is acceptable to the Securities and Exchange Commission.

#### **.04 Depreciation of Clothing Rented to Individuals**

*Inquiry*—Company A maintains a stock of tuxedos, shoes and related items which are rented to individuals. Management estimates that this stock will have a useful life of approximately two years. Additional stock will be purchased from time to time as required. At the end of each fiscal year, a complete physical inventory is taken of all items on hand. What is the most appropriate accounting treatment for the stock of rental clothing?

*Reply*—The clothing represents a fixed asset to be depreciated over its estimated life. The estimated life should be adjusted periodically to reflect experience and should not exceed two years. The depreciation charge should be computed monthly based on inventory at the beginning of the period plus additions during the current year.

Logically it seems that loss and retirement of clothing will relate to that clothing first purchased. Accordingly the first-in first-out basis would appropriately account for such loss and retirement.

**.05 Classification of Costs of Constructing a Golf Course**

*Inquiry*—How should the costs of constructing a golf course be broken down into depreciable and nondepreciable classifications?

*Reply*—For the costs incurred in constructing a golf course, those expenditures made to change the land itself, exclusive of buildings, should be treated as permanent improvements to the land and are not, therefore, depreciable. These costs would include clearing the land, building fairways, changing the contour of the earth by moving and filling, building sand traps, and creating water hazards. If trees are planted, and their lives can be estimated, it would appear to be proper to depreciate these over such lives. In the absence of any reasonable estimate, trees and shrubs should be carried at cost. Any structures such as buildings, shacks or stands should be depreciated along with the costs of any vehicles such as trucks or carts, and any equipment used. A watering system should be depreciated as it is made of material that will not last indefinitely.

**.08 Additional First Year Depreciation**

*Inquiry*—A corporation reports depreciation expense on its financial statements at the same amount that it claims on its income tax return. If that amount included the maximum \$10,000 deduction for additional first year depreciation (election to expense recovery property) allowed for tax purposes, whereas, normal depreciation was \$18,000, would the financial statements be in conformity with generally accepted accounting principles?

*Reply*—ARB No. 43, chapter 9C, *Depreciation*, paragraph 5, states, in part: “. . . depreciation accounting, a system which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit . . . in a systematic and rational manner . . .” Accordingly, if any arbitrary additional first year depreciation amount is included in the financial statements and it is material, it would be a departure from generally accepted accounting principles. Refer to SAS No. 58, *Reports on Audited Financial Statements*, paragraph 50, and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, paragraph 6, for guidance on materiality. [Amended]

**.09 Amortization of Leasehold Improvement**

*Inquiry*—A zoological society leases property in the city zoo for concession stands. The society plans to construct a new building, which will house several concession stands, on the leased property. When construction is complete the title to the building will be turned over to the city. How should the building be accounted for by the zoological society?

*Reply*—The construction of a building on leased property is considered a leasehold improvement. A leasehold improvement is a permanent improvement or betterment that increases the usefulness of the leased property and will revert to the lessor at the end of the lease term. The costs of such improvements are normally amortized either over the life of the improvement or the lease term, whichever is shorter.

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[The next page is 4201.]

## Section 5220

### ***Interest Expense***

#### **.01 Deferral of Payment of Interest**

*Inquiry*—A client experienced problems in meeting its current obligations and reached an agreement with its primary creditor concerning several mortgage loans. Under the agreement, the interest rate on these loans will, for the present, be reduced from 10 percent to 8 percent, but the lender has the option in the future of increasing the interest rate to 11 percent to recover the foregone interest. At the maturity date, any unpaid interest calculated at the original 10 percent rate will be due.

How should the interest expense be recorded on the client's financial statements?

*Reply*—Interest should be accrued at the rate of 10 percent, the original rate under the mortgage loans. This debit would represent the interest expense charged to income. The credit would be segregated between current liabilities (an amount representing the 8 percent rate) and noncurrent liabilities (an amount representing the "deferred interest").

#### **.03 Computation of Interest Expense on Long-Term Redeemable Bonds**

*Inquiry*—A bank has issued four year non-negotiable savings bonds with interest of 7 percent for the first year,  $7\frac{1}{2}$  percent for the second year, 8 percent for the third year and  $8\frac{1}{2}$  percent for the fourth year. The depositor has the option to request that he be paid his interest on a semi-annual or annual basis, but few do so, and the normal procedure is that the interest will be compounded and left on deposit for the four years.

If a bond is redeemed prior to maturity, interest is paid to the bondholder at the rate of 5 percent per annum for the period that the bond was held, less 90 days. Few instances of bond redemption prior to maturity are anticipated.

Which of the following methods of accounting for interest expense is appropriate?

(1) Accrue interest at 7 percent for the first year,  $7\frac{1}{2}$  percent for the second year (plus the compounding factor), 8 percent for the third year (plus the compounding factor), and  $8\frac{1}{2}$  percent for the fourth year (plus the compounding factor), making a debit to the interest expense and a credit to the accrued interest payable on four year bonds.

(2) Determine the total amount of interest that will be due to the holder upon the maturity of the bond and accrue a pro rata share of this amount for each month of the four year period that the bond is in effect.

*Reply*—A rate of interest should be used which reflects the bank's liabilities and assumes that the bondholders will not redeem their bonds and not withdraw the interest prior to maturity. This is essentially the second approach above.

**.05 Amortization of Prepaid Interest on Discounted Notes**

*Inquiry*—An equipment leasing company will use as of the beginning of the year the interest method to amortize prepaid interest on new discounted notes. But it will continue to use the straight-line method to amortize prepaid interest on notes discounted earlier. Is the adoption of the interest method on a prospective basis a change in accounting principle?

*Reply*—APB Opinion No. 21, *Interest on Receivables and Payables*, paragraph 15, states that the interest method of amortization should be used but that other methods of amortization may be used if the results obtained are not materially different from those which would result from the interest method.

If the results in earlier periods would not have differed materially by using the interest method, the interest method may be adopted for the new notes, disclosed, and not be reported as a change in accounting principle.

If the results in earlier periods would have been materially different by using the interest method, the interest method should be adopted for the old and new notes, and be reported as a correction of an error.

**.06 Imputed Interest on Shareholder Loans**

*Inquiry*—A section of the Internal Revenue Code requires, under certain circumstances, that a company impute interest on demand loans made to a shareholder of the company. Would this also be required under generally accepted accounting principles? If not, must it be disclosed and would there be an effect on the deferred income tax accounts?

*Reply*—No. APB Opinion No. 21, *Interest on Receivables and Payables*, paragraph 2, states that the opinion applies to receivables and payables which represent contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates. Imputed interest would not be required on demand loans since they have no fixed or determinable due date.

However, disclosure of this transaction would be required under FASB Statement No. 57, *Related Party Transactions*.

There would be no effect on the deferred income tax accounts since this would be considered a permanent difference.

**.07 Imputed Interest on Note Exchanged for Cash Only**

*Inquiry*—If an enterprise receives cash in exchange for a non-interest bearing long-term note payable with a stated amount equal to the cash received, must interest be imputed on the note in accordance with APB Opinion No. 21, *Interest on Receivables and Payables* (AC I69)?

*Reply*—If there are rights or privileges other than cash attendant to the exchange, the value of such rights or privileges should be given accounting recognition pursuant to APB Opinion No. 21, paragraph 7 (AC I69.104). If the note is issued solely for cash (that is, the cash received is equivalent to the face amount of the note) and no other right or privilege is exchanged, it is presumed to have a present value at issuance measured by the cash proceeds exchanged. [Amended June 1995.]

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[The next page is 4281.]

## Section 5230

### ***Employee Benefit Plans***

#### **.06 Deferred Compensation Payable To Surviving Spouse**

*Inquiry*—Corporation A and its president entered into an employment contract. The contract stipulated that if the president died while employed by Corporation A, Corporation A would pay \$500 a month to the president's widow for the rest of her life. Shortly after the contract was signed, the president died. The present value of the estimated future payments by Corporation A to the president's widow is \$X. Should Corporation A accrue the \$X?

*Reply*—Under APB Opinion No. 12, *Omnibus Opinion—1967*, paragraphs 6–8, the estimated amounts to be paid under a compensation contract would normally be accrued over the period of active employment. The president's death accelerates recognition of a liability that is reasonably determinable from actuarial tables. Accordingly, the present value of the estimated future payments not previously recognized should be accrued and recognized as an expense.

#### **.09 Deferred Compensation Arrangement Funded by Life Insurance Contracts**

*Inquiry*—A company has a deferred compensation contract with one of its employees. In accordance with APB Opinion No. 12, *Omnibus Opinion—1967*, paragraph 6, the estimated amount of future payments was accrued over the period of active employment. The company purchases a life insurance policy on the employee, naming the company as beneficiary. May the cash surrender value earned on the policy be offset against the liability for the deferred compensation arrangement?

*Reply*—No. FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*, paragraph 2, specifies that the cash surrender value on a life insurance contract should be reported on the balance sheet as an asset with any changes in that value reflected as an adjustment of insurance expense for the period. No right of offset or other deviations from the above accounting would be appropriate regardless of the funding objective pertaining to the purchase of the insurance contract, as stated in FASB Technical Bulletin No. 85-4, paragraph 1, footnote 1.

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[The next page is 4381.]





## Section 5240

### Cost Allocation

#### .01 Transfer Pricing Between Manufacturing Division and Selling Division

*Inquiry*—X Company has two branches, both of which manufacture and sell the same type of items. In one transaction, Branch A made a sale of \$100,000. Branch B shipped the merchandise for this sale to Branch A. This merchandise had a cost on Branch B's books of \$70,000. How should the revenues and costs of this sale be allocated between Branches A and B?

*Reply*—When intracompany sales take place, revenues and costs are allocated by establishing transfer prices. In this case, the transfer price is the price Branch B will charge Branch A for the merchandise. Transfer prices must be set in such a way as to benefit the company as a whole, and consideration must be given to the effects the transfer prices will have on management decisions.

There are basically two methods of setting transfer prices: cost or market price. There are, however, many variations of these methods.

The transfer price could be based on standard cost of production, standard cost plus a return on investment, actual cost, variable cost, marginal cost, or simply a price negotiated by the divisions.

If there are outside suppliers of this product, the market price may be used as the transfer price. Market prices have the advantage of being relatively objective and, therefore, less subject to argument. Market prices may encourage the branches to consider market forces and outside opportunities which, to a certain extent, may be beneficial to the company. It is often difficult, however, to find market prices which accurately reflect the opportunity costs of intracompany sales.

Where intracompany transactions account for a large share of the division's sales, transfer prices must be chosen carefully so that each division is encouraged to operate for the good of the company as a whole. Where intracompany sales occur only occasionally and are not an important part of the division's activities, the choice of transfer prices is not as critical, and it may be easiest to negotiate a price or simply allow one of the divisions a "sales commission." In any event, the financial statements of the branches should be footnoted to disclose the treatment of the transaction.

No matter which transfer pricing method is chosen, the results on the company's financial statements will be the same, sales of \$100,000 and costs of goods sold of \$70,000, since the intracompany sale will be eliminated in the consolidation.

#### .10 Sale of Research and Development Technology

*Inquiry*—A company has incurred material research and development costs in the current year. Subsequent to the balance sheet date but prior to issuance of the financial statements, the company commenced negotiations and sold the research and development technology to an unrelated company. May the company capitalize the incurred research and development costs in its annual financial statements in light of the subsequent sale?

*Reply*—No. FASB Statement No. 2, *Accounting for Research and Development Costs*, paragraph 12, states that research and development costs should be expensed when incurred. There is no justification for capitalizing the costs because the technology will be sold. The company should disclose the subsequent sale of the research and development technology in the footnotes to its financial statements if the amount is material.

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[The next page is 4501.]

## Section 5260

### ***Estimated Losses***

#### **.01 Recognition of Estimated Losses on Uncompleted Contracts**

*Inquiry*—An engineering firm manufactures and sells telemetry components on the basis of bids previously submitted to customers. In some cases, engineering time is required to modify a component to customer specifications. Since the amount of required engineering time is not known at the time a bid is submitted, costs to complete a particular job may exceed the bid price. The firm completes all jobs.

Presently all costs that accumulate on a particular job (direct materials, labor, and applied manufacturing and engineering overhead) are charged to that job and treated as work in process, even though the costs may exceed the selling price. Once the job is completed, it is taken out of work in process inventory and treated as costs of completion in the month that the job is shipped. Therefore, a loss on a job is recognized only when the job is shipped. When cost to complete a job is expected to exceed the bid price, what disclosure should be made on the balance sheet?

*Reply*—The problem faced by the firm is not primarily one of disclosure but rather that of satisfying the generally accepted accounting principle of “providing for losses which are reasonably certain to occur.”

It is assumed that the firm is accounting on the completed-contract basis. With regard to construction companies using this method of accounting, ARB No. 45, *Long-Term Construction-Type Contracts*, paragraph 11 states, “Although the completed-contract method does not permit the recording of any income prior to completion, provision should be made for expected losses in accordance with the well established practice of making provision for foreseeable losses.” The same concept applies to companies accounting under the percentage-of-completion method (*ibid.*, par. 6).

A possible journal entry to recognize the loss would be a charge to “Estimated Loss on Uncompleted Contracts” while crediting “Estimated Liability for Loss on Uncompleted Contracts.” This estimated liability could then be deducted from any excess of accumulated costs over related billings (or added to any liability arising from billings in excess of accumulated costs) for balance sheet purposes. If the loss is not deductible for tax purposes, part of the income tax paid should be set up as a deferred charge.

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[The next page is 4551.]



## Section 5290

### Other Expenses

#### .02 Classification of Expenses Which Are Taxable to Employees

*Inquiry*—An amendment to the Internal Revenue Code requires, under certain circumstances, that an employer include as income, the fair value for the use of a company automobile, in the employee's wage and tax statement (Form W-2).

Should this be reported in the company's statement of income as compensation to employees?

*Reply*—No. The fair value is the amount the employee would have paid to use the car if the employee had owned it. The employer should report, as automobile expenses, the amount of actual expenses it incurred as owner of the car.

#### .04 Accounting for Relocation Costs

*Inquiry*—A corporation is relocating its production facilities to a different location. May the costs of relocating be capitalized?

*Reply*—A related matter is discussed in FASB Emerging Issues Task Force (EITF) Issue 88-10, *Costs Associated with Lease Modification or Termination*, where the question of whether any costs, particularly moving costs, incurred by a lessee in connection with changing from one lease to another lease may be deferred and amortized over the new lease term, is answered. In the discussion of EITF Issue 88-10, EITF task force members agreed that the predominant practice is to charge the costs of moving from a former location to expense as incurred. The SEC observer at the EITF discussion noted that as a general rule, the SEC staff would object to the deferral of moving costs. Additionally, one of the primary characteristics of an asset as defined by FASB Concepts Statement No. 6, *Elements of Financial Statements*, is that an asset embodies a probable future benefit that involves a capacity, singly, or in combination with other assets, to contribute directly or indirectly to future net cash inflows. The costs of relocation do not embody any future benefit and they should therefore be expensed when incurred.

#### .05 Accrual of Audit Fee

*Inquiry*—A CPA has been engaged to audit the financial statements of a client company. The audit is being conducted after year end. Is it proper to accrue the audit fee as an expense of the year under audit?

*Reply*—According to FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 145, "The goal of accrual accounting is to account in the periods in which they occur for the effects on an entity of transactions and other events and circumstances, to the extent that those financial effects are recognizable and measurable." The audit fee expense was incurred in the period subsequent to year end. Therefore, it is properly recorded as an expense in the subsequent period. However, fees incurred in connection with planning the audit, together with preliminary procedures (e.g., confirmation work) would be accruable for the year under audit.

**.06 Accounting for a Lease Trial Period**

*Inquiry*—A lease agreement allows a prospective lessee the free use of newly introduced specialized equipment for 30 days prior to entering into a long-term lease agreement for the equipment. The prospective lessee is not committed to enter into a long-term lease agreement at the beginning or during the 30-day trial period and there is no economic penalty to the lessee if the lessee does not enter into that agreement. How should the prospective lessee account for the 30-day trial period?

*Reply*—The 30-day trial period is part of the lessor's marketing strategy. Therefore, the lessee should not report any lease expense during the 30-day trial period. If the lessee subsequently enters into the lease arrangement, the date of inception should begin on the first day of the lease with no accounting recognition given to the trial period.

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**[The next page is 4801.]**

## Section 5400

### ***Extraordinary Items***

#### **.01 Loss on Abandonment of Sales Project**

*Inquiry*—A company is engaged primarily in commercial and agricultural land sales, but some retail land sales and condominium sales are also made. The company acquired a retail land sales project under an agreement stating that, if the company did not desire to pursue the project, the property would be returned with no liability to the company.

The company invested a considerable amount of money in the project, but because of the declining state of the economy, the company decided to return the project to the original owner before any sales had been made.

Does the abandonment of the project represent a disposal of a segment of the business, an unusual and nonrecurring extraordinary loss, or an ordinary loss?

*Reply*—Paragraph 13 of Accounting Principles Board Opinion No. 30 describes a segment of the business as “. . . a component of an entity whose activities represent a separate major line of business or class of customer.” Paragraph 20 of the Opinion sets forth the two criteria for classification of an event or transaction as an extraordinary item. Although the criterion of infrequency of occurrence is met, it does not appear that the unusual nature criterion, described as “the possession of a high degree of abnormality, and of a type clearly unrelated to, or only incidentally related, to the ordinary and typical activities of the entity,” portrays this transaction.

If the company's formal decision to disengage itself from retail land sales applies to its entire retail land sales operation, the write-off should be considered as part of the sale of a segment of a business, but the segment to be accounted for must be the whole retail land sales operation. Otherwise, the write-off should be accounted for in accordance with paragraph 26 of APB Opinion No. 30 as a material transaction that occurs infrequently, but does not meet the criterion for classification as unusual in nature.

#### **.02 Sale of Cotton Futures Commitment Contracts**

*Inquiry*—A textile manufacturer entered into firm purchase commitments for cotton at a very favorable price. At the present time, the corporation has an unusually long position of purchase commitments at a low fixed price. Some of these contracts may be sold at a tremendous profit which is extremely material in relation to normal operating income. This results from the tremendous increase in cost of raw cotton during recent months. The corporation has not sold such commitment contracts in the past; nor does it anticipate selling such contracts in the future.

Will the sale of cotton futures commitment contracts be considered an extraordinary item?

*Reply*—Paragraphs 19–22 of Accounting Principles Board Opinion No. 30 discuss the criteria for extraordinary items. In order to be classified as an extraordinary item, an event or transaction would have to be both unusual in

nature and infrequent in occurrence. The transaction would not meet the “unusual nature” test. Making a commitment for future delivery of cotton to insure a source of supply would be part of the normal operations of a textile manufacturer. Any resulting gain or loss would therefore be considered ordinary. Although the corporation has not sold such commitment contracts in the past; nor does the corporation anticipate selling such contracts in the future, any gain realized on the sale of such a contract should not be considered an extraordinary item under APB Opinion No. 30. However, it should be shown as a separate line item in the income statement in accordance with paragraph 26 of the Opinion.

#### **.04 Reporting the Proceeds From Life Insurance on an Officer**

*Inquiry*—A company received the life insurance proceeds on the death of its president before the end of its fiscal year and intends to report the amount in its income statement as an extraordinary item. Would this be in conformity with generally accepted accounting principles?

*Reply*—No. APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, paragraph 20, states that “extraordinary items are events and transactions that are distinguished by their unusual nature and by the infrequency of their occurrence.” The receipt of insurance proceeds from an officer’s life insurance policy is an infrequent occurrence, but it is not unusual in nature. Since it does not meet *both* the criteria of unusual and infrequent it does not qualify as an extraordinary item.

APB Opinion No. 30, paragraph 26, states “a material event or transaction that is unusual in nature *or* occurs infrequently but not both, and, therefore, does not meet both criteria for classification as an extraordinary item, should be reported as a separate component of income from continuing operations.”

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[The next page is 4851.]



## Section 5500

### **FASB Statement No. 128, Earnings per Share**

#### **.02 Earnings Per Share of Wholly-Owned Subsidiaries**

*Inquiry*—The annual report of a holding company with five wholly owned subsidiaries shows the consolidated net income and earnings per share of the companies. If the report also includes the individual income statements of the five subsidiaries, is it necessary to include individual earnings per share figures?

*Reply*—Paragraph 6 of FASB Statement No. 128, *Earnings per Share* (AC E11), does not require presentation of earnings per share in statements of wholly owned subsidiaries.

Therefore, it is not necessary to show earnings per share figures for the subsidiaries. [Amended September 1997]

#### **.03 Weighted Average Shares Outstanding for an Interim Period**

*Inquiry*—A company retired some of its common stock during the first quarter of its fiscal year. Should earnings per share for the interim period be based on annualized weighted average shares outstanding or the weighted average shares outstanding during the period?

*Reply*—The earnings per share computation should be based on the weighted average shares outstanding during the interim period, and not on an annualized weighted average. See the illustration in FASB Statement No. 128, *Earnings per Share*, appendix C, for an example computation of the weighted average shares outstanding for an interim period. [Amended September 1997]

#### **.13 Shares Held as Collateral Under Subscription Agreement**

*Inquiry*—A corporation had 150,000 shares of common stock outstanding and granted options for an additional 50,000 shares. The options were exercised, and shares were issued upon execution of a subscription agreement and a note for the total option price payable in ten annual installments. Counsel has advised that under state law shares acquired under such a subscription agreement are entitled to full vote and dividends even though they are not fully paid and are held as security under the agreement. The corporation cannot enforce payment for the shares under the agreement. If the purchaser defaults, the company just does not release the shares.

The corporation has no other options, warrants, convertible debentures or other potentially dilutive securities outstanding.

After the exercise of the options as described above, how should the earnings per share be calculated?

*Reply*—Since the shares have been issued and are merely being held as collateral in connection with the subscription agreement, and based upon the fact that the shares issued under the agreement are entitled to full vote and dividend rights, earnings per share should be computed using 200,000 shares outstanding. [Amended June 1995]

**.15 Stock Dividend Declared But Not Paid at Balance-Sheet Date**

*Inquiry*—A client declared a 5 percent stock dividend to shareholders of record in December, 19X4, payable in 19X5. In calculating the weighted average number of shares outstanding for determining the earnings per share for 19X4, how should this stock dividend apply?

*Reply*—FASB Statement No. 128, *Earnings per Share*, paragraph 54 (AC E11.147), requires the computations of basic and diluted EPS to be adjusted retroactively for all periods presented to reflect a change in capital structure resulting from a stock dividend. Therefore, the 5 percent stock dividend should be considered as being outstanding for every month of 19X4, as well as for every month of every preceding period presented. [Amended September 1997]

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## Section 5600

### Leases

#### .04 Accounting for Subleases

**Inquiry**—A corporation leased a building and, ultimately, subleased half of the space to a third party with the lease agreement between the two original parties remaining in effect. Management believed that a fairer presentation was made by netting the rental income from the sublease against its own minimum lease payments. Is the corporation properly accounting for its leased property and sublease income?

**Reply**—No. FASB Statement No. 13, *Accounting for Leases*, paragraph 39 (AC L10.135), states that the original lessee, as sublessor, shall continue to account for the obligation related to the original lease as before. The sublease shall be accounted for in accordance with FASB Statement No. 13, paragraphs 7 (AC L10.103) and 8 (AC L10.104), depending upon which of the criteria the original lease met. If the original lease is an operating lease, the original lessee shall account for both it and the new lease as operating leases.

#### .05 Deferral of Rental Expense Until Occupancy

**Inquiry**—An entity entered into a lease agreement under an operating lease for a three-year term. The entity was prevented from occupying the premises under lease until several months after the lease term began because the premises weren't ready for their intended use. During that period, the entity underwent activities necessary to get the premises ready for use, such as constructing leasehold improvements and obtaining the necessary Certificate of Occupancy. May the lease payments during that period be deferred and charged to expense over the period the premises were occupied?

**Reply**—While the authoritative accounting literature does not address this question specifically, it appears from the sources discussed below that rental expense under an operating lease should be recorded from the date the lessee takes possession or control of the leased property. Until that time, any rental payments maybe deferred.

1. FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases* (AC L10.527A–.527F), which addresses, among other things, the accounting for scheduled rent increases in an operating lease, states in paragraph 2(a) (AC L10.527B), rental payments should be recognized as expense when the “*lessee take possession of or controls the physical use of the property.*” If the rent increases are due to the lessee’s use of additional space, paragraph 2(b) (AC L10.527B) states “the escalated rents should be considered rental expense . . . and recognized in . . . the years the lessee has control over the use of additional leased property” (emphasis added).

The entity obtained control over the premises to use as it wished only after it received the certificate of occupancy. This supports deferring the initial rental payments and charging them to expense after that date.

2. FASB Technical Bulletin No. 85-3, *Accounting for Operating Leases With Scheduled Rent Increases* (AC L10.525-527), discusses the accounting for rent inducements or "rent holidays." It too focuses on the period in which the leased property is *physically employed* to record rent expense rather than the period in which the rental payment is *due*. The leased property was "physically employed" only after the certificate of occupancy was obtained.
3. Under the present accounting model, certain costs may be added to an asset's acquisition cost until an asset is ready for its intended use. For example, under FASB Statement No. 34, *Capitalization of Interest Costs* (AC I67), interest may be classified as part of a qualifying asset's acquisition cost during the period the entity is undergoing the activities necessary to get those assets ready for use. By analogy, costs incurred by a lessee to get the leased premises ready for its intended use, including rental costs, may be deferred.

#### **.06 Recognition of Marketing Expense Related to Lease**

*Inquiry*—A company that leases out security monitoring systems also sells, to the lessee, related equipment used with the monitoring system. As part of a marketing strategy to encourage the leasing of the security monitoring system, the related equipment is sold at a loss. May the loss be deferred and amortized over the noncancellable lease term of the security monitoring system?

*Reply*—No. The loss should be recognized when it occurs as a marketing expense.

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## TIS Section 6000

# SPECIALIZED INDUSTRY PROBLEMS

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## Section 6130

### ***Finance Companies***

#### **.01 Amortization of Discount on Receivables of Consumer Finance Companies**

*Inquiry*—A client in the consumer finance business loans money for short periods of time. What method should be used to amortize discounts on such loans?

*Reply*—In determining income from loans receivable which have been issued at a discount, the required method of income recognition for any such discount is the interest method, as described in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (AC L20), and as required by the AICPA Audit and Accounting Guide *Audits of Finance Companies*, paragraphs 2.10, 2.11, and 2.13. [Amended]

#### **.02 Method of Recognizing Revenue From Finance Charges**

*Inquiry*—A finance company would like to establish a policy of recognizing 15% of the finance charges on discount loans as revenues in the first month of the loan and recognizing the balance of such charges as yield adjustments as the receivables are liquidated. Is this an acceptable method of recognizing revenues from finance charges?

*Reply*—No. The AICPA Audit and Accounting Guide *Audits of Finance Companies*, paragraph 2.13, requires that the interest (actuarial) method should be used to account for interest income in accordance with FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases* (AC L20). In addition, FASB Statement No. 91, paragraph 5 (AC L20.104), requires that certain direct loan acquisition costs be deferred and treated as yield adjustments in applying the interest method. [Amended]

#### **.03 Method of Recognizing Revenue From Service Charges**

*Inquiry*—A company finances insurance premiums of individuals through various insurance agents. The company's policy is to receive completed premium finance agreements directly from the insurance agents. The amount financed includes a finance charge and a nonreturnable service charge. The finance charge is recognized in income by the interest method.

How should the service charge be recognized on the records of the company?

*Reply*—In accordance with the AICPA Audit and Accounting Guide *Audits of Finance Companies*, paragraph 2.18, the service charge should also be recognized in income over the life of the related loan as an adjustment of yield using the interest method in accordance with FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (AC L20). [Amended]

**.04 Method of Recognizing Revenue From Commissions on Loan Insurance**

*Inquiry*—A finance company receives commissions for loan insurance. How should the company recognize commission revenues?

*Reply*—The AICPA Audit and Accounting Guide *Audits of Finance Companies*, paragraph 5.21, states that the insurance commissions received by finance companies from independent insurers should be credited to a deferred income account when received and systematically amortized over the life of the related insurance contracts. The method of commission amortization should be consistent with the method of premium income recognition for that type of policy in accordance with FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (AC In6). [Amended]

**.05 Disclosure of Contractual Maturities of Direct Cash Loans**

*Inquiry*—AICPA Audit and Accounting Guide *Audits of Finance Companies*, paragraph 2.44, calls for disclosure of contractual maturities of direct cash loans. At December 31, 19X1, a company has only three loans outstanding of \$36,000 each, payable monthly as follows: 12 installments of \$3,000 each; 24 installments of \$1,500 each; and 36 installments of \$1,000 each. How would these contractual maturities properly be shown?

*Reply*—Appropriate disclosure of the amounts to be received would be: 19X2, \$66,000; 19X3, \$30,000; and 19X4, \$12,000. Refer to the Audit and Accounting Guide *Audits of Finance Companies*, appendix A, Note B, for an illustration of such disclosure. [Amended]

**.06 Balance Sheet Presentation of Subordinated Debt**

*Inquiry*—A consumer finance company, whose financial statements are used only by the company and its banks, would like to include subordinated debt in its balance sheet with the caption "Total Subordinated Notes and Shareholders' Equity." The company believes that presentation would show more clearly the position of the banks with respect to other creditors. Would the presentation be acceptable if the statements were clearly labeled, "For the Use of Banks and Bankers Only"?

*Reply*—No. Although the total of subordinated long-term debt and stockholders' equity is important to creditors of finance companies, the prominent presentation of this total in balance sheets causes many users of financial statements to interpret this amount as total stockholders' equity, and, for this reason, its use is not acceptable.

The proposed balance sheet presentation would not be in conformity with generally accepted accounting principles even if the financial statements are clearly and conspicuously labeled, "For the Use of Banks and Bankers Only." [Amended]

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## Section 6140

### Not-For-Profit Organizations

#### .01 Inventory Valuation for a Not-for-Profit Scientific Organization

*Inquiry*—A not-for-profit scientific organization produces products that are sold at a price less than cost. The difference between cost and sale proceeds is covered by contributions. The not-for-profit organization reports inventories in its financial statements at an arbitrary amount and discloses that fact on the face of the financial statements. Is this accounting appropriate?

*Reply*—No. Accounting Research Bulletin No. 43, Chapter 4, *Inventory Pricing*, paragraph 8 (AC I78.109) states:

A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as *market*.

Accordingly, inventories should be valued at lower of cost or market and not at an arbitrary amount. The fact that the difference between the sales proceeds and the costs is covered by contributions does not change the application of the requirements of ARB No. 43 (AC I78.109). [Amended June 1995]

#### .02 Income Recognition of Membership Dues by Not-for-Profit Organization

*Inquiry*—A local not-for-profit organization collects membership dues and does not provide any services to its members in return for the dues. It records the dues as contributions and recognizes them as revenue in the period they are received. The organization provides services, such as seminars, group insurance, etc., to its members at an extra cost.

Is this the appropriate accounting method?

*Reply*—Yes. This organization qualifies as a not-for-profit organization under the definition in FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations* (AC No5). Accordingly, FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, paragraph 8 (AC C67.108), would require that the dues be recognized as contributions revenue when received since the members receive no benefits from the dues. If the member did receive benefits from those dues, dues revenue would be recognized over the period of membership (AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, paragraph 5.16). [Amended June 1995]

#### .03 Lapsing of Time Restrictions on Receivables That are Uncollected at Their Due Date

*Inquiry*—Paragraph 15 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made* (AC No5.144), provides that “receipts of unconditional promises to give with payments due in future periods shall be

reported as restricted support unless explicit donor stipulations or circumstances surrounding the receipt of a promise make clear that the donor intended it to be used to support activities of the current period. For example, receipts of unconditional promises to give cash in future years generally increase temporarily restricted net assets.” Paragraph 167 notes that “most unconditional promises to give with payments due in future periods will be recognized as temporarily restricted support with time restrictions that expire in the periods those payments are due. That recognition should avoid misunderstandings that some respondents said would occur if promises to give due in future periods were recognized as unrestricted revenue and were perceived by users of financial statements as currently available funds.”

Do time restrictions on contributions receivable lapse when the receivable is due or when it is collected?

**Reply**—Time restrictions on contributions receivable lapse when the receivable is due. (In some cases, the due date may be explicitly stated. In other cases, circumstances surrounding receipt of the contribution may make clear the implicit due date. In yet other cases, the due date may be unclear. NPOs should consider the facts and circumstances surrounding the promise to give to determine the due date, if any.)

#### **.04 Lapsing of Restrictions on Receivables if Purpose Restrictions Pertaining to Long-Lived Assets are Met Before the Receivables are Due**

**Inquiry**—Paragraph 14 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made* (AC No5.143), provides that “a restriction on an organization’s use of the assets contributed results either from a donor’s explicit stipulation or from circumstances surrounding the receipt of the contribution that make clear the donor’s implicit restriction on use.” These are purpose restrictions. Paragraph 15 provides that “receipts of unconditional promises to give with payments due in future periods shall be reported as restricted support unless explicit donor stipulations or circumstances surrounding the receipt of a promise make clear that the donor intended it to be used to support activities of the current period. For example, receipts of unconditional promises to give cash in future years generally increase temporarily restricted net assets.” These are time restrictions. Footnote 5 to paragraph 17 provides as follows:

If two or more temporary restrictions are imposed on a contribution, the effect of the expiration of those restrictions is recognized in the period in which the last remaining restriction has expired. Temporarily restricted net assets with time restrictions are not available to support expenses until the time restrictions have expired. Time restrictions implied on gifts of long-lived assets expire as the economic benefits of the acquired assets are used up; that is, over their estimated useful lives. In the absence of donor stipulations specifying how long donated assets must be used or an organization’s policy of implying time restrictions, restrictions on long-lived assets, if any, or cash to acquire long-lived assets expire when the assets are placed in service.

NPOs may receive promises to give contributions that are restricted by donors for investment in long-lived assets. In some circumstances, the assets may be placed in service, and the purpose restrictions met, prior to the due date of the contribution. For example, an NPO may have a capital campaign, asking for commitments to contribute over the next five years so the organization can build a new facility. A donor may promise to give \$100,000 in five years in response to that request.

Are the restrictions met when the assets are placed in service or when the receivable is due?

**Reply**—NPOs should consider the facts and circumstances surrounding the promise to give and whether those facts and circumstances indicate that the donor intended the contribution to be used to support activities of the current period, with constructing the building or placing it in service considered activities of the current period. If circumstances indicate that the donor intended to support activities of the current period, there is no time restriction and footnote 5 of FASB Statement No. 116 (AC No5.147) would not be applicable, unless a restriction was placed on the contribution other than constructing the building. If circumstances indicate that the donor's intent is not to support activities of the current period, there are both a time restriction and a purpose restriction. In conformity with footnote 5 of FASB Statement No. 116 (AC No5.147), the effect of the expiration of restrictions is recognized in the period in which the last remaining restriction has expired.

#### **.05 NPO Accounting for Loans of Cash That are Interest Free or That Have Below-Market Interest Rates**

**Inquiry**—FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made* (AC No5), defines a *contribution* as “an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.” Some NPOs receive loans of cash that are interest free or that have below-market interest rates.

Should interest expense and contribution revenue be reported for loans of cash to NPOs that are interest free or that have below-market interest rates?

**Reply**—Interest expense and contribution revenue should be reported in connection with loans of cash to NPOs that are interest free or that have below-market interest rates (regardless of whether the loan is between related parties). Those contributions should be measured at fair value, which is the difference between the fair value of the loan at market rates and the fair value of the loan at its stated rate. The corresponding entry would be to interest income for the donor and to interest expense for the donee.

##### *Example 1*

On January 1, 1998, an NPO with a December year end receives an interest-free loan of \$200,000, payable on December 31, 2000. The purpose of the loan is to pay operating expenses and the appropriate imputed rate of interest is 6 percent.

1/1/98

db. Cash	200,000	
cr. Loan payable		168,000
cr. Contribution revenue—restricted		32,000

(Receipt of cash; liability reported at the fair value of the loan using the present value of \$200,000 due in three years, discounted at 6 percent.)

12/31/98

db. Interest expense	10,000	
cr. Loan payable		10,000

(Accretion of loan using the effective interest method.)

Specialized Industry Problems

db. Restricted net assets	10,000	
cr. Unrestricted net assets		10,000

(Reclassification due to lapse of restriction.)

12/31/99

db. Interest expense	10,600	
cr. Loan payable		10,600

(Accretion of loan using the effective interest method.)

db. Restricted net assets	10,600	
cr. Unrestricted net assets		10,600

(Reclassification due to lapse of restriction.)

12/31/00

db. Interest expense	11,400	
cr. Loan payable		11,400

(Accretion of loan using the effective interest method.)

db. Restricted net assets	11,400	
cr. Unrestricted net assets		11,400

(Reclassification due to lapse of restriction.)

db. Loan payable	200,000	
cr. Cash		200,000

(Payment of the loan.)

Example 2

On January 1, 1998, an NPO with a December year end receives an interest-free loan of \$200,000, payable on demand. The purpose of the loan is to pay operating expenses and the appropriate imputed rate of interest is 6 percent. The loan is repaid on December 31, 2000.

1/1/98

db. Cash	200,000	
cr. Loan payable		200,000

(Receipt of cash.)

12/31/98

db. Interest expense	12,000	
cr. Contribution revenue		12,000

(Contribution revenue for below-market rate of interest on loan [loan balance x interest rate: \$200,000 x .06].)



12/31/99

db. Interest expense	12,000	
cr. Contribution revenue		12,000

(Contribution revenue for below-market rate of interest on loan [loan balance x interest rate: \$200,000 x .06].)

12/31/00

db. Interest expense	12,000	
cr. Contribution revenue		12,000

(Contribution revenue for below-market rate of interest on loan [loan balance x interest rate: \$200,000 x .06].)

db. Loan payable	200,000	
cr. Cash		200,000

(Payment of the loan.)

## **.06 Functional Category of Cost of Sales of Contributed Inventory**

**Inquiry**—How should the cost of sales of contributed inventory be reported? For example, should it be reported as a separate supporting service, as program, or as fundraising?

**Reply**—Cost of sales of contributed inventory should be reported as the cost of a separate supporting service, unless the item sold is related to a program activity, in which case, cost of sales is reported as a cost of a program activity. Cost of sales of contributed inventory should not be reported as fundraising.

## **.07 Functional Category of Costs of Special Events**

**Inquiry**—Paragraph 13.06 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* provides that “fund-raising costs, including the cost of special fund-raising events, are incurred to persuade donors to make contributions to an organization and should be expensed as incurred.” Paragraph 13.30 provides that “*fund-raising activities* involve inducing potential donors to contribute money....They include publicizing and conducting fund-raising campaigns...and conducting special fund-raising events....” Paragraph 13.18 provides guidance on accounting for special events and provides that “organizations may report the gross revenues of special events and other fund-raising activities with the cost of direct benefits to donors (for example, meals and facilities rental) displayed either (1) as a line item deducted from the special event revenues or (2) in the same section of the statement of activities as are other programs or supporting services *and allocated, if necessary, among those various functions.*” [*Emphasis added.*]

Should all costs of special fund-raising events, such as costs of direct donor benefits that are provided in exchange transactions, be reported as fund-raising?

**Reply**—The discussion of special fund-raising events in paragraphs 13.06, 13.18, and 13.30 of the Guide provide that some, but not necessarily all, costs of special fund-raising events should be reported as fundraising. Certain costs of special fund-raising events, such as costs of direct donor benefits that are provided in exchange transactions, should be reported in categories other than fundraising.

## .08 Functional Category of the Costs of Direct Donor Benefits

*Inquiry*—NPOs may hold special events that provide donor benefits. For example, an organization may hold a special event and provide a meal to donors, which would be a direct donor benefit. Paragraphs 13.17 to 13.22 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance on reporting the costs of special events, including the costs of direct donor benefits. Paragraph 13.15 provides that, if cost of sales relates to an item that is program related, cost of sales should be reported as program expense. Otherwise, cost of sales could be reported as a separate supporting service. Also, footnote 10 to paragraph 5.12 of the Guide provides that the cost of premiums provided that are greater than nominal in value should be reported as cost of sales. However, the Guide provides no guidance concerning the functional category in which the costs of direct donor benefits should be reported in circumstances in which the benefits are not program related, beyond providing that they should be reported as a supporting service.

In which functional category should the costs of direct donor benefits that are not program related be reported?

*Reply*—The costs of donor benefits that are not program related and that are provided in exchange transactions should be reported as a separate supporting category, such as cost of sales, and should not be reported as fundraising.

The costs of donor benefits that are not program related and that are provided in transactions that are other than exchange transactions, such as a fund-raising dinner for which there is no charge to attend, should be reported as fundraising.

## .09 Reporting Bad Debt Losses

*Inquiry*—Paragraph 20 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations* (AC No5.118), provides that expenses should be reported as decreases in net assets.

Paragraph 25 (AC No5.122) provides that “a statement of activities may report gains and losses as net amounts if they result from peripheral or incidental transactions or from other events and circumstances that may be largely beyond the control of the organization and its management.”

Paragraph 5.56 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* provides that, if the fair value of contributions arising from unconditional promises to give cash or noncash assets decreases subsequent to initial measurement because of changes in the quantity or nature of assets expected to be received, the decrease should be recognized as expenses or losses (bad debt) in the period(s) in which the expectation changes.<sup>1</sup>

May bad debt losses be netted against contribution revenue?

*Reply*—Bad debt losses are prohibited from being netted against contribution revenue under paragraph 25 of FASB Statement No. 117 (AC No5.122) because losses are permitted to be netted only against gains, and not against revenues.

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<sup>1</sup> The Guide's provision that certain decreases in the fair value of contributions arising from unconditional promises to give should be accounted for as losses, rather than as expenses, is an accounting convention. This convention provides that, in circumstances in which the net assets related to receivables are represented as restricted net assets, decreases in net assets should be reported as decreases in restricted net assets, rather than as decreases in unrestricted net assets.

**.10 Consolidation of Political Action Committee**

*Inquiry*—Some not-for-profit organizations are related to other not-for-profit organizations that perform political activities that the reporting organization does not wish to perform, perhaps because performing those activities may threaten the reporting organization's tax exempt status, the reporting organization is precluded from conducting such activities, or for other reasons. For example, a membership organization may establish and sponsor a political action committee (PAC) whose mission is to further the interests of the membership organization. The resources held by the PAC are used for the purposes of the membership organization and the governing board of the PAC is appointed by the board of the membership organization.

Does SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (ACC 10,610), require consolidation of PACs in the circumstances described above?

*Reply*—SOP 94-3 (ACC 10,610) requires consolidating PACs in the circumstances described above. Under SOP 94-3 (ACC 10,610), the threshold issues pertaining to the circumstances described above are whether there is (1) control through a majority voting interest in the board of the PAC and (2) an economic interest. In the circumstances described above, both are present. Control through a majority voting interest in the board of the PAC exists because the governing board of the PAC is appointed by the board of the membership organization. An economic interest exists because the PAC holds significant resources that must be used for the purposes of the membership organization.

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[The next page is 5521.]



## Section 6300

### ***Insurance Companies***

#### **.01 Recognition of Commission Income by Insurance Agency**

*Inquiry*—Insurance agents and brokers receive commissions on the insurance policies that they place for their clients with insurance companies. Commissions consist of a percentage of the premiums that the clients pay for the policies. On policies that are cancelled before the end of their term, usually one year, the insurance company charges back the portion of the commissions related to the unearned premiums to the originating agent or broker. In addition, some brokers may receive contingent commissions from underwriters based on the profitability of policies placed with an underwriter. How should an insurance agent or broker account for revenue from such commissions?

*Reply*—Commissions should be recognized on the date on which (a) the client is afforded protection under the policy (effective date), (b) the premium due under the policy can be reasonably estimated, and (c) the premium is billable to the client. A provision should be made for expected adjustments relating to policy cancellations when they can be reasonably estimated in accordance with FASB Statement No. 5, *Accounting for Contingencies* (AC C59). Contingent commissions should generally be recognized when the insurance agent or broker is notified by the underwriter of the amount to be received. [Amended]

#### **.02 Method of Recognizing Revenue From Commissions on Credit Life Insurance**

*Inquiry*—Under arrangements with a lending institution, an insurance agency provides credit life insurance to mortgagors. The borrower pays the premium for the entire term of the insurance (as much as eight years) when the loan is made, and the insurance agency remits to the insurance company this entire sum less a commission.

Should this commission income be recognized when it is received, or should it be recognized over the term of the policy?

*Reply*—Generally, credit life insurance appears to have more of the characteristics of casualty insurance than it does of life insurance. In particular, from the agent's viewpoint, payment for the policy usually occurs in a lump sum from which agent commissions are deducted. Generally, the efforts of the agency in connection with any individual policy terminate when collection is made or, at least, when the proceeds from the collections are remitted to the insurance company. It would therefore seem that the recognition of income should occur when proceeds of the policy are received.

However, as there is a potential liability for returned premiums, it would appear that a reasonable allowance should be provided at this time for estimated commissions on the portion of the policies that may be cancelled in future years. Most finance companies should have adequate statistics upon which to base such estimates. If the finance company is new, there may be statistics available from similar enterprises.

**.03 Recognition of Income on Unclaimed Refunds Due Policyholders on Policy Cancellations**

*Inquiry*—An insurance agency has a material amount of accounts payable legally due to policyholders who have cancelled their insurance prior to the end of the policy term. The company does not notify these policyholders that these amounts are due them. When, if ever, should these credits be taken into income?

*Reply*—These accounts payable should continue to be reported as liabilities until such time as the individuals involved legally lose their claim to these amounts. Legal counsel should be consulted for an opinion as to whether these amounts would have to be paid over to the state under an escheat law.

Consideration should also be given to the appropriateness of notifying these policyholders that this money is due them.

**.04 Reserve for Future Claims of Title Insurance Company**

*Inquiry*—A title insurance company must place part of its premiums in a reserve for future claims. When should this reserve be recognized as income?

*Reply*—The jurisdiction under which a title insurance company operates usually requires that a stipulated percentage of premiums collected must be deferred in an unearned premium account. Generally, the unearned premium is taken into income over a ten-year period since most claims against title policies tend to occur during this ten-year period. However, actual claims are not charged to the unearned premium account. Actual claims are charged against income (title claims account) with the credit to "Reserve for Claims." The reserve for claims represents reported claims that have surfaced. The unearned premium account is intended to cover unsurfaced claims.

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[The next page is 5641.]

## Section 6400

### **Health Care Organizations**

#### **.04 Hospital as Collecting Agent for Physicians**

*Inquiry*—Under an agreement with several physicians, a hospital acts as collecting agent for the physicians' fees, and the physicians, in return, provide professional services at the hospital. These physicians are not employees; payroll taxes are not paid for them, and the hospital cannot exercise any of the prerogatives of an employer. To enable it to collect the physicians' Medicare fees, the hospital holds valid assignments. Should the amounts collected as physicians' fees be included in the income and expenses of the provider hospital?

*Reply*—No. As discussed in the AICPA Audit and Accounting Guide *Health Care Organizations*, paragraph 3.02, health care organizations may receive and hold assets owned by others under agency relationships; for example, they may perform billing and collection services for physicians. In accepting responsibility for those assets, an organization incurs a liability to the principal under the agency relationship to return the assets in the future. In the example above, the hospital is functioning as a conduit with respect to the physicians' fees. As a result, the fees should be reported as a liability to the physicians and not recognized in the statement of revenues and expenses. Agency funds are reported as unrestricted assets. [Amended September 1997]

#### **.12 General Obligation Bonds Issued for Current Use by City Owned Hospital**

*Inquiry*—A hospital is a city municipal enterprise. The city council issued general obligation bonds to provide funds for the hospital's operations, without restriction. The hospital's assets will not be used to pay principal or interest on the bonds. Should the general obligation bond liability be reported in the hospital's financial statements?

*Reply*—No. The AICPA Audit and Accounting Guide *Health Care Organizations*, paragraph 7.15, states that if a health care organization has no obligation to make payments of principal and interest on the debt, the organization should not reflect the liability on its balance sheet. The proceeds from the bond issue are contributions from the city. Therefore, the hospital should not report the bonds as a liability in its financial statements. [Amended September 1997]

#### **.16 Disclosure Required in Consolidated or Combined Financial Statements**

*Inquiry*—What disclosures are required when consolidated or combined financial statements are issued?

*Reply*—The entities being consolidated or combined should be appropriately identified and the basis for combining or consolidating the entities, including the nature of the interrelationship of the entities, should be disclosed in the notes to the financial statements. Governmental entities are required to follow the accounting and disclosure provisions of GASB Statement No. 14, *The Financial Reporting Entity* (GAFRS section 2100). [Amended June 1995]

**.17 Elimination of Profit on Intercompany Sales**

*Inquiry*—ARB No. 51, *Consolidated Financial Statements*, paragraph 6 (AC C51.109), addresses the elimination of intercompany profit or loss on assets remaining within a combined or consolidated group. FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, paragraph 16 (AC Re6.126), indicates the following with regard to intercompany profit:

Profit on sales to regulated affiliates shall not be eliminated in general purpose financial statements, if both of the following criteria are met:

- a. The sales price is reasonable.
- b. It is probable that, through the rate-making process, future revenue approximately equal to the sales price will result from the regulated affiliate's use of the products.

Since health care providers are, in certain cases, reimbursed for operating costs, it is possible that, assuming they meet certain related party tests under third-party regulations, an entity could receive reimbursement on intercompany sales that include a profit. Thus, one could argue that under that circumstance, it would not be appropriate to eliminate profit on intercompany sales using the criteria set forth in FASB Statement No. 71 (AC Re6).

*Reply*—In some instances health care organizations may encounter situations where they fall under FASB Statement No. 71, paragraph 5 (AC Re6.115). Generally, however, as explained in FASB Statement No. 71, paragraph 62 (AC Re6.115, footnote 6), the normal Medicare and Medicaid arrangements are excluded from the scope of FASB Statement No. 71 (AC Re6) on the basis that the "regulator" is also a party to the contract. Accordingly, gains or losses on sale of assets within the group should be eliminated in combined or consolidated financial statements. However, these gains or losses would be recognized and disclosed as appropriate in the separate financial statements of the members of the group.

**.19 Offsetting of Limited Use Assets**

*Inquiry*—Can limited-use assets of one entity be offset against the related liability of another entity in combined or consolidated financial statements?

*Reply*—Unless a right of setoff exists as defined in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (AC B10), assets, in general, should not be offset against related liabilities in any financial statement presentation. [Amended]

**.20 Format of Combined or Consolidated Financial Statements**

*Inquiry*—When presenting combined or consolidated financial statements of various health care entities, is there a prescribed or recommended presentation format?

*Reply*—No. The sample financial statements contained in the AICPA Audit and Accounting Guide *Health Care Organizations*, do not prescribe the format of statements. In addition, no single format for combined or consolidated financial statements has been considered appropriate in all circumstances.

**.25 Accounting for Transfer of Assets From Not-for-Profit to For-Profit Entities**

*Inquiry*—How should subsequent transfers of assets, evidenced as additional investment, from not-for-profit entities to for-profit entities be accounted for by the transferee and transferor?



*Reply*—Additional investments in for-profit entities (subsequent to the original transfer of assets) should be reflected by the transferee as an increase in capital stock and/or paid-in capital. The transferor would record a corresponding increase in its investment account in the for-profit entity, if a financial interest was received (e.g., additional capital stock).

## **.26 Transfer of Assets From Subsidiary For-Profit Entity to Not-for-Profit Stockholder Parent**

*Inquiry*—How should transfers of assets from a “subsidiary” for-profit entity (F) to a not-for-profit entity (N) that is a minority stockholder of F be recorded?

*Reply*—This transaction would generally be recorded as a dividend, which would be reported as a reduction in F’s retained earnings. Any dividend in excess of retained earnings is a “liquidating” dividend; as such, it would be reported as a reduction in F’s paid-in capital account. If N accounts for its investment in F using the equity method, then the not-for-profit entity would report all dividends received as a reduction of its investment account, in accordance with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (AC 182). If N’s investment in F is accounted for using the cost method, because the conditions for applying the equity method are not met, the dividends would be reported as income.

## **.28 Valuation of Assets Transferred Between Related Entities Under Common Control**

*Inquiry*—At what value should the transfers of assets between related entities under common control be recorded by the transferee?

*Reply*—Assets transferred from one related entity under common control to another generally would not be recorded by the transferee at the fair value at the date of transfer, but rather at the carrying value of the transferring entity. This treatment is consistent with the guidance prescribed by Interpretation No. 39 of APB Opinion No. 16, *Transfers and Exchanges Between Enterprises Under Common Control* (AC B50.645–.648).

## **.29 Timing of Recording Transfers Between Related Entities**

*Inquiry*—When should a transfer of assets between related entities be recorded—only when the transfer is actually made, or at some earlier point?

*Reply*—In most situations, transfers should be recorded at the time they are formally obligated to occur (formal board resolutions, legal notes, passage of title to real estate, etc.). This would be the case when each of the entities have independent governance, and the timing of the transfer is controlled by the governing board of the transferor. Yet, in situations where there is clear, common control of the related entities, it would be appropriate to record transfers at the time when both (a) the transfer amount is known and (b) the receiving entity is given control over the timing of the transfer.

## **.30 Accounting for Transactions Involving Medicaid Voluntary Contribution or Taxation Programs**

*Inquiry*—The Medicaid program is set up on a state-by-state basis to provide medical assistance to the indigent. Although state-administered, the program is actually a joint federal and state program for which the federal government picks up a portion of the cost. Under this arrangement, the federal government “matches” a percentage of the total amount paid by the state to health care providers. This matching is referred to as federal financial participation.

States have attempted to increase the amount of federal matching funds for which they are eligible by increasing the amount of medical assistance they provide. In order to pay for the increased medical assistance, some states have imposed a tax on health care organizations and/or sought donations or other voluntary payments from them. As a result, the states have been able to generate additional federal matching funds without expending additional state funds. How should a health care organization account for these taxes or donations made to the state?

*Reply*—Congress has passed legislation prohibiting the use of health care organization taxes or donations except in limited situations.

The accounting for these types of programs is dependent on the individual facts and circumstances. For example, if there is a guarantee that specific monies given to the state by the health care organization will be 'returned' to the organization from the state, those amounts should be recorded as receivables. In addition, if the health care organization has met all requirements to be legally entitled to additional funds from the state, the revenue/gain should be recognized.

However, if the monies go into a pool with other contributions which are then disbursed based on factors over which the health care organization has little or no control, the payments should be recognized as an expense. Any subsequent reimbursements would be recognized as revenue/gain when the provider is entitled to them and payment is assured.

Care should be taken to avoid delayed recognition of expenses or to improperly recognize contingent gains. Because of complexities involved, it may be necessary to consult with legal counsel.

### .32 Use of Pooling-of-Interests Method

*Inquiry*—How, if at all, should APB Opinion No. 16, *Business Combinations* (AC B50), be applied to business combinations involving not-for-profit health care organizations?

*Reply*—APB Opinion No. 16 (AC B50) explicitly addresses only business combinations that involve transfers of ownership interests. However, the AICPA Audit and Accounting Guide *Health Care Organizations* (the Guide), paragraph 1.33, states that "circumstances exist under which reporting on the combination of two or more not-for-profit organizations . . . by the pooling of interests method better reflects the substance of the transaction than reporting by the purchase method. Therefore, not-for-profit organizations are, under certain circumstances, permitted to report by the pooling-of-interest method, even though they generally do not issue common stock. Such circumstances include the combination of two or more entities to form a new entity without the exchange of consideration."

Paragraph 11.28 of the Guide also states that APB Opinion No. 16 (AC B50) "may provide a useful framework" when evaluating similar transactions entered into by not-for-profit health care business organizations that are similar to a pooling of interests, such as a transaction involving change in control but no exchange of consideration (for example, a change in sole corporate member).

However, because not-for-profit health care entities do not issue common stock and there is no private ownership, they are subject to different laws and practice regarding control and governance. Therefore, the provisions of APB Opinion No. 16 (AC B50) cannot be applied literally. If the transaction is deemed similar to a pooling of interests, no step-up in basis is required. Accord-

ing to paragraph 1.34 of the Guide, an example of acceptable practice in such circumstances is to report the assets, liabilities, and net asset balances of the combined entities as of the beginning of the year and disclose the information that would be required to be disclosed for a pooling of interests under APB Opinion No. 16 (AC B50).

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**Note:** The FASB is working on a project regarding *Business Combinations*. The results of this project could significantly affect the use of the pooling-of-interests method. The timing of this project has not yet been established.

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### **.33 Accounting for a Joint Operating Agreement**

**Inquiry**—Two not-for-profit health care systems enter into a Joint Operating Agreement whereby both (the Venturers) agree to jointly operate and control certain of their hospitals while sharing in the operating results and residual interest upon dissolution based upon an agreed-upon ratio. Neither of the Venturers receives cash or other monetary assets as part of entering into the Agreement. How should the Venturers account for the Agreement?

**Reply**—Joint Operating Agreements are similar to joint ventures and typically are characterized by factors such as:

- Common purpose (e.g., to share risks and rewards; to develop a new market, health service or program; to pool resources)
- Joint funding: all parties contribute resources toward its accomplishment
- Defined relationship: typically governed by an agreement
- Joint control: control is not derived from holding a majority of the voting interest

Even though the Agreement does not provide for a separate legal entity (such as a corporation or partnership), the same principles apply. For example, since there is joint control (i.e., neither party controls the venture), consolidation would not be appropriate. Instead, such agreements should be accounted for similar to a corporate joint venture using the equity method of accounting (see AICPA Interpretation No. 2 of APB Opinion No. 18, *Investments in Partnerships and Ventures* [AC I82.512], or APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* [AC I82]). Since the transaction did not reflect the culmination of the earnings process, the Venturers' basis in the investment would be recorded at net book value.

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[The next page is 5841.]



## Section 6500

### ***Extractive Industries***

#### **.03 Disclosure of Contingent Liability for Royalties**

*Inquiry*—A company is forming a new subsidiary company which is purchasing the assets of an existing coal mining partnership. The total consideration is \$2,000,000, which is to be paid in the following manner:

- (1) \$750,000 in cash at the time of closing, which is considered as payment for coal land owned in fee, mining equipment, supplies, and other real estate, all of which have a fair market value of at least \$750,000.
- (2) \$1,250,000 to be paid as an overriding royalty of 10¢ per ton for all coal mined by the purchaser on the properties both owned and leased, acquired from the sellers or on any subsequently acquired properties.

Should the \$1,250,000 be recorded as a liability on the statement of financial position? If the \$1,250,000 is recorded as a liability and reduced monthly at the time that the 10¢ per ton overriding royalty is paid, how should the asset account be amortized?

*Reply*—It would be improper to reflect the total amount of the stipulated overriding royalty as a liability in the financial statements with a correlative charge being made to an asset account. The only possible rationale for setting these amounts up immediately, is to base such treatment on the contentions that (a) from a going concern standpoint, it is likely the total amount in question will eventually be paid; and (b) the transaction is viewed as involving a “premium” or “purchase price” undertaken to be paid for the acquisition of a leasehold. This rationale is erroneous since no immediate payment for the leasehold rights is made.

The \$1,250,000 is a contingent liability—a commitment entirely conditioned on the actual mining of coal. Accordingly, royalties should be accrued as a liability only when, and to the extent that, tonnage (to which the royalty applies) is actually mined. In the purchase agreement, there is a liability on the overriding royalty if no coal is mined.

The rule of informative disclosure requires that the essential facts concerning the property acquisitions be indicated in a footnote to the statements, including an adequate explanation as to the nature and amount of the company’s contingent liability.

Although there are instances where royalty payments are reflected as administrative or selling expense, in this case the royalties are paid for the right to mine the coal. The royalty cost may be viewed as a direct burden on production cost and should be accumulated as part of the cost of coal mined. The royalty cost then would be matched with revenues at the point of sale, as part of the cost of coal sold.

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[The next page is 5941.]



## Section 6600

### *Real Estate*

#### **.01 Method of Recognizing Revenue from Commissions by Real Estate Brokerage Firm**

*Inquiry*—A client is a real estate broker and also manages real estate. The client is the exclusive broker for all its affiliates and acts as broker for outside parties as well. All of the affiliates invest in raw land for appreciation and occasionally improve and subdivide parcels. None of the properties are extensive enough to be considered “retail land sales companies.” Sales are probably half for second home sites and half for larger parcels bought for investment. Sales are usually for cash with an occasional mortgage taken by the seller. The client usually receives a gross brokerage commission of 10%-15% which is shared with its salesmen and co-brokers, retaining an average of 5%. Commissions are received at closing and co-brokers are paid shortly after the closing. Salesmen draw against firm purchase and sale agreements and are credited with the commission on closing. If a buyer fails to complete a purchase, his deposit is usually retained by the client in lieu of the brokerage commission, which legal counsel indicates is permitted under law.

The client records brokerage commission income when a firm purchase and sale agreement is accepted. This is an agreement which specifies price and all terms of sale, has no unusual or difficult conditions, and is secured by a deposit of 10% or more of the purchase price. This method was adopted by the client to more closely match revenues and expenses. Indirect selling expenses, including advertising, are treated as period costs. The costs of co-brokerage and salesmen’s commissions are also accrued at that time. The client’s contention is that the earnings process has been substantially completed, and the wait until closing (usually 30-90 days but occasionally longer) is a legal formality rather than an integral part of the broker’s work. Very few sales are not closed, and the price and terms of sale rarely change. From an audit point of view, many of the open sales at year-end have closed by completion of the audit field work. The client’s financial statements do disclose the method of accounting employed for brokerage commissions.

Is this present method of accounting for brokerage commissions considered acceptable?

*Reply*—Revenue recognition is discussed in FASB Concepts Statement No. 5, *Recognition and Measurement of Business Enterprises*, paragraphs 83 and 84. Paragraph 83 states in part:

“Revenues are not recognized until earned. An entity’s revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.”

Therefore, the client’s method of accounting for commission income at the time when a firm purchase and sale agreement is entered into would be acceptable. However, because of state laws governing real estate operations, recognition of

commission income might have to be postponed, depending on the particular legal requirements of a given state, until such time as the broker is legally entitled to receive that commission.

### **.03 Accounting for Sale of Property With Option to Repurchase**

*Inquiry*—A corporation sold a parcel of land to a bank. The corporation has an option to repurchase the land for a period of three years. The corporation received the full purchase price at the time of sale.

What is the proper accounting treatment for this transaction?

*Reply*—The conclusion in FASB Statement No. 66, *Accounting for Sales of Real Estate*, paragraph 26, is that a transaction whereby a seller has an obligation or an option to repurchase the property must be accounted for as a financing, leasing, or profit sharing arrangement. A right of first refusal based on a bona fide offer by a third party is ordinarily not an obligation or an option to repurchase.

### **.04 Method of Recognizing Profit on Sale of Undeveloped Land With a Release Provision**

*Inquiry*—One hundred acres of undeveloped land was sold for \$10,000 per acre for a total consideration of \$1,000,000. The buyer made a cash down payment of \$250,000, and the balance of \$750,000 is payable in three annual installments of \$250,000. The agreement has a release provision that title to the acreage will be released to the buyer on a basis of 115% of the sales price. Therefore, of the \$250,000 down payment, \$217,000 would be applicable to the release of 21.7 acres, and the balance of \$33,000 would be applicable to the remaining acreage. At this point, there would be a balance due on the sales agreement of \$750,000 against which \$33,000 would apply. The buyer would have this privilege every year, and the only security would be the land underlying the agreement.

What is the proper accounting treatment?

*Reply*—FASB Statement No. 66, *Accounting for Sales of Real Estate*, paragraph 15 (AC Re1.115), states:

If the amounts applied to unreleased portions do not meet the initial-and continuing-investment criteria as applied to the sales value of those unreleased portions, profit shall be recognized on each released portion when it meets the criteria in paragraph 5 as if each release were a separate sale.

Paragraph 5 (AC Re1.105) states, in part:

Profit on real estate sales transactions shall not be recognized by the full accrual method until all of the following criteria are met:

- a. A sale is consummated.
- b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property.
- c. The seller's receivable is not subject to future subordination.
- d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with property.

Presumably, the tests referred to would have to be met continuously; that is, at the time of closing and at each release date.



The relationship of the \$33,000 to the \$750,000 is not sufficient “to constitute an adequate initial and continuing investment” related to the unreleased property. Therefore, “profit should be recognized as if each release were a separate sale” as stated in paragraph 15 (AC Re1.115). [Amended]

#### **.07 Accounting for Nonmonetary Exchange of Land**

*Inquiry*—A real estate company is engaged in developing residential communities, but they occasionally sell undeveloped parcels of land. The company has entered into an agreement whereby it will exchange land zoned for industrial use having a cost basis of \$10,000 for residential land having a fair value of \$50,000.

Is it proper to record the land received at \$50,000 and recognize a gain of \$40,000?

*Reply*—APB Opinion No. 29, paragraph 21(a) (AC N35.108a), indicates that “an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers . . .” does not culminate an earnings process. This exchange represents only a shift in real estate held as inventory. Therefore, the exchange should be reported on the basis of the recorded amount of the nonmonetary asset given up, \$10,000.

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[The next page is 6151.]



## Section 6700

### Construction Contractors

#### .01 Distinction Between Long-Term and Short-Term Construction Contracts

*Inquiry*—A construction company considers all contracts that are less than one year in duration as short-term contracts and accounts for them on a completed contract method. Long-term contracts are accounted for on the completed-contract method or the percentage of completion method depending on other factors.

Does the distinction made by the company conform with generally accepted accounting principles?

*Reply*—SOP No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, paragraph 31 (ACC 10,330.31), and the AICPA Audit and Accounting Guide *Construction Contractors*, page 123, state that the completed-contract method may be used as the basic accounting method only if the financial position and results of operations reported on that basis would not vary from those resulting from the use of the percentage-of-completion method, “for example, in circumstances in which an entity has primarily short-term contracts.” SOP No. 81-1, paragraph 31 (ACC 10,330.31), also states that an entity using the completed-contract method as its basic accounting method should depart from that policy for a single contract or a group of contracts not having the features described in the paragraph. Thus, it appears that the distinction made by the company conforms to generally accepted accounting principles. [Amended]

#### .10 Payments for Landfill Rights

*Inquiry*—A construction contractor pays for rights allowing the contractor to extract a specified volume of landfill from a third party's property for a period of three years. How should the payment for landfill rights be classified in the contractor's balance sheet?

*Reply*—Until the landfill is extracted, the contractor should classify the payment for landfill rights as a deferred charge. The portion of the landfill payment related to the volume of landfill extracted should be reclassified as project costs. A deferred charge remaining at the termination of the agreement should be written off as an expense.

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[The next page is 6351.]



## Section 6910

### *Investment Companies*

#### **.03 Basis for Valuation of Investments in Rental Property**

*Inquiry*—An investment company has substantial investments in assets other than securities, particularly rental real estate. The AICPA Audit and Accounting Guide *Audits of Investment Companies*, discusses only the valuation of investments in securities. In the regulations to the Investment Company Act of 1940, however, Rule 2a-4, paragraph (a)(1) states, "Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company." How should the investment in rental property be reported?

*Reply*—The AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 1.30, states that values and changes in values are as important to investors as the investment income earned. That is because interests in investment companies are traditionally bought and sold at current net asset values. Therefore, as stated in paragraph 1.30, investment companies report their securities at value, defined as the quoted market price for securities for which market quotations are readily available, or as an estimate of fair value as determined in good faith by the board of directors for other securities. SEC *Codification of Financial Reporting Policies*, Sec. 404.03.b.iv., offers guidance on valuing securities in good faith.

Accordingly, the rental property in this client's portfolio should be accounted for at fair value.

Paragraph 9.08 of the guide contains an example of an independent auditor's report used for expressing an opinion on financial statements in which securities' values have been estimated by the board of directors in the absence of readily ascertainable market values. [Amended June 1995.]

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[The next page is 6471.]



## Section 6930

### **Employee Health and Welfare Benefit Funds**

#### **.01 Computation of Liability for Accumulated Eligibility Credits**

*Inquiry*—A self-insured fund charges its members premiums of \$50 per month per individual to participate in the plan. Accumulated eligibility credits for future benefits are as follows: 400 members, 3 months; 500 members, 6 months; 800 members, 9 months; and 0 members, 12 months. Would the following computation of liability for accumulated eligibility credits be acceptable?

400 members × 3 months × \$50 .....	\$ 60,000
500 members × 6 months × \$50 .....	150,000
800 members × 9 months × \$50 .....	360,000
Liability for accumulated eligibility credits .....	<u>\$570,000</u>

*Reply*—No; the above computation is incomplete. Statement of Position No. 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*, paragraph 43 (ACC 10,530.48), states that the obligation for accumulated eligibility credits should consider assumptions for mortality and expected employee turnover or other appropriate adjustments, to reflect the obligation at the amount expected to be paid. [Amended June 1995]

#### **.02 Disclosure of Maintenance of Benefits Provision**

*Inquiry*—A self-insured fund is covered by an agreement under which the employers are subject to a maintenance of benefits provision. The employers are required to maintain a cash reserve of approximately one month's cost of operations. The employers are required to maintain such a reserve for existing unreported claims for any member eligible through the financial statement date under any circumstances, whether there be a strike, industry-wide layoff, or fund termination.

The AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, indicates in paragraphs 4.101 and 4.104 that claims incurred, but not reported, and future payment of benefits based on participant's accumulated eligibility arising from hours accumulated should be presented as liabilities in the financial statements of the plan. How should the maintenance of benefits provision be shown?

*Reply*—For multiemployer plans that have not yet adopted Statement of Position No. 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* (ACC 10,530), potential benefit claims should be reflected as "estimated health claims incurred but not reported" and "estimated future benefits based on participant's accumulated eligibility" on the statement of net assets available for benefits. The cash account should be segregated to disclose the portion related to this obligation. There should also be adequate disclosure of the maintenance of benefits provision of the agreement.

For plans that have adopted Statement of Position No. 92-6 (ACC 10,530), potential benefit claims (incurred but not reported [IBNR] and accumulated

eligibility credits) should be reflected as benefit obligations on the face of one or more financial statements. They should not be shown as liabilities on the statement of net assets available for benefits. [Amended June 1995]

### .03 Financial Statement Presentation of Underwriting Deficits

*Inquiry*—The administrator of an employee health and welfare benefit plan has questioned an item on the plan's statement of net assets available for benefits. The item appears in the liabilities section as follows:

Reserve for underwriting deficit—(Note 3) \$10,000

Note 3 reads as follows:

Reserve for underwriting deficit represents a liability with the XYZ Life Insurance Company for claims paid in excess of premiums during the current policy year. This liability will be applied to reduce any refunds which may accrue in the future. Such a refund was received during the current year.

The related debit to the credit setting up the liability was to "Underwriting Deficit," and is included in health claims deductions in the "Statement of Changes in Net Assets Available for Benefits."

The administrator takes the position that this item should be excluded entirely from the financial statements because:

1. The policy provides that any underwriting deficit in one policy year is not immediately recoverable by the insurance company but only recoverable against underwriting "gains" of succeeding years, if any.
2. Upon cancellation of the policy by the underwriter, the fund is relieved of any liability for any unrecovered underwriting deficit existing on date of cancellation.
3. Although there were usually underwriting "gains" in past years, there is no assurance that future underwriting "gains" will occur to permit recovery of the deficit.

Should the underwriting loss be reflected in the financial statements in the year in which it occurs?

*Reply*—Yes, if certain criteria are met. For multiemployer plans that have not yet adopted Statement of Position No. 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* (ACC 10,530), the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraphs 4.99 and 4.100, discusses accrued experience rating adjustments. The Audit and Accounting Guide, paragraph 4.100, states:

Experience ratings, determined by the insurance company or by estimates, may also result in a premium deficit. Premium deficits should be recorded as a liability of the plan (or a reduction of a deposit, if applicable) if (a) it is probable that the deficit will be applied against the amounts of future premiums or experience-rating refunds and (b) the amount can be reasonably estimated. If no accrual is made for premium deficit because one or both of the conditions are not met, or if an exposure to loss exists in excess of the amount accrued, disclosure of the premium deficit should be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.

A footnote states that considerations in determining whether it is probable that a premium deficit will be applied against future premiums or refunds include (a) the extent to which the contract with the insurance company requires payment of such deficits and (b) whether the plan intends to transfer coverage to another insurance company.



The way in which the so-called “underwriting deficits” offset against underwriting “gains” indicates that the “underwriting deficits” are comparable to the situation discussed in the audit and accounting guide. Therefore, if it is probable that there will be future “underwriting gains” under the contract, the “underwriting deficits” should be reported as a liability with accompanying footnote disclosure.

For plans that have adopted Statement of Position No. 92-6, paragraph 42 (ACC 10,530.47), states that premium deficits that meet the above criteria should be included in the plan’s benefit obligations. They should not be shown as liabilities on the plan’s statement of net assets available for benefits. [Amended June 1995.]

#### **.04 Definition of “Current” for Discount Rate Calculation**

*Inquiry*—FASB Statement No. 87, *Employers’ Accounting for Pensions*, paragraph 44 (AC P16.138), states, “Assumed discount rates shall reflect the rates at which pension benefits could be effectively settled. It is appropriate in estimating those rates to look to available information about rates implicit in current prices of annuity contracts that could be used to effect settlement of the obligation . . . .” What date should be used for measurement of a current price?

*Reply*—The “current price” of an annuity may be determined as of the date upon which the measurement of the plan assets and obligations is based. That date is generally determined in accordance with FASB Statement No. 87, paragraph 52 (AC P16.148), which states “measurements of plan assets and obligations . . . shall be as of the date of the financial statements or, if used consistently from year to year, as of a date not more than three months prior to that [financial statement] date.”

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[The next page is 6521.]



Section 6935

Profit Sharing and Pension Plans

.02 Depreciation of a Real Estate Investment Owned by a Defined Benefit Pension Plan

*Inquiry*—A defined benefit pension plan has invested in real estate which owns and receives rents from various stores in a shopping center. The financial statements include an expense for depreciation based on original cost. FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, paragraph 11 (AC Pe5.110), requires that plan investments in real estate be presented at their fair value at the reporting date. Consequently, by providing for depreciation expense, the unrealized appreciation on this asset is increased.

Should depreciation expense be reflected for this plan investment?

*Reply*—No. Depreciation expense is normally an adjustment of the valuation of fixed assets reported at cost, in accordance with FASB Statement No. 35, paragraph 14 (AC Pe5.113), which requires plan assets used in plan operations to be presented at cost less accumulated depreciation or amortization. Accordingly, since plan investments in real estate are to be reported at fair value, there is no requirement to provide for depreciation expense.

.03 Computation of Net Appreciation/Depreciation in Fair Value of Investments

*Inquiry*—FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, paragraph 15 (AC Pe5.114), requires the statement of changes in net assets available for benefits to include separate disclosure of the net appreciation (depreciation) in fair value for each significant class of investments. The AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraphs 3.25(a) and 4.38 or 4.105(a), requires the same disclosure for defined contribution plans and employee health and welfare benefit plans. How can this amount be computed?

*Reply*—FASB Statement No. 35, paragraph 15, footnote 7 (AC Pe5.114, footnote 10), states that the net appreciation (depreciation) in the fair value of investments should include both realized and unrealized gains (losses). This amount may be computed by aggregating the realized and unrealized gains and losses for each individual security. However, this would be quite time-consuming if the plan has a large portfolio of investments. As an alternative, the following formula may be used to compute the net appreciation (depreciation) in the fair value of investment:

Market value at 12/31/X1 .....	\$XXX
Less: Total proceeds of assets sold in 19X2 .....	< XX>
Add: Total cost of assets purchased in 19X2 .....	XX
Less: Market value at 12/31/X2 .....	<XXX>
Net appreciation/depreciation in fair value of investments .....	<u><u>\$XXX</u></u>

**.04 Benefits Payable to Terminated Participants of a Defined Contribution Plan**

*Inquiry*—Should benefits payable to terminated participants of a defined contribution [such as profit sharing or 401(k)] plan be classified as a liability in the plan financial statements?

*Reply*—No. Classifying benefits payable to participants as a liability is inappropriate because, by definition, net assets available for benefits (the difference between plan assets and liabilities) represents benefits owed to all participants—both active and terminated. Therefore, only amounts owed to nonparticipants (that is, third parties) should be classified as liabilities.

However, benefits payable to terminated participants should be disclosed in accordance with paragraph 3.28 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, which states:

The financial statements should also disclose, if applicable—

- m.* Amounts allocated to accounts of persons who have elected to withdraw from the plan but have not yet been paid. These amounts should not be reported as a liability on the statement of net assets available for benefits, in financial statements prepared in conformity with generally accepted accounting principles. A footnote to reconcile the audited financial statements to the Form 5500 may be necessary to comply with ERISA . . . .

[Amended June 1995]

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[The next page is 6551.]

## Section 6940

### Franchisors

#### .01 Method of Accounting for Sale of Territorial Franchise Right

*Inquiry*—A client sells territorial franchise rights to region managers for \$30,000 with ten percent taken in cash and the remainder as a note. The region manager in turn sells franchises in his territory. The note is payable at the rate of \$1,000 per franchise sold in the territory but is due in three years regardless of the number of franchises sold.

The collectibility of the notes depends on the performance of the region managers. The company has been able to resell territories of managers who have been unsuccessful, and the down payments have been refunded in these instances.

What is the proper method of accounting for these franchise fees and the related costs of selling the territories?

*Reply*—In discussing initial franchise fees for area franchises, FASB Statement No. 45, *Accounting for Franchise Fee Revenue*, paragraph 8 (AC Fr3.104), states: "... revenue ordinarily shall be recognized when all material services or conditions relating to the sale(s) have been substantially performed or satisfied by the franchisor." In FASB Statement No. 45, paragraph 5 (AC Fr3.101), the Board defines substantial performance as follows:

... Substantial performance for the franchisor means that (a) the franchisor has no remaining obligation or intent—by agreement, trade practice, or law—to refund any cash received or forgive any unpaid notes or receivables; (b) substantially all of the initial services of the franchisor required by the franchise agreement have been performed; and (c) no other material conditions or obligations related to the determination of substantial performance exists ...

Therefore, the sale of the regions is not a completed transaction which would allow the recognition of income when the sale is made (i.e., when the down payment and notes are received) since the company's practice of refunding down payments to region managers and, in effect, excusing nonpayment of their notes would violate item (a) above.

Since payment of the notes is on the basis of specific performance (i.e., at the rate of \$1,000 per franchise sold in the region), as a practical matter, a reasonable basis for recognizing deferred revenue would be over the estimated number of franchises to be opened in a region.

With regard to the costs of selling the territories, FASB Statement No. 45, paragraph 17 (AC Fr3.113), states:

Direct (incremental) costs relating to franchise sales for which revenue has not been recognized ordinarily shall be deferred until the related revenue is recognized; however, the deferred costs shall not exceed anticipated revenue less estimated additional related costs. Indirect costs of a regular and recurring nature that are incurred irrespective of the level of sales, such as general, selling, and administrative costs, shall be expensed as incurred. Costs yet to be incurred shall be accrued and charged against income no later than the period in which the related revenue is recognized ...

Therefore, deferral and amortization of costs "incurred to produce the region sales" could be accounted for in a manner similar to the deferral and recognition of revenue discussed in the preceding paragraph. The operating expenses of the company should be charged off as a period cost. [Amended]

## **.02 Revenue Recognition for Franchisors**

*Inquiry*—A franchise agreement is entered into whereby the franchisor agrees to provide to a franchisee the technical information necessary to manufacture a product. In addition, the franchisor agrees to provide consultation needed to produce the product for the next five years. The agreement states that 80 percent of the franchise fee is to be paid in the first year of the agreement, and five percent is to be paid in each of the next four years. How should the franchisor recognize the revenue from this agreement?

*Reply*—This issue is addressed in FASB Statement No. 45, *Accounting for Franchise Fee Revenue* (AC Fr3). Paragraph 7 (AC Fr3.103), states that "if it is probable that the continuing fee will not cover the cost of the continuing services to be provided by the franchisor and a reasonable profit on those continuing services, then a portion of the initial franchise fee shall be deferred and amortized over the life of the franchise. The portion deferred shall be an amount sufficient to cover the estimated cost in excess of continuing franchise fees and provide a reasonable profit on the continuing services." This Statement defines continuing franchise fee as "consideration for the continuing rights granted by the franchise agreement and for general or specific services during its life."

In the above situation, it is unlikely the five percent of revenues the franchisor will receive in years two through five is sufficient to cover the costs, and a reasonable profit, on the raw materials and services provided. Therefore, the franchisor should defer a portion of the first year's franchise fee and amortize it over the next four years at a rate that will cover costs and provide a reasonable profit.

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[The next page is 6601.]

## Section 6950

### ***State and Local Governmental Units***

#### **.18 Accounting for the Issuance of Zero-Coupon Bonds and Other Deep Discount Debt by a Governmental Entity**

*Inquiry*—A governmental entity issues zero-coupon bonds due in 10 years. Even though bond interest and principal is not due until the end of the bond's term, a sinking fund was established. When should interest expense be recognized and principal payments be deducted from the debt?

*Reply*—The treatment by governmental entities of the bond discount related to deep-discount debt has not been specifically addressed in authoritative literature. As discussed in *Governmental Accounting, Auditing and Financial Reporting*, by the Government Finance Officers Association, the accrual of principal and interest payments for zero-coupon bonds and other deep-discount debt is not recommended because the requirement that payments be due "early in the next year" is not met. The face amount of the debt less the discount presented as a direct deduction should be presented in the general long-term debt account group. The net value of the bonds should be accreted (the discount reduced) over the life of the bonds in the long-term debt account group. This presentation shows what amount would be payable if the debt were required to be paid today. The interest method provides an acceptable means of amortizing the discount. However, the straight line amortization method may also be used if its application would not produce amounts that differ materially from those that would be achieved if the interest method were applied.

#### **.21 Auditor's Reports on Local Governments**

*Inquiry*—A state law referring to the audit of local governments requires every auditor's report to state that the audit was conducted in accordance with generally accepted auditing standards and with the auditing standards prescribed by the state auditor. The law also requires the auditor's report to conform with the standard report form and to contain a reference to a report of comments and recommendations.

May a CPA include such wording in the opinion if he or she has followed the standards prescribed by the state auditor and he or she has included a report of comments and recommendations?

*Reply*—A CPA may state in the report that the audit has been conducted in accordance with generally accepted auditing standards and with the standards prescribed by the state treasurer if the audit was in fact conducted in conformity with these standards.

Also a CPA may include in the auditor's report a reference to a report of comments and recommendations if such a report has in fact been issued. [Amended June 1995.]

#### **.22 State Accounting Guide Differs From GAAP**

*Inquiry*—Are reports on financial statements conforming to the State accounting guide requirements considered special reports under SAS No. 62, *Special Reports* (AU 623)?

*Reply*—Yes. Reports on financial statements conforming to the State accounting guide requirements are considered special reports. SAS No. 62, paragraph 4 (AU 623.04), states that a basis of accounting that an entity uses to comply with the requirements or financial reporting provisions of a government regulatory agency to whose jurisdiction it is subject is a comprehensive basis of accounting other than generally accepted accounting principles. SAS No. 62, paragraph 8 (AU 623.08), illustrates a special report for financial statements filed solely with the regulatory agency. [Amended June 1995.]

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[The next page is 6701.]



## Section 6960

### ***Colleges and Universities***

#### **.12 Allocation of Overhead**

*Inquiry*—A private college has many individual restricted programs funded from federal, state and private contributions. One of the programs was charged a \$97,000 overhead expense amount, with the credit going to revenue in another program. Is it appropriate under generally accepted accounting principles to record revenue based on the overhead allocation?

*Reply*—No, it is inappropriate. The allocation of overhead is an interprogram transaction that should not be reported as revenue of the program providing the services but rather as a reduction of expense of such program. For additional information related to this topic, see the AICPA's Audit and Accounting Guide *Not-for-Profit Organizations*, paragraph 16.03. [Amended June 1995]

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[The next page is 6851.]



## Section 6980

### ***Brokers and Dealers***

#### **.01 Auditor's Report on Internal Control for Broker-Dealers**

*Inquiry*—Some state regulatory agencies are requesting that their name be included in the restrictive paragraph of the auditor's report on internal accounting control for broker-dealers. Because most broker-dealers must comply with Securities and Exchange Commission (SEC) regulations, the report on internal accounting control from their auditors includes a report on the additional requirements of Rule 17a-5(g) as well as a report on their study and evaluation as part of an audit. The restriction paragraph of the report illustrated in the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, appendix D, therefore includes the SEC as a designated recipient of the report and reads as follows:

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [*designated self-regulatory organization*], and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and should not be used for any other purpose.

One state agency suggested revising the paragraph to reflect other agencies as recipients as follows:

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [*designated self-regulatory organization*], and other regulatory agencies and should not be used for any other purpose.

Is this proposed revised wording appropriate in view of the fact that not all regulatory agencies use the SEC's Rule 17a-5(g) criteria or other established criteria for the evaluation of the adequacy of internal control procedures for their purposes?

*Reply*—No. The above suggested wording is not appropriate because the report would then be distributable to all other non-SEC regulatory agencies, and as stated, most agencies, including those of the 50 states, do not establish criteria in reasonable detail and in terms susceptible to objective application for the auditor's study, evaluation and report on the control procedures for the agencies' purposes. [Amended September 1997]

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[The next page is 6901.]



## Section 6990

### ***Common Interest Realty Associations***

#### **.01 Personal Property of Timeshares**

*Inquiry*—Should a common interest realty association (CIRA) that is a timeshare development report as assets personal property that it owns and uses as internal unit furnishings for timeshare units.

*Reply*—Yes. The AICPA Audit and Accounting Guide *Common Interest Realty Associations*, paragraph 2.01, provides that common property includes personal property that is owned by the CIRA and used on common real property. Paragraph 2.11 of the Guide provides that “CIRAs should recognize common personal property, such as furnishings, recreational equipment, maintenance equipment, and work vehicles, that is used by the CIRA in operating, preserving, maintaining, repairing, and replacing common property and providing other services, as assets.” Personal property that is owned by a CIRA and used as internal unit furnishings for timeshare units is common personal property that is used by the CIRA in providing other services.

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**[The next page is 7001.]**



# TIS Section 7000

## SPECIALIZED ORGANIZATIONAL PROBLEMS

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## Section 7200

### Partnerships

#### .01 Balance Sheet Presentation of Drawings in Excess of Capital Contributions

*Inquiry*—Two partners each contributed capital of \$100 to form a partnership for the construction of a shopping center. The partnership has obtained several loans to fund the construction, but no payments on these loans are due for two years. The partners each withdrew excess funds of \$50,000 from the partnership out of the proceeds of the loans.

How would the balance sheet show the \$200 of capital and \$100,000 of withdrawals?

*Reply*—Whether the \$50,000 payments to the partners are permissible depends on the terms of the construction loan commitment. If the partnership agreement is silent concerning these payments, and they are, in fact, not loans to the partners, the \$50,000 withdrawn by each partner represents drawings in anticipation of profits. As drawing accounts, they would normally be closed to the partners' capital accounts. In the situation presented, it would result in a "negative" capital account for each partner in the amount of \$49,900 in the partners' equity section of the balance sheet. Full disclosure of the circumstances causing the negative balance should also be included.

#### .02 Provision for Income Taxes on Partnership Income

*Inquiry*—A partnership agreement provides that in computing net profits, there will be a provision for income taxes, and the amount of the provision for income taxes will be considered an expense of the partnership. In the preparation of the income statement, would the net profit figure after income taxes be considered as having been determined according to generally accepted accounting principles?

*Reply*—Between themselves, partners may agree to compute net profits in any fashion they wish; but for financial presentation purposes, a provision for income taxes should not be set up. The absence of this item in the financial statement can be explained in the form of a footnote to the income statement. If the income statement shows a net profit figure after income taxes, the statement is not prepared in accordance with generally accepted accounting principles.

#### .07 Accounting for Syndication Costs of Limited Partnerships

*Inquiry*—How should the amounts paid to attorneys, accountants or engineers; commissions paid to selling agents; fees paid to regulatory bodies; and printing costs for a private offering of a limited partnership be accounted for? Should they be deferred and amortized similar to organization costs in a corporation?

*Reply*—No. Organization costs of a corporation are normally considered to be the initial legal and other fees paid to incorporate a business in a particular state and are normally an immaterial amount.

The expenses referred to in the inquiry are similar in nature to stock issue costs such as underwriting discounts, professional fees and other expenses clearly and directly attributable to receiving proceeds of the shares issued by a corporation. These costs would be a reduction of paid-in capital in an offering of stock. Accordingly, these costs should be a reduction of capital contributed by the partners in a limited partnership.

#### **.08 Income Allocation of Limited Partnership**

*Inquiry*—A real estate limited partnership allocates the depreciation deduction entirely to the limited partners in accordance with the provisions of the partnership agreement. This is done in order to induce investment in the venture by the limited partners. Would such an allocation in the financial statements conform with generally accepted accounting principles (GAAP)?

*Reply*—Yes. Allocation of partnership income is determined by the partnership agreement. Therefore, in computing the income allocable to the limited and general partners, the depreciation deduction may be allocated entirely to the limited partners, in financial statements prepared in conformity with GAAP.

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[The next page is 7351.]

## Section 7400

### ***Related Parties***

#### **.06 Exchange of Interest Bearing Note for Non-Interest Bearing Note**

*Inquiry*—Corporation A has an interest bearing note receivable from an officer/shareholder. Corporation A plans to exchange the present note for a non-interest bearing note. Should the non-interest bearing note be discounted in accordance with APB Opinion No. 21?

*Reply*—Yes. The non-interest bearing note should be discounted in accordance with APB Opinion No. 21, and there should be recognition of compensation or a dividend distribution, depending on what the unstated right or privilege represents.

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[The next page is 7401.]



## Section 7500

### ***Estates and Trusts***

#### **.01 Trust Funds for Perpetual Care of Cemetery**

*Inquiry*—In accordance with state laws, a cemetery conducting business as a closely held corporation is required to set aside in a perpetual trust, with a corporate trustee, a certain amount from the sales proceeds of lots and crypts to be used for the perpetual care of the cemetery. The cemetery has no recourse to the principal of the trust, but receives all income earned by the trust assets. Before the state law was enacted, the cemetery made contributions to a similar trust as part of the contract of sale of lots. The cemetery contends that assets deposited with the trustee should not be reflected as part of its financial position because it has no claim to the corpus of the trust. Is this an appropriate method to account for such a trust?

*Reply*—The cemetery management is technically correct in contending that the assets deposited with the trustee should not be reflected as part of the financial position of the cemetery. Situations analogous to that of the cemetery include escrow funds held by an escrow company which are shown in a separate statement; trust funds established by third parties under which a college or university has a beneficial interest only in the resulting income, the trust corpus in such case not being included as an asset in the balance sheet of the college or university; and employees' pension, health, and welfare funds which are reflected in a separate statement.

Although the cemetery's balance sheet need not reflect the trust fund assets, the balance sheet should reflect the cemetery's agency obligation(s), i.e., the cemetery's liability either by contract or statute to pay over certain portions of monies received or receivable to the trustee.

The accounting treatment is the same whether the cemetery has entered into a contract to establish a trust or whether the cemetery's obligation to do so is required by statute.

Footnote disclosure of amounts held in trust, income from which is used in whole or in part to meet the cemetery's commitments respecting perpetual care, would be desirable but not mandatory in order to make the statements not misleading (unless the statute itself calls for such disclosure). If footnote disclosure concerning the trust fund assets is made, the cemetery could also reiterate its policy or procedure of promptly remitting monies to the trustee in connection with cash and deferred payment transactions.

None of the AICPA's official Bulletins or Opinions have dealt specifically with the matter of accountability for, and presentation of, funds or property received by an accounting entity in various somewhat related capacities, i.e., as custodian, bailee, factor, depository, agent to receive and pay over, stockholder, or trustee. Technically, the trust funds are not required to be reported by any accounting entity other than the trust.

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[The next page is 7431.]





## Section 7600

### ***Business Combinations—General***

#### **.01 Date of Acquisition of a Company**

*Inquiry*—A corporation acquired a company for cash in March, subject to the same basic terms as negotiated orally in early January. It would like to designate December 31, the previous year-end of the acquired company, as the acquisition date, subject to imputed interest. The written contract does not specifically mention the date effective control passes to the acquiring company, although the December 31 balance sheet was prepared in accordance with Accounting Principles Board Opinion No. 16, paragraph 88(c) in anticipation of the acquisition.

Would it be proper to use December 31 of the previous year as the effective date of control of acquired company?

*Reply*—If the terms of the plan of combination were announced in writing or otherwise formally made known to the stockholders of the acquired company in early January, it would be appropriate to use, for accounting purposes, a balance sheet as of that date or any later balance sheet near the date of the cash payment with appropriate adjustment for imputed interest on the cash payment. If the December 31 balance sheet would not differ materially from a balance sheet prepared in early January, the December 31 balance sheet might be used.

Paragraph 93 of APB Opinion No. 16, states:

The Board believes that the date of acquisition of a company should ordinarily be the date assets are received and other assets are given or securities are issued. However, the parties may for convenience designate as the effective date the end of an accounting period between the dates a business combination is initiated and consummated.

Paragraph 46 of APB Opinion No. 16, states, in part:

A plan of combination is initiated on the earlier of (1) the date that the major terms of a plan, including the ratio of exchange of stock, are announced publicly or otherwise formally made known to the stockholders of any one of the combining companies (2) the date that stockholders of a combining company are notified in writing of an exchange offer.

It is assumed that there were no dividends, redemptions of stock, or other transactions between the acquired company and its stockholders between December 31 and the date the assets were taken over by the purchaser. It is also assumed that the fair market value (rather than book value) of the assets of the acquired company, which must be determined in order to properly allocate the purchase price, did not change appreciably between December 31 and the date of initiation of the transaction.

#### **.02 Date of Consummation of a Business Combination**

*Inquiry*—A client signed an agreement on June 30 for the acquisition of another company. The agreement calls for a closing date to be held only after the buyer receives financial statements of the seller for past years, and the seller receives a ruling from the Internal Revenue Service that the transaction

will not be taxable. It is anticipated that these conditions will be met within sixty days of the signing of the agreement at which time stock will be exchanged.

The company's year ends on June 30, and the auditor is in the process of examining the financial statements of the client. The auditor believes that the two companies have effectively combined their interests as of the year-end. According to the requirements of Accounting Principles Board Opinion No. 16, paragraph 47g, was the combination consummated before the end of the client's fiscal year?

*Reply*—APB Opinion No. 16 does not define the term “consummated” as it is used in paragraph 47g. However, in that the two companies have effectively combined their interests before the end of the year, and the two conditions to the agreement were not major obstacles, paragraph 47g would not preclude the auditor from considering the transaction as consummated before the end of the year.

### **.03 Financial Statement Presentation of Agreement to Acquire Company**

*Inquiry*—A client has entered into an agreement to acquire fifty percent of the stock of a corporation. To finance the acquisition, the company has arranged for a third party, a bank, to acquire the fifty percent interest in the corporation, and the company will purchase these shares from the bank over a five-year period. The price to be paid the bank for these shares has been fixed, subject only to changes in the prevailing interest rates.

When the bank acquires the fifty percent ownership, the by-laws of the corporation will be changed, and the client will be allowed to control half the seats of the board of directors.

Should the contract with the bank be considered an executory contract with the investment recorded only as the shares are acquired from the bank, or should the entire obligation be recorded on the client's financial statements?

*Reply*—The date of an acquisition in which the acquisition is being financed by an outside party depends primarily upon the date on which the principal rights of ownership are acquired. It would appear that the principal rights of ownership of equity securities are the rights to realize future gains in value and to be subject to future losses in value of the investee. Under the contract in question, the client has the right, subject to payment of the agreed amounts, to obtain the benefit of future earnings of the investee; and further, any losses in value of the purchased securities will be borne by the client. The principal attributes of ownership have been acquired by the company, and, therefore, the 50% interest and the related liability should be shown on the company's balance sheet.

### **.04 Conditions for Pooling of Interests Method**

*Inquiry*—If any of the seven conditions set forth in paragraph 47 of Accounting Principles Board Opinion No. 16 are not met, a business combination must be treated as a purchase.

Condition “a” of this paragraph requires:

The combination is effected in a single transaction or is completed in accordance with a specific plan within one year after the plan is initiated.

Condition “g” requires:

The combination is resolved at the date the plan is consummated . . .

Is a combination resolved when a specific plan is initiated, completed, or consummated?

*Reply*—Paragraph 47(g) states that the existence of any provision for future issuance of stock or other compensation subsequent to the date a combination is consummated (based on market prices or earnings subsequent to consummation) would require that the combination be accounted for as a purchase. Paragraph 47(a) requires that the combination must be effected within one year following the initiation of the plan. The word “consummated” in subparagraph “g” should be read to include both the phrase “effected in a single transaction” and “completed” as used in subparagraph “a”.

This means that there may be conditions at the date of initiation of a plan as to the number of shares which may be issued. However, as long as these conditions are met by date of consummation of the plan and such date of consummation is not more than one year after the date of initiation, pooling of interest accounting is not precluded. The definition of consummation of a plan is discussed in Accounting Interpretation No. 4 of APB Opinion No. 16.

### .05 Accounting for Acquisition Costs Incurred in Merger

*Inquiry*—In acquiring Corporation B, Corporation A incurred certain legal, accounting, printing, and other costs. These costs were capitalized and are being amortized over a forty-year period. Corporation B also incurred similar costs which were capitalized and are being amortized.

Consolidated financial statements are being prepared with the acquired Corporation B as an operating subsidiary of the acquiring Corporation A.

Were the merger costs properly handled, or should they be adjusted at this time?

*Reply*—Interpretation 33 of Accounting Principles Board Opinion No. 16 relates to costs of maintaining an “acquisitions department,” and states:

All “internal” costs associated with a business combination are deducted as incurred in determining net income under APB Opinion No. 16. This answer applies to costs incurred for both “poolings” (see paragraph 58) and “purchases” (see paragraph 76). Naturally, costs incurred in unsuccessful negotiations are also deducted as incurred.

Paragraph 76 specifies that in a business combination accounted for by the purchase method the cost of a company acquired includes the *direct* costs of acquisition. These direct costs, however, are “out-of-pocket” or incremental costs rather than recurring internal costs which may be directly related to an acquisition. The direct costs which are capitalized in a purchase therefore include, for example, a finder’s fee and fees paid to outside consultants for accounting, legal, or engineering investigations or for appraisals, etc. All costs related to effecting a pooling of interests, including the direct costs listed above, are charged to expense as specified in paragraph 58.

Costs of printing securities should reduce the fair value assigned to the securities, in accordance with paragraph 76 of APB Opinion No. 16.

The language in paragraph 76 and interpretation 33 indicates that the direct costs incurred by the acquiring corporation may be capitalized, but the costs incurred by the target (acquired) company may not. Therefore, the costs should have been expensed by Corporation B under APB Opinion No. 16. This should now be treated as a correction of an error under APB Opinion No. 20, *Accounting Changes*, and accounted for as a prior period adjustment.

The costs incurred by Corporation A should have been considered as part of the cost of investment and not necessarily capitalized and amortized separately.

**.06 Exchange of Stock Involving Companies Under Common Control**

*Inquiry*—Individual Y owns 100% of Corporation A and Corporation B. Individual Y exchanges his stock in Corporation A for 100 additional shares in Corporation B, thus creating a parent-subsidiary relationship. Prior to this transaction the assets, liabilities, and stockholders' equity of A and B were as follows:

Company A

Assets .....	<u>\$500,000</u>
Liabilities .....	\$100,000
Common stock, no par value, 200 shares authorized and issued ...	100,000
Retained earnings .....	<u>300,000</u>
Total .....	<u>\$500,000</u>

Company B

Assets .....	<u>\$ 50,000</u>
Liabilities .....	\$ 20,000
Common stock, no par value, 1,000 shares authorized, 100 shares issued and outstanding .....	20,000
Retained earnings .....	<u>10,000</u>
Total .....	<u>\$ 50,000</u>

How should Company B account for and record this transaction?

*Reply*—The exchange would be accounted for in accordance with AICPA Interpretation No. 39 of APB Opinion No. 16, "Transfers and Exchanges Between Companies Under Common Control," which stipulates that an exchange of stock involving companies under common control "would be accounted for at historical cost in a manner similar to that in pooling of interests accounting."

Company B would record this transaction as follows:

Investment in A .....	400,000
Common stock of B. ....	100,000
Retained earnings of A .....	300,000

This entry records B's investment in A at the carrying amount of A's stock (\$100,000 + \$300,000). The separate account for retained earnings of A is established to emphasize that the retained earnings are not a source of dividends to B's stockholder, as is often true in a statutory merger.

This entry also reflects the underlying theory of pooling accounting—the combining of stockholder interests concept (APB Opinion No. 16, *Business Combinations*, paragraph 53)—while recognizing the separate corporate identity of the pooled subsidiary. APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, holds that the total stockholders'

equity of the parent company should equal the total stockholders' equity shown in the consolidated financial statements. Paragraph 19 of that Opinion states, in part, "The difference between consolidation and the equity method lies in the details reported in the financial statements. Thus, an investor's net income for the period and its stockholders' equity at the end of the period are the same whether an investment in a subsidiary is accounted for under the equity method or the subsidiary is consolidated (except as indicated in paragraph 19i)."

#### **.08 Shareholder Contribution of Land**

*Inquiry*—What value should be recorded for land contributed to a corporation by its sole shareholder?

*Reply*—Generally, a shareholder who owns more than 50 percent of a corporation is deemed to be a controlling shareholder. Accordingly, the land should be recorded at the shareholder's historical cost as discussed in AICPA Interpretation No. 39 of APB Opinion No. 16, "Transfers and Exchanges Between Companies Under Common Control." [Amended]

#### **.09 Use of Stepped-Up Basis in Recording Acquisition of Majority Interest**

*Inquiry*—Company A is 100 percent owned by a family. The family also owns a 43 percent interest in Company B, with the remaining 57 percent owned by unrelated third parties. Company A purchases the 57 percent interest in Company B paying more than net book value and shortly thereafter the remaining 43 percent interest in Company B is transferred to Company A. If A then combines with B, can A use a stepped-up basis in recording the net assets of B?

*Reply*—Yes. The 57 percent interest that was acquired from an unrelated party should be accounted for by the purchase method according to APB Opinion No. 16, *Business Combinations*, paragraph 11, which states, "the purchase method accounts for business combination as the acquisition of one company by another. The acquiring company records as its cost the acquired assets less liabilities assumed."

The 43 percent interest that was owned by the family and transferred to Company A should be recorded at the family's predecessor basis according to AICPA Interpretation No. 39 of APB Opinion No. 16, "Transfers and Exchanges Between Companies Under Common Control," which states that assets and liabilities transferred between entities under common control be accounted for at historical cost in a manner similar to that in pooling of interests accounting.

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## Section 7610

### ***Purchase Method***

#### **.01 Acquisition of Parent Company by Subsidiary**

*Inquiry*—Company A owns seventy percent of the outstanding voting common stock of Company B. A “downstream” merger, whereby Company B, the subsidiary, would acquire the assets of Company A, is planned. The transaction would be recorded following the purchase method of accounting. Some controversy has arisen over whether Company B can be the surviving corporation after the transaction is completed. Could the subsidiary company become the survivor company after the merger?

*Reply*—In Accounting Interpretation No. 20 to Accounting Principles Board Opinion No. 16, concerning the acquisition of minority interest, the following statement appears:

Whether a parent acquires the minority or a subsidiary acquires its parent, the end result is a single shareholder group, including the former minority shareholders, owning the consolidated net assets.

In a “downstream” merger the effect of the transaction is that the stockholder group is increased by acquisition of the former minority shareholders of the subsidiary. The transaction should be accounted for as if the surviving company were the parent, rather than the subsidiary. The subsidiary should, therefore, adjust its accounts to reflect any difference between the parent’s equity and unamortized cost to the parent of its investment in the subsidiary (including the effect of any difference between the fair value of the stock held by minority shareholders at date of the combination and the net equity position of such minority in the surviving company).

The stockholders’ equity of the surviving company should be adjusted to reflect the stockholders’ equity of the former parent, after giving effect to acquisition of the former minority interest. If the resulting capital account is less than the par or stated value of the capital stock of the survivor, an appropriate transfer must be made from retained earnings.

Whether the former parent or the former subsidiary is the surviving company is a legal matter, not an accounting matter and, therefore, is not subject to Accounting Principles Board pronouncements. Accounting for the transaction, however, should follow the substance of the transaction. The accounting for the surviving company should, therefore, be the same whether it is the parent or the subsidiary that survives.

#### **.02 Income of Acquired Company Pending Approval of Merger by Regulatory Agency**

*Inquiry*—Corporation A executed a stock purchase agreement in January, 19X5, whereby A would purchase the stock of Corporation B. This purchase must be approved by the Interstate Commerce Commission. A and B also entered into a temporary management agreement which was approved by the

ICC effective March 1, 19X5. Under this temporary management agreement, A will operate B until the ICC rules on the purchase. Any income or losses of B during the term of the agreement will be credited or charged to A regardless of the ruling of the ICC. How should Corporation A account for the operations of B during the temporary management period?

*Reply*—The profit or loss under the temporary management agreement should be accounted for by the acquiring company in accordance with paragraphs 93 and 94 of Accounting Principles Board Opinion No. 16. As indicated in paragraph 93 of the Opinion, using March 1, 19X5, as the effective date of acquisition would require an adjustment of the cost of the acquired company and net income otherwise reported to compensate for recognizing income before consideration was transferred. Income of the acquired company included in consolidation would have to be reduced by imputed interest as provided in the last sentence of paragraph 93. Paragraph 94 also indicates, "... income of an acquiring corporation for the period in which a business combination occurs should include income of the acquired company after the date of acquisition by including the revenue and expenses of the acquired operations based on the cost to the acquiring corporation."

#### **.06 Purchase of Corporation With Negative Net Worth**

*Inquiry*—Corporation A will purchase 100% of Corporation B by issuing its stock to the stockholders of Corporation B. The stock will have a value of approximately \$3,900. The balance sheet of Corporation B at the time of purchase will have a negative net worth of approximately \$700. Should Corporation A record its investment at \$3,900 with subsequent equity adjustments to be made in the future as they occur, or should Corporation A record the investment at zero and show the \$3,900 as "Unamortized Excess Cost Over Net Assets of Subsidiary at Date of Acquisition" which would be amortized over a period of years?

*Reply*—It is assumed that the combination of Corporation A and B is being accounted for as a purchase, because all the criteria for pooling of interests accounting have not been met. Corporation A should record the investment at \$3,900; the consolidation entry to eliminate the investment would result in "goodwill" of \$4,600 because of the \$700 negative net worth at acquisition. The equity adjustments referred to would only be required if Corporation A prepared "parent company only" financial statements for issuance to its stockholders as "the financial statements of the primary reporting entity" (see paragraph 14 of Accounting Principles Board Opinion No. 18).

The application of the purchase method is discussed in some detail beginning with paragraph 66 of APB Opinion No. 16. Paragraphs 87-89 deal with recording assets acquired and liabilities assumed, which should, essentially, be recorded at fair market values. Any excess of cost over net assigned values should be reported as goodwill and amortized in accordance with paragraphs 27-31 of APB Opinion No. 17, *Intangible Assets*.

#### **.08 Allocation of Purchase Price to Assets**

*Inquiry*—Corporation A was formed for the purpose of acquiring from Corporation B certain assets and its name. Corporation A will not assume any of Corporation B's liabilities. The terms of the purchase agreement state that for the assets being sold by the seller, the buyer shall pay a purchase price of \$400,000, which shall be allocated as follows: \$50,000 to real estate, \$250,000



to equipment, and the balance to all other assets. The other assets include accounts receivable, prepaid expense items, a truck, and merchandise inventories.

The real estate and equipment values are based on appraisals by reputable appraisers. The receivables are at book value, the prepaid items are computed, and the truck is of small value. When all these assets have been considered, the balance of the purchase price allocable to inventory is considerably below its value.

Should the values assigned to the real estate and equipment be reduced in order to record the inventory at the value placed on it by the company, or should the stated values for real estate and equipment be used and the balance of purchase price allocated to the remaining assets?

*Reply*—Paragraphs 88 and 91 of Accounting Principles Board Opinion No. 16 would require that cash, receivables, and inventory be set up at estimated realizable value at date of the purchase. The balance of the purchase price should be assigned to the real estate and equipment, after allowing appropriate values for any miscellaneous accounts. Use for accounting purposes of values arbitrarily assigned in the purchase agreement would under the circumstances be contrary to generally accepted accounting principles as expressed in paragraph 91.

#### **.09 Allocation of Purchase Price to Assets Purchased in Bulk**

*Inquiry*—A corporation purchased all the assets of another company consisting of inventory (parts and supplies), machinery and equipment, dies, furniture and fixtures, etc. Detailed schedules supported such assets but no amounts or values were assigned by the seller.

The corporation has elected to value the inventory at fair market value or at original cost of the seller, whichever is lower. The records of seller are available to establish costs. The machinery and equipment, dies and furniture and fixtures are to be assigned values at estimates so that the total assigned cost equals the total purchase price. No goodwill is deemed to exist. The assets are material balance sheet items.

Is this treatment of assigning values for the bulk purchase of assets in accordance with generally accepted accounting principles?

*Reply*—Paragraph 68 of Accounting Principles Board Opinion No. 16 states that a bulk purchase of assets is treated in the same manner as a business combination under the purchase method. The proper method of allocating costs to the individual assets in a purchase is discussed in paragraphs 87 through 92 of APB Opinion No. 16.

Paragraph 88(c) indicates that inventories of raw material should be valued at current replacement cost, while finished goods should be valued at estimated selling price less cost of disposal and an allowance for a reasonable profit for the selling effort of the acquiring corporation. While in many cases this will agree substantially with the cost basis as shown on the records of the seller, such cost basis should not be used automatically. Further, fair market value to the purchaser must provide an allowance for the cost of disposal and a normal profit margin.

If the balance to equal the purchase price is less than the sum of replacement costs of the machinery and equipment, dies, and furniture and fixtures, the balance of course should be assigned to such tangible fixed assets on the basis

of current replacement costs. If, however, such costs do not exhaust the purchase price, the balance being paid for is presumably for some intangible asset. If such intangible asset is being recognized, it must be amortized over an appropriate period not to exceed forty years. [Amended]

#### **.10 Asset Values Stated in Purchase Agreement**

*Inquiry*—Can a purchase agreement, which identifies specific assets of the acquired company and sets their purchase prices, govern the valuation of these assets in accounting for a business combination, or must the acquirer adhere to the valuation principles stated in paragraphs 87 (AC B50.145) and 88 (AC B50.146) of Accounting Principles Board Opinion No. 16 despite the agreement?

*Reply*—For purposes of recording the business combination, the provisions of paragraphs 87 (AC B50.145) and 88 (AC B50.146) of APB Opinion No. 16 should be followed and cannot be circumvented by the purchase agreement.

#### **.14 Value of Receivables Purchased Decreased at Closing Date**

*Inquiry*—A purchaser of an enterprise found that the value of the accounts receivable, included in the total assets to be purchased, had decreased at the closing date of the agreement. The seller holds the buyer to the original agreement price for the business.

What is the proper treatment on the books of the purchaser for the excess paid for accounts receivable?

*Reply*—A bargained price measures an outlay deemed prudent by the purchaser at the time of consummating a transaction. The difference in accounts receivable should not be written off as a loss immediately. The difference either represents a claim upon the seller (which could be set up as a receivable) on the ground that a certain amount of receivables were bargained and not received, or the excess paid represents additional goodwill, a premium the purchaser was willing to pay for future profit expectations.

#### **.16 Amortization of Cost of Long-Term Land Leases Acquired**

*Inquiry*—A real estate investment trust, is acquiring substantially all of the net assets of a company whose principal holdings are improved rental real estate. The combination is being accounted for as a purchase.

The assets being acquired include several favorable long-term (99 years) land leases. The amount at which these leases are being recorded was derived by taking the capitalized economic value of the property as if owned and subtracting the capitalized value of the lease to arrive at the total economic value of the lessee's interest. The depreciated value of the improvements was then deducted to determine the residual leasehold value of the land.

What would be the period of amortization of the long-term land leases under these circumstances?

*Reply*—Any value assigned to the leased property should not exceed the current appraised value of the property account less its residual value at termination of the lease (discounted to present value), and reduced by any favorable (to the sublessee) factors of current subleases. Such value may be amortized over the life of the lease.

#### **.19 Step Up in Basis of a Company's Assets as a Result of a Change in Its Ownership**

*Inquiry*—Corporation A purchased the total outstanding stock of Corporation B and elected, under section 338 of the Internal Revenue Code, to treat the

transaction as a purchase of assets. The effect of the transaction and election was to increase (step up) the carrying amounts of the assets of Corporation B to their fair values for tax purposes based on the purchase price (the subsidiary's liabilities plus the amount Corporation A paid for its stock) paid by Corporation A. Is a similar step up in basis acceptable for financial reporting purposes?

*Reply*—APB Opinion No. 16, *Business Combinations*, provides guidance on accounting for the purchase of the stock of one company by another in consolidated financial statements, and requires that the assets and liabilities of an acquired company be stated, for that purpose, at their fair values at the date of acquisition. The authoritative literature does not address the step up of the carrying amounts of assets in the separate accounts of an acquired company to reflect the purchase of its stock by another entity or group of stockholders. However, an AcSEC Issues Paper, “*Push Down*” Accounting, contains an advisory conclusion that the values assigned to an acquired company's assets and liabilities under APB Opinion No. 16 for consolidated financial statement purposes in an acquisition involving at least a 90 percent change in ownership may be used (“pushed down”) in the separate financial statements of the acquired company. The methods for determining the fair values of the assets and liabilities in a business combination required to be accounted for as a purchase are described in APB Opinion No. 16, paragraphs 87 and 88.

## **.20 Accumulated Depreciation in a Purchase Business Combination**

*Inquiry*—In a purchase business combination, a used market did not exist for certain plant and equipment to be used, therefore, it was valued at replacement cost new less estimated accumulated depreciation in accordance with APB Opinion No. 16, *Business Combinations*, paragraph 88, footnote 11. Should the estimated accumulated depreciation be recorded by the acquirer as a contra account to the plant and equipment, which would be shown at replacement cost new?

*Reply*—No. Replacement cost new less estimated accumulated depreciation is a method used to approximate the current fair value of a used asset. Only the net amount should be shown on the balance sheet.

## **.21 Reduction of Carrying Value of Restricted Long-Term Equity Securities**

*Inquiry*—Corporation P purchased corporation S for a price substantially below the fair value of S Corporation's net assets. The sole assets of Corporation S are long-term equity securities which are restricted from being sold for a three year period by a contractual agreement. Should these securities be reduced by a proportionate part of the excess fair value over cost?

*Reply*—Yes. APB Opinion No. 16, *Business Combinations*, paragraph 91, states that the values assigned to net assets acquired should not exceed the cost of the acquired company. An excess over cost should be allocated to reduce proportionally the values assigned to noncurrent assets (except long-term investments in marketable securities).

FASB Interpretation No. 16, *Clarification of Definitions and Accounting for Marketable Equity Securities that Become Nonmarketable*, paragraph 6, states that if a restricted security cannot qualify for sale within one year or market price quotations are not available for unrestricted shares of the same class, the security is considered nonmarketable.

The equity securities owned by Corporation S should be reduced by a proportionate share of the excess fair value over cost because they are nonmarketable and do not meet the exception in APB Opinion No. 16, paragraph 91.

## **.22 Negative Goodwill in Unclassified Balance Sheet**

*Inquiry*—APB Opinion No. 16, *Business Combinations*, paragraph 91, discusses an excess of acquired net assets over cost, which should be allocated to reduce proportionately the values assigned to noncurrent assets (except for long-term investments in marketable securities) in determining their fair values. What is the appropriate accounting in a situation involving an unclassified balance sheet?

*Reply*—The allocation process under APB Opinion No. 16, paragraph 91, would focus on the nature of the assets regardless of whether a classified or unclassified balance sheet is presented, and would allocate the excess to long lived assets, except for investments in marketable securities.

## **.23 Sale of Parent Stock in Subsidiary to Minority Shareholder**

*Inquiry*—A parent company owns 80 percent and an unrelated minority owns the remaining 20 percent of a subsidiary. The parent sells 10 percent of its ownership in the subsidiary to the minority shareholder for an amount in excess of what the parent paid for that stock.

Would the parent record a gain for the amount received in excess of carrying value (based on the equity method)? If so, would that gain be eliminated in consolidation, or remain on the consolidated income statement?

*Reply*—Authoritative literature does not address this specific situation. However, Interpretation No. 39 to APB Opinion No. 16, *Transfers and Exchanges Between Companies Under Common Control*, states that the acquisition of all or part of the shares held by the minority interest of a subsidiary is never considered a transaction between enterprises under common control and should be accounted for as a purchase. Therefore, a transaction in the opposite direction, i.e., the minority interest acquires the stock of the subsidiary held by the parent, also should be accounted for as a purchase.

Any amount received by the parent in excess of its carrying value (based on the equity method) would be recorded as a gain, in the consolidated statements. The "gain" should be shown as a transfer from consolidated equity to the minority interest.

## **.24 Acquisition of Minority Interest**

*Inquiry*—A parent corporation (P) has a wholly-owned subsidiary (S), who in turn owns 90 percent of another company (C). The remaining 10 percent (minority interest) is held by stockholders who are outside the corporate structure. P paid \$220,000 to acquire the minority interest shares of C. How would this acquisition be accounted for by P?

*Reply*—Interpretation No. 26 of APB Opinion No. 16, *Acquisition of Minority Interest*, states that the acquisition of some or all of the stock held by minority stockholders of a subsidiary—whether acquired by the parent, the subsidiary itself, or another affiliate—should be accounted for by the purchase method. Thus, purchase accounting applies when (a) a parent exchanges its common

stock or assets or debt for common stock held by minority shareholders of its subsidiary, (b) the subsidiary buys as treasury stock the common stock held by minority shareholders, or (c) another subsidiary of the parent exchanges its common stock or assets or debt for common stock held by the minority shareholders of an affiliated subsidiary.

Based on the above, P would account for this acquisition by the purchase method. The \$220,000 would be allocated proportionately to 10 percent of the fair value of the assets and liabilities acquired in the same manner as under the purchase method described in APB Opinion No. 16, *Business Combinations*.

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## Section 7620

### ***Applicability of Pooling of Interests Method***

#### **.03 Affiliate Acquiring Interest in Company Wholly Owned by Parent**

*Inquiry*—A client owns 45 percent of a foreign holding company, with the balance owned by unrelated parties. The foreign company wishes to acquire a 65 percent interest in a U.S. operating company. This operating company will be sold to a U.S. holding company which is presently 100 percent owned by the client. The selling price will be substantially above the foreign company's cost.

What method of accounting should be used to reflect these transactions?

*Reply*—Because the client owns 45 percent of the foreign holding company's stock, the equity method of accounting for this investment would be appropriate. In APB Opinion No. 18, paragraph 17, the Board concluded that in order to achieve a reasonable degree of uniformity in application, an investment (direct or indirect) of 20 percent or more of the voting stock of an investee should lead to a presumption that, in the absence of evidence to the contrary, an investor has the ability to exercise significant influence over an investee.

Interpretation 39 to Opinion No. 16 should be followed in accounting for the "sale" of the 65 percent interest to the U.S. 100 percent owned subsidiary. APB Opinion No. 16 deals with accounting for business combinations. The interpretation discusses transfers and exchanges between companies under common control, which is similar to this situation.

Interpretation 39 states:

In general, paragraph 5 excludes transfers and exchanges that do not involve outsiders. For example, a parent company may transfer the net assets of a wholly owned subsidiary into the parent company and liquidate the subsidiary, which is a change in legal organization but not a change in the entity. Likewise, a parent may transfer its interest in several partially owned subsidiaries to a new wholly owned subsidiary, which is again a change in legal organization but not in the entity. Also, a parent may exchange its ownership or the net assets of a wholly owned subsidiary for additional shares issued by the parent's partially owned subsidiary, thereby increasing the parent's percentage of ownership in the partially owned subsidiary but leaving all of the existing minority interest outstanding.

Interpretation 39 states, "None of the above transfers or exchanges is covered by APB Opinion No. 16," and, "The assets and liabilities so transferred would be accounted for at historical cost in a manner similar to that in pooling of interests accounting." But, the acquisition of all or part of the outstanding shares held by the minority interest would be accounted for by the purchase method.

#### **.04 Combination of Related Companies—I**

*Inquiry*—An individual owns two corporations. It is desirable to maintain only one corporate structure, therefore the brother and sister corporations are being merged. Would the pooling of interests method be appropriate?

*Reply*—Paragraph 5 of APB Opinion No. 16 states in part:

The term business combination in this Opinion excludes a transfer by a corporation of its net assets to a newly formed substitute corporate entity chartered by the existing corporation and a transfer of net assets or exchange of shares between companies under common control . . . such as between a parent corporation and its subsidiary or between two subsidiary corporations of the same parent.

Accounting Interpretation No. 39 of APB Opinion No. 16 illustrates the application of paragraph 5, and indicates, "The assets and liabilities so transferred would be accounted for at historical cost in a manner similar to that in pooling of interests accounting."

### **.05 Combination of Related Companies—II**

*Inquiry*—Company A is a real estate holding corporation owning land and buildings, forty percent of which are occupied by Company B.

The shareholders of Company A are the spouses of two of the three shareholders of Company B. The third shareholder is also related by marriage to the other two shareholders of Company B and married to the daughter of one of the shareholders of Company A.

The book value of A's assets are about ten percent of those of B.

Voting preferred stock was issued to effect the merger of Company A with Company B. Company B then set up the real estate corporation as a separate division, mortgaged the property, and used the funds in its operations.

Is the merger of Company A with Company B to be treated as a pooling of interests or a purchase?

*Reply*—Paragraph 5 of APB Opinion No. 16, *Business Combinations*, states, "The term business combination in this Opinion excludes a transfer by a corporation of its net assets to a newly formed substitute corporate entity chartered by the existing corporation and a transfer of net assets or exchange of shares between companies under common control . . . such as between a parent corporation and its subsidiary or between two subsidiary corporations of the same parent."

Interpretation No. 39 of Opinion No. 16 deals with transfers and exchanges between companies under common control. The following excerpts are from that interpretation: "In general, paragraph 5 excludes transfers and exchanges that do not involve outsiders . . . . The assets and liabilities so transferred would be accounted for at historical cost in a manner similar to that in pooling of interests accounting." Therefore, even though voting preferred stock was issued (which would preclude a pooling under paragraph 47b of APB Opinion No. 16), the merger of A should be treated in a manner similar to a pooling of interests if the family relationship is such that the companies were deemed to be under common control. If the family relationship leads to the conclusion that the companies are not under common control, then the merger would come under the provisions of APB Opinion No. 16 and purchase accounting would be required. However, in the absence of evidence to the contrary, the close family relationship among the stockholders would lead to the conclusion that A and B are under common control; therefore, Interpretation No. 39 would apply, and the transaction should be recorded in a manner similar to a pooling of interests.



### **.06 Combination of Related Companies—III**

*Inquiry*—The Stock of Parent Company was held by four family members. Several years ago, the operating assets of two divisions were transferred to two newly formed corporations, A and B, in exchange for their stock. One family member exchanged his Parent stock for a minority interest in A and another exchanged his Parent stock for a minority interest in B.

Early this year, A and B were combined in a pooling of interests transaction, forming AB. Recently, AB was combined with the original Parent. The 2 family members holding AB stock will receive stock of Parent. Parent has only one class of stock.

Would the treatment of the combination of AB and Parent as pooling of interest be in accordance with APB Opinion No. 16?

*Reply*—Interpretation No. 39 of APB Opinion No. 16 dealing with business combinations involving transfers and exchanges between companies under common control states:

In general, paragraph 5 excludes transfers and exchanges that do not involve outsiders. For example, a parent company may transfer the net assets of a wholly owned subsidiary into the parent company and liquidate the subsidiary, which is a change in legal organization but not a change in the entity. Likewise, a parent may transfer its interest in several partially owned subsidiaries to a new wholly owned subsidiary, which is again a change in legal organization but not in the entity. Also, a parent may exchange its ownership or the net assets of a wholly owned subsidiary, thereby increasing the parent's percentage of ownership in the partially owned subsidiary but leaving all of the existing minority interest outstanding.

None of the above transfers or exchanges is covered by APB Opinion No. 16. The assets and liabilities so transferred would be accounted for at historical cost in a manner similar to that in pooling of interests accounting.

It should be noted, however, that purchase accounting applies when the effect of a transfer or exchange is to acquire all or part of the outstanding shares held by the minority interest of a subsidiary (see paragraph 43). The acquisition of all or part of a minority interest, however acquired, is never considered a transfer or exchange by companies under common control. (See Interpretation No. 26 of APB Opinion No. 16, "Acquisition of Minority Interest.")

The case described involves companies under common control because of ownership by the parent company and family members, and, therefore, the combination should be accounted for at historical cost.

### **.07 Combination of Related Companies—IV**

*Inquiry*—Corporation A acquired Corporation B in an exchange of common stock. Corporation B is owned by two individuals in the amounts of 60 percent and 40 percent of the stock issued. Corporation B owned 12 percent of Corporation A before acquisition. The two individuals who own Corporation B, own stock of Corporation A and, including their beneficial ownership through the stock which Corporation B owns in Corporation A, they own over 50 percent of Corporation A.

How would this acquisition be classified and reflected on the records of the acquiring corporation?

*Reply*—It is assumed that the interest in Corporation A of each of the two individuals who own Corporation B are roughly in the same proportion to each other as is their ownership of Corporation B.

Paragraph 5 of APB Opinion No. 16 excludes from the definition of a business combination the transfer of net assets or exchange of shares between companies under common control. Paragraph 5 seems to apply whether the common control was exercised by a corporation or by individuals.

Although APB Opinion No. 16 does not address itself to the proper accounting for a combination of such companies, it would be appropriate to apply the pooling of interests method. However, certain of the disclosures required for a pooling of interests in business combinations would not be required for mergers of companies under common control. Such combinations should reflect generally any costs of acquisition that were incurred by the joint owner, but which were not reflected on the books of the companies being combined. Interpretation No. 39 of APB Opinion No. 16 relates to transfer and exchanges between companies under common control and can be used as a basis for application of the pooling of interests method.

### **.08 Acquisition of a Division of Another Company**

*Inquiry*—A company is acquiring a division of another company. APB Opinion No. 16, paragraph 5, reads in part, “The conclusions of this section apply equally to business combinations in which one or more companies become subsidiary corporations, one company transfers its net assets to another, and each company transfers its net assets to a newly formed corporation.”

Is this transaction excluded from APB Opinion No. 16, and, if not, what method of accounting should be used?

*Reply*—The first sentence of APB Opinion No. 16, paragraph 5, states, “This section covers the combination of a corporation and one or more incorporated or unincorporated businesses; both incorporated and unincorporated enterprises are referred to in this section as companies.” The division should be viewed as an “unincorporated enterprise” because whether the other company chose to operate under a divisional or parent-subsidiary structure is largely a matter of management preference and form over substance. Therefore, this acquisition is covered by APB Opinion No. 16 and the purchase method should be used.

### **.09 Pooling of Interest Following Abandonment of Previous Attempt to Merge**

*Inquiry*—A year ago Company A was acquired by Company B in an exchange of stock. A condition of this exchange was that Company B would register its stock with the SEC within one year. If such a registration was not completed, the shareholders of the two companies would again be separate, autonomous, and unrelated entities.

Company B was unable to register its stock and the exchange of stock was subsequently reversed. Company A is now contemplating combining with another company.

One of the conditions for using the pooling of interest method for business combinations is stated in paragraph 46 of APB Opinion No. 16 as follows:

Each of the combining companies is autonomous and has not been a subsidiary or division of another corporation within two years before the plan of combination is initiated.

Was Company A a subsidiary of Company B?

*Reply*—Although Company A had been involved in an attempted business combination which was abandoned after one year, the failure of the transaction would indicate that the company had not in fact been a division or subsidiary of another company. Therefore, the requirement of paragraph 46 of APB Opinion No. 16 would not preclude a subsequent business combination from being accounted for as a pooling of interest.

#### **.10 Business Combination Following a “Spin-Off”**

*Inquiry*—A company which owns 100 percent of two subsidiaries is considering combining with another company through an exchange of stock. Prior to any combination, however, the company intends to spin-off to its present stockholders the capital stock of the two subsidiaries. These two subsidiaries account for approximately 50 percent of the gross revenue of the combined enterprise. Would the combination, after the spin-off, qualify as a pooling of interest or as a purchase under APB Opinion No. 16?

*Reply*—Paragraph 47c of APB Opinion No. 16 (AC B50.106c) states that in order to be considered a pooling of interest, “none of the combining companies changes the equity interest of the voting common stock in contemplation of effecting the combination either within two years of the date the combination is initiated or between the dates the combination is initiated and consummated; changes in contemplation of effecting the combination may include distributions to stockholders and additional issuances, exchanges, and retirements of securities.”

Therefore, in accordance with paragraph 47c of APB Opinion No. 16 (AC B50.106c), the transaction must be considered a “purchase.” [Amended June 1995.]

#### **.11 Pooling of Interest Following Acquisition of Treasury Stock**

*Inquiry*—A company has decided that it is over-capitalized and wishes to acquire treasury shares in order to reduce its capitalization. Assuming that the number of shares acquired is material as contemplated by the Interpretation No. 20 of APB Opinion No. 16, will the company be precluded from entering pooling of interest business combination for a period of two years? If the company decides to accomplish this reduction in capitalization by a pro rata redemption of outstanding shares, is it similarly precluded from entering pooling of interests business combinations for two years?

*Reply*—Interpretation No. 20 relates to paragraphs 47(c) and (d) of APB Opinion No. 16.

Paragraph 47(d) states, “Each of the combining companies reacquires shares of voting common stock only for purposes other than business combinations, and no company reacquires more than a normal number of shares between the dates the plan of combination is initiated and consummated.” In determining intent, both in subparagraphs (c) and (d) of paragraph 47 and subparagraph (a) of paragraph 46, it is presumed that a transaction is in contemplation of the business combination if it occurs within two years prior to the initiation of the plan.

As stated in the Interpretation to APB Opinion No. 16, paragraph 47(d), this presumption may be overcome if it is shown that the shares have been or will be reissued in stock option or other compensation plans or as payments in purchase combinations. It will also be overcome if the stock is resold prior to the business combination.

However, if the stock is not reissued, it should be evident that some of the stockholders are being paid in cash, rather than receiving stock of the combined company or that some stockholders have been paid in cash for part of their stock. APB Opinion No. 16 expressly precludes pooling of interests accounting when stockholders of either of the combining companies are paid in part by cash.

The Interpretation of APB Opinion No. 16, paragraph 47(d), lists specific purposes for acquiring treasury stock which would not prohibit pooling of interests accounting treatment: stock option or compensation plans, stock dividends declared, "purchase" business combinations, and resolving existing contingent share agreements from a prior business combination. Each of these purposes is similar in that they all include a subsequent distribution of the stock. In other words, the company is reacquiring the stock for some subsequent business purpose. "Over-capitalization" as a specific purpose differs from these examples because the company is not acquiring these shares for a subsequent business purpose.

Therefore, treasury stock acquisitions to avoid over-capitalization is a business purpose which will prevent pooling of interests accounting for business combinations for two years. This assumes that the violation has not been "cured" by resale of these shares prior to consummation.

A pro rata redemption of shares is, in substance, the same as an acquisition of treasury stock. Accordingly, the company will also be ineligible to enter pooling of interests business combinations for two years if it chooses this method to reduce its capitalization.

Also see the SEC's Codification of Financial Reporting Policies, Sec. 201.02 (ASRs 146 and 146A).

## **.12 Exchange of Shares Between Companies Under Common Control**

*Inquiry*—The voting common stock of Corporations A and B are owned by the same interests but not in the same proportion. In addition, B has outstanding nonvoting common stock which is identical to the voting common stock, except for the voting privilege. None of the holders of the voting stock own nonvoting stock, although members of their families and family related trusts are owners of part of the nonvoting stock with the balance being held by key employees and others. It is proposed that B remain in existence but that all of its voting stock be acquired by A in exchange for voting stock of A. The nonvoting stock will not be exchanged.

Based upon current financial statements, the nonvoting interest in B represents approximately 35 percent of the stockholders' equity in that corporation and would represent approximately 20 percent of the combined stockholders' equity.

What is the proper accounting for the combination of these two companies?

*Reply*—Paragraph 5 of APB Opinion No. 16 excludes from the term "business combination" an exchange of shares between companies under common control. Such a combination, although thus excluded from the provisions of APB Opinion No. 16, should generally be accounted for in the same manner as a pooling of interests. Even if the combination of the two companies should be considered a business combination subject to APB Opinion No. 16, allowing the nonvoting stock of one of the companies to remain outstanding would not result

in a business combination being accounted for as a purchase, if all other conditions indicated use of the pooling method. Interpretation No. 39 of APB Opinion No. 16 discusses transfers and exchanges between companies under common control.

### **.13 Effect on Pooling of Interests of Contingently Issued Shares Held in Escrow**

*Inquiry*—A client and another company have agreed to a plan of combination which is intended to meet all of the criteria for pooling of interests accounting.

The client's attorneys have prepared a preliminary draft of an indemnity-escrow agreement which may provide for deposit in escrow of 30 percent of the total shares to be issued to affect the combination, to secure, compensate, and indemnify the issuer regarding breach of certain warranties and other matters coming within the type of "general management representation" as referred to in Interpretation 30 of APB Opinion No. 16.

One of the requirements stated in paragraph 47 of APB Opinion No. 16 is:

- g. The combination is resolved at the date the plan is consummated and no provisions of the plan relating to the issue of securities or other consideration are pending.

This condition means that (1) the combined corporation does not agree to contingently issue additional shares of stock or distribute other consideration at a later date to the former stockholders of a combining company, or (2) the combined corporation does not issue or distribute to an escrow agent common stock or other consideration which is to be either transferred to common stockholders or returned to the corporation at the time the contingency is resolved.

An agreement may provide, however, that the number of shares of common stock issued to effect the combination may be revised for the later settlement of a contingency at a different amount than that recorded by a combining company.

Interpretation No. 14 of APB Opinion No. 16 states:

The only contingent arrangement permitted under paragraph 47-g is for settlement of a contingency pending at consummation, such as the later settlement of a lawsuit. A contingency arrangement would also be permitted for an additional income tax liability resulting from the examination of "open" income tax returns.

Interpretation No. 30 states:

The most common type of contingency agreement not prohibited in a pooling by paragraph 47g is the "general management representation" which is present in nearly all business combinations. In such a representation, management of a combining company typically warrants that the assets exist and are worth specified amounts and that all liabilities and their amounts have been disclosed. The contingency agreement usually calls for an adjustment in the total number of shares exchanged up to a relatively small percentage (normally about 10%) for variations from the amounts represented, but actual adjustments of the number of shares are rare.

Would the 30 percent of the shares to be issued held in escrow preclude the use of the pooling of interests method?

*Reply*—The contingencies covered in Interpretation No. 14 are more susceptible of quantification than those discussed in Interpretation No. 30. The 10 percent referred to in No. 30 should not be viewed as a ceiling if the escrow shares are earmarked for contingencies, such as those discussed in No. 14. However, No. 30 also states:

... the contingency agreement is merely a device to provide time for the issuing company to determine that the representations are accurate so it does not share risks arising prior to consummation. Although the time required will vary with circumstances, these determinations should be completed within a few months following consummation of the combination. In any case, the maximum time should not extend beyond the issuance of the first independent audit report on the company making the representations following consummation of the combination.

#### **.14 Issuance of Stock for Contingent Earnings Rights of Acquired Company's Stockholders**

*Inquiry*—Corporation A plans to combine with Corporation B, with A being the surviving corporation. A will issue its shares of stock to the stockholders of B. B also has a preexisting obligation to certain of its shareholders who have certain contingent earnings rights requiring issuance of additional common stock. Corporation A has agreed to assume this obligation and will issue shares of its own stock to these stockholders. May this merger be treated as a pooling of interest?

*Reply*—The issuance of A's common shares to the holders of the contingent earnings rights would not prohibit using the pooling of interests method to account for the business combination. Issuing common stock for this obligation is similar to assuming or exchanging common stock for a debt security. Therefore, it would be proper to apply that part of APB Opinion No. 16, paragraph 47, which states, "... a corporation issuing stock to effect the combination may assume the debt securities of the other company or may exchange substantially identical securities or voting common stock for other outstanding equity and debt securities. ..."

#### **.15 Pooling of Interests Precluded by Agreement to Redeem Stock**

*Inquiry*—Corporation A, a personal holding company, has an agreement with its sole shareholder to redeem the corporation's stock at fair market value on the date of the shareholder's death.

Corporation B, whose stock is publicly traded, proposes to merge with A. All stockholders will exchange their stock for voting common stock in the resulting Corporation AB.

Assuming that the exchange of stock meets all other requirements for a pooling of interests, would the assumption of the redemption agreement by AB negate the pooling under the "contingent bailout" or "planned transaction" provisions of APB Opinion No. 16?

Also, if pooling is permissible, would the result be changed if AB amended the agreement to provide a specific redemption price not related to the fair market value of the stock at the death of A's shareholder?

*Reply*—Paragraphs 48a and 48b of APB Opinion No. 16 specify that a combined corporation may not agree to retire or reacquire any of the common stock issued to effect the combination or enter into financial arrangements for

the benefit of the former stockholders of a combining company if a business combination is to be accounted for by the pooling of interests method. Furthermore, Interpretation No. 21 of the Opinion states, in part, that the critical factor in meeting the conditions of APB Opinion No. 16, paragraphs 48a and 48b, is that the voting common stock issued to effect a business combination remains outstanding outside the combined corporation without arrangements on the part of any of the corporations involving the use of their financial resources to "bailout" former stockholders of a combining company or to induce others to do so.

These references lead to the conclusion that pooling of interests accounting would not be permitted under these circumstances despite the preexistent aspect of the agreement with A's sole stockholder.

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## Section 7630

### ***Application of Pooling of Interests Method***

#### **.02 Exchange of Stock on a Share for Share Basis With Different Stated Values**

*Inquiry*—Corporation A merged with Corporation B, leaving Corporation A as the survivor. The terms of the merger stated that the shareholders of Corporation B would exchange their stock on a “share for share basis” for the stock of Corporation A. The stock of Corporation B has a stated value and was sold originally at \$.05 per share, but the stock of Corporation A has a stated value of \$.10 per share. When Corporation A issued its stock for Corporation B’s stock on a “share for share basis,” the net effect resulted in Corporation A’s stock being issued at a discount of \$.05 per share.

What is the proper statement presentation for this transaction?

*Reply*—APB Opinion No. 16, *Business Combinations*, paragraph 53, states in part, “The amount of outstanding shares of stock of the combined corporation at par or stated value may exceed the total amount of capital stock of the separate combining companies; the excess should be deducted first from the combined other contributed capital and then from the combined retained earnings.”

Since the merger was effected by an exchange of stock on a “share for share basis,” it is assumed that pooling of interests accounting would be appropriate. Based upon the above quotation, a sufficient amount should be transferred from the combined other contributed capital and then from the combined retained earnings in order to reflect A’s capital at the number of shares outstanding times \$.10 per share.

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# TIS Section 8000

## AUDIT FIELD WORK

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## Section 8200

### ***Internal Control***

#### **.02 Determining Accuracy of Cash Collections for Coin-Operated Machines**

*Inquiry*—How can the accuracy of the cash collections be determined for a chain of laundromats with several thousand machines? The coin-operated machines do not employ the use of meters, counters, locked boxes, or any other devices that would provide a basis for control.

*Reply*—One method to determine if the machines' receipts are being surrendered intact is to occasionally fill selected coin-operated machines with marked coins. The subsequent collections can then be reviewed to make sure the same coins have been turned in. It may also be possible to correlate revenues with consumption of water and electricity by these machines. Furthermore, it may be possible to determine the expected revenues from an installation and the extent to which the machines are being used by observation of the activities of selected installations.

#### **.04 Communication With Audit Committee**

*Inquiry*—An auditor has been engaged to perform an audit on a small, privately-held company. It has only two owners and no audit committee or other oversight group. Does the auditor have the responsibility to communicate certain matters to the owners under SAS No. 61, *Communication With Audit Committees*?

*Reply*—SAS No. 61 requires that an auditor communicate certain matters related to the conduct of an audit to those who have responsibility for oversight of the financial reporting process. Some of the items that need to be communicated relate to the auditor's responsibility under generally accepted auditing standards (GAAS), significant accounting policies, management judgments and accounting estimates, significant audit adjustments, disagreements with management, etc.

The communications required by SAS No. 61 are applicable to (1) entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee) and (2) all Securities and Exchange Commission (SEC) engagements.

Since the company has no oversight group and the engagement is not an SEC engagement, the auditor has no SAS No. 61 responsibility on this engagement.

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[The next page is 8491.]





## Section 8220

### Sampling

#### .01 Application of SAS No. 39

*Inquiry*—When should the auditor apply the audit sampling principles in SAS No. 39?

*Reply*—Audit sampling is only one of many tools used by auditors to obtain sufficient, competent evidential matter to support an opinion regarding financial statements. SAS No. 39 outlines design, selection, and evaluation considerations to be applied by the auditor when using audit sampling. As a general rule, audit sampling can be used—

- in performing tests of controls that provide an audit trail of documentary evidence,
- in substantive testing to test details of transactions and balances, and
- in dual purpose tests that test a control that provides documentary evidence of performance and whether the recorded monetary amount of transactions or balances is correct.

Thus, the portion of SAS No. 39 pertaining to tests of controls (paragraphs 31 through 42) applies when sampling techniques are used to test the operating effectiveness of the controls. The portion of SAS No. 39 pertaining to substantive tests (paragraphs 15 through 30) applies when sampling techniques are used to test details of transactions or balances.

SAS No. 39 defines audit sampling as “the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.” A key to understanding that definition is the *intent* of the auditor in applying the audit procedure. As noted in footnote 1 of SAS No. 39, the auditor may examine less than 100 percent of the items comprising an account balance or class of transactions for reasons *other than* evaluating a characteristic of the balance or class. For example, the auditor is not performing audit sampling in the following situations:

- An auditor traces several sales transactions through a client’s accounting system to gain an understanding of the manner in which transactions are processed. SAS No. 39 would not apply because the auditor’s intent was to gain an understanding of the processing of these transactions by the accounting system, not to evaluate a characteristic of all sales transactions processed by the accounting system.
- The auditor might examine several large sales invoices that comprise a significant portion of the account balance and leave the remaining portion of the balance untested or test the remaining items by other means, such as the application of analytical procedures. Again, SAS No. 39 does not apply because the auditor does not intend to evaluate all items in the account balance based on the examination of the large items.

Another consideration in determining whether SAS No. 39 is applicable to circumstances in which an auditor examines less than 100 percent of the items comprising an account balance or class of transactions is the purpose of the test being applied. If he intends to project the test results to the entire account balance or class of transactions for the purpose of evaluating a characteristic of the balance or class, the auditor should follow the guidance in SAS No. 39. For example, if the auditor intends to examine selected sales invoices to draw a conclusion as to whether sales are overstated, he should apply audit sampling as described in SAS No. 39—he intends to draw a conclusion about all sales. On the other hand, if the auditor selects several large sales invoices for certain audit tests and then applies analytical procedures to the remaining invoices, he is not sampling according to SAS No. 39—his examination of the large items is not intended to lead him to a conclusion about the other items. In that case, any conclusion about whether sales are overstated would be based on the combined results of the test of large sales invoices, inquiry and observations, analytical procedures, and other auditing procedures performed related to overstatement of sales.

In determining whether SAS No. 39 applies to a given audit procedure, the auditor should also consider the population in which he is interested. The auditor might choose to divide a single reporting line on the financial statements into several populations. For example, accounts receivable might be divided into wholesale receivables, retail receivables and employee receivables. Each of these populations can be tested using a different audit strategy. The sampling concepts in SAS No. 39 apply only to populations for which audit sampling is used. Use of audit sampling on one population does not mandate its use on remaining populations.

### **.03 Adequate Size for Nonstatistical Samples**

*Inquiry*—Is there a rule-of-thumb for determining an adequate size for nonstatistical samples for substantive audit tests?

*Reply*—There is no rule-of-thumb that is appropriate for all applications. SAS No. 39 imposes no requirement to use quantitative aids, such as sample size tables, to determine sample size. Nor does SAS No. 39 impose a rule regarding minimum sample size. Just as before the issuance of SAS No. 39, judgment is the key. Auditors often use benchmarks or starting points such as sample sizes used in prior years or in similar circumstances in other audit engagements in determining what sample size is appropriate for a given sampling application. Paragraph 23 of SAS No. 39 lists factors that influence the auditor's judgment in determining sample size. Those factors include—

- Tolerable misstatement allowable.
- The risk of incorrect acceptance.
- The characteristics of the population (e.g., the variability of the amounts of items in the population and the expected misstatement in the population).

If the auditor considered factors such as these in determining sample size in prior years or in other engagements, there may be no reason to believe that sample sizes based on these benchmarks or starting points are inadequate. Individual firms or auditors often prefer to set their own rules regarding a benchmark or starting point for determining sample size. SAS No. 39 does not prohibit such policies. It merely alerts the auditor to factors he should consider in judging the adequacy of sample size.

#### **.04 Documentation Requirements of SAS No. 39**

*Inquiry*—Does SAS No. 39 impose any new documentation requirements?

*Reply*—No, SAS No. 39 contains no new specific documentation requirements. The documentation standards set forth in the statements on auditing standards dealing with documentation apply to audit sampling applications just as they apply to other auditing applications. For example, SAS No. 22, *Planning and Supervision*, states that the auditor should prepare a written audit program and SAS No. 41, *Working Papers*, requires the auditor to prepare working papers that record the work that the auditor has done and the conclusions that he has reached concerning significant matters. Thus, with regard to audit sampling applications, the auditor's audit program might document such items as the objectives of the sampling application and the audit procedures related to those objectives. The auditor's record of the work performed might include—

- The definition of the population and the sampling unit, including how the auditor considered completeness of the population.
- The definition of misstatement.
- The method of sample selection.
- A list of misstatements identified in the sample.
- An evaluation of the result of the sampling application.
- Conclusions reached by the auditor.

#### **.05 Methods to Select Representative Sample**

*Inquiry*—What are some selection methods that can be used to select a representative sample?

*Reply*—There is no requirement in SAS No. 39 that random sampling selection methods be used. Representative sampling methods used by auditors include—

- Haphazard sampling.
- Systematic sampling.
- Random-number sampling.

Haphazard sampling consists of selecting sampling units without any conscious bias, that is, without any special reason for including or omitting items from the sample. Haphazard sampling does not imply that units can be selected in a careless manner. Rather, a haphazard sample is selected in a manner that can be expected to be representative of the population. For example, where the physical representation of the population is a file cabinet drawer of vouchers, a haphazard sample of all vouchers processed for the year 19XX might include any of the vouchers that the auditor pulls from the drawer, regardless of each voucher's size, shape, location, or other physical features. The auditor using haphazard selection should be careful to avoid distorting the sample by selecting, for example, only unusual or physically small items or by omitting items such as the first or last items in the physical representation of the population.

Systematic sampling consists of determining a uniform interval, and one item is selected throughout the population at each of the uniform intervals from the starting point.

Random-number sampling entails matching random numbers generated by a computer or selected from a random-number table with, for example, document numbers.

Another method sometimes used in practice is block sampling. Block sampling consists of selecting groups of sequential transactions (for example, all vouchers processed on several selected dates). Using block samples may be inefficient because in order for a block sample to be adequate to lead to an audit conclusion, a relatively larger number of blocks should be selected. If an auditor decides to use block sampling, he should exercise special care to control sampling risk in designing his sample.

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## Section 8310

### ***Evidential Matter: Securities***

#### **.02 Confirmation of Securities Held in Street Name**

*Inquiry*—A CPA firm has been engaged to perform the initial audit of a pension plan and trust. Most of the trust assets are investments held in street name by a brokerage house. Some negotiable bearer bonds, held in a bank, are in denominations not traceable to the trust account since the bond may represent investments by more than one customer. In addition to its monthly account statements the broker will certify details and ownership of investments at the statement date and will permit examination of certain of its internal records. The bank will also certify details and ownership of investments held for the trust.

Would the fact that the securities are held in “street name” and in some cases in denominations which cannot be traced to the trust’s account preclude obtaining sufficient competent evidential matter on which to base an opinion on the financial statements of the pension plan and trust?

*Reply*—Statement on Auditing Standards No. 31 discusses evidential matter. Physical inspection and count of the securities in this case appear to be impracticable; therefore, evidential matter concerning the securities would presumably consist primarily of confirmations received from the brokerage houses and other financial institutions which have possession of the securities. Whether or not confirmations would represent sufficient evidence is really a matter for the auditor’s professional judgment. [Amended]

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[The next page is 8571.]



## Section 8320

### ***Evidential Matter: Inventories***

#### **.01 Reliance on Observation of Inventories at an Interim Date**

*Inquiry*—Although its fiscal year ends on March 31, a client has always counted its physical inventory on December 31. The March 31 ending inventory has always been calculated by the gross profit method which has proven over the past to be quite accurate. No perpetual inventory records are kept.

Can the auditor rely on an observation of inventory that takes place three months prior to the balance sheet date?

*Reply*—SAS No. 1, section 331, *Receivables and Inventories*, paragraphs 9–12, discusses evidential matter regarding inventories. SAS No. 1, section 331, paragraph 10, states, “When the well-kept perpetual inventory records are checked by the client periodically by comparisons with physical counts, the auditor’s observation procedures usually can be performed either during or after the end of the period under audit.” SAS No. 1, section 331, paragraph 12, states in part, “. . . it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate test of intervening transactions.”

Normally, observing an inventory-taking on December 31 when a client has a March 31 year-end and perpetual records are used as the basis of the March 31 inventories, would present no unusual problems since the tests of intervening transactions referred to in SAS No. 1, section 331, paragraph 12, usually can be readily applied. However, if the client keeps no perpetual records of inventory, the tests of the intervening transactions would, in effect, cause the auditor to create the perpetual records as a basis for the March 31 inventory.

#### **.02 Observation of Physical Inventory on a First Audit**

*Inquiry*—A company maintains large inventories of tractor parts in five different locations. The quantities of each part may be quite small, averaging six or seven pieces; but there are approximately 5000 different parts on hand, some as much as twenty years old. The company has been taking complete physical inventories at the end of each year. In the past, the parts inventories have been valued at the current catalogue prices.

A CPA has been engaged to perform the company’s first audit. What procedures may be followed in establishing the value of the parts inventory?

*Reply*—It would appear necessary under sections SAS No. 1, section 331, *Receivables and Inventories*, paragraphs 1 (AU 331.01) and 9 (AU 331.09), and SAS No. 58, *Reports on Audited Financial Statements*, paragraphs 40 through 44 (AU 508.40 through .44), that the auditor observe the client’s count of the parts inventory. Presumably tests should be made in each of the five locations.

Inventory pricing should be based on historical cost, rather than current selling price. While it may not be practicable to determine cost individually for the large number of parts on hand, it might be appropriate to determine the ratio of cost to catalogue price to obtain an approximation of the cost of current

inventory. Also, some allowance, based on experience, should be made for obsolescence. Presumably a part will have little current value if there is a probability it will not be sold within five years. Costs of warehousing items for such a period may often approach the discounted value of the sales price.

Based upon observations and upon discussions with the client's employees, the auditor may be able to obtain some impressions as to the reliability of the earlier inventories. This would be supported by a comparison of this year's inventory with the prior year's, and by knowledge of sales and production in the current year. [Amended]

### **.03 Cost of Inventories Acquired from Principal Stockholder**

*Inquiry*—A corporation purchased merchandise from a stockholder who owns 99 percent of the corporation's stock and executed a chattel mortgage in favor of the stockholder. The merchandise was acquired by the stockholder prior to the formation of the corporation.

How can the CPA be sure the purchase price of this merchandise is reasonable?

*Reply*—The "seller's" cost can be ascertained through the examination of his cost records, invoices, etc., and comparing his total cost with the selling price to the corporation. Also, the taking of inventory can be observed and verified against physical quantities and classifications of inventory, against transfer documents and against the transferor's cost records and invoices. If the latter records are not available, the auditor can price the inventory at the current replacement cost which can be obtained by reference to recent invoices, communication with suppliers, or references to recent merchandise catalogs.

A basic consideration in this case is the fact that, upon incorporation, there is a continuance of beneficial interest in the inventory transferred and in the proceeds from its eventual disposition by virtue of the chattel mortgage and the 99 percent stock ownership. Accordingly, the transferor's cost should be carried over and continued on the books of the newly organized corporation.

### **.04 Reliance on Estimates of Coal Inventories by Experts**

*Inquiry*—An electric utility maintains a large stockpile of coal. The auditors rely on the calculations of an engineering firm in their test of this inventory. The amount of coal by weight is estimated by multiplying the volume of the coal pile, calculated in cubic feet, by the estimated average density of the coal, measured in pounds per cubic foot. The calculated amount is then compared with the utility's perpetual inventory records, and, if the variance is not considered material, the perpetual inventory is accepted as the accurate amount.

Because of the uncertainties involved in this method, particularly in the estimation of the average density of the coal, the engineers are reluctant to render an opinion on the amount of coal on hand. Other methods of calculating the amount of coal such as the "two coal-pile" theory are uneconomical.

In all cases, this inventory is a material item in the accounts of the utility. What alternative auditing procedures might be used in these circumstances?

*Reply*—While a slight change in density of the coal might result in a change in computed quantity of coal on hand, the effect would most likely not be material in relation to the balance sheet or statement of operations of the utility



company. Perhaps, using the criteria of statistical sampling, the engineers would be willing to state that there is a X% probability that the quantity of coal is a certain amount plus or minus X% (or some other measure of variability).

#### **.05 Dates of Observation of Inventories Which Are Kept on Perpetual Records**

*Inquiry*—A retail dealer in tires and tubes has twenty-two stores. Each month the dealer takes inventory at two stores. The dealer's auditor has observed the inventory taking at ten locations. To avoid the need for extra help at year end, January 31, the auditor proposes to visit the remaining locations shortly after December 31 and:

- Count the tires on hand at that time
- Reconcile the count back to the daily report at December 31.

Do the above described procedures constitute an adequate observation of inventories?

*Reply*—Section 331.09-.14 of Statement on Auditing Standards No. 1 discusses evidential matter for inventories. Section 331.10 states:

When the well-kept perpetual inventory records are checked by the client periodically by comparisons with physical counts, the auditor's observation procedures usually can be performed either during or after the end of the period under audit.

Presumably the dealer has the necessary perpetual records which allow the taking of inventory at two stores each month during the year. Therefore, the proposed procedures would be acceptable and meet the requirement for inventory observation.

#### **.06 Observation of Consignment Inventories Stored in Public Warehouse**

*Inquiry*—Corporation A sells supplies and equipment for manufacturing jewelry. Silver on consignment from a supplier is kept in a vault adjacent to where Corporation A keeps its silver inventory. The supplier employs an independent warehouse firm to protect the consigned silver. The bonded employee of the warehouse firm has sole access to the consignment silver and performs the duties of warehouse manager for Corporation A. The warehouse firm pays the salary of the bonded employee but is reimbursed by Corporation A. Since the possibility for substitutions between Corporation A's silver inventories and the consignment silver exists, the auditors of Corporation A, in conducting a physical observation of Corporation A's silver inventories, also want to conduct a physical observation of the consignment silver. Is it necessary for the auditors of Corporation A to observe the consignment silver?

*Reply*—SAS No. 1, section 331.14, and SAS No. 1 section 901.24-.28 (as amended by SAS No. 43) deal with controls and auditing procedures for owner's goods stored in public warehouses. Section 901.28 makes reference to section 331.14 which provides that obtaining direct confirmation from the custodian is acceptable, except that supplemental procedures are to be applied in cases where such inventories represent a significant proportion of the client's current assets or total assets. Among the steps recommended for the auditor to follow, to the extent considered necessary, is the observation of physical counts of the goods wherever practicable and reasonable.

Because of the relationship which Corporation A has with the warehouse and the bonded employee, and the possibility for substitutions of inventory between Corporation A and the supplier, the auditors should observe the consignment inventory and Corporation A's inventory at the same time.  
[Amended]

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[The next page is 8671.]

## Section 8330

### ***Evidential Matter: Fixed Assets***

#### **.01 Verification of Real Estate Ownership**

*Inquiry*—What procedures may be followed in the verification of real property accounts? Is it sufficient to examine the documents involved in the purchase of the property, to examine the real estate tax bills, and to communicate with the holders of any mortgages or trusts secured by the property? Should the client be required to assume the expense of a title search by an attorney?

*Reply*—It is generally conceded that examination of public records which contain the history of transactions relating to realty, as well as the current status of that property, is normally the function of an attorney or title company rather than that of an auditor. Accordingly if it is feasible for the client to obtain a letter from an attorney or title company which defines the interest the company holds in the land based upon a title search, this appears to be the best evidence available as to title and encumbrances.

If this procedure is too costly, then the following other audit procedures may supply sufficient indicia of title as to enable the auditor to assume that the client does, in fact, own the land subject to named liens.

1. Compare legal description of land found in deed with that found in the title insurance policy, abstract of deed, tax receipts, etc.
2. Verify current payment of carrying expenses of land in question, such as insurance premiums, tax payments, payments to mortgagee, etc.
3. Examine any rent receipts which may show evidence of continuing ownership.
4. Visit the land in question, if this is practicable.
5. Request an attorney's letter describing any conveyances or encumbrances of real property that may have been effected during the period covered in the audit, as well as his opinion regarding present status of title.
6. Obtain statement from client as to condition of title and encumbrance.
7. Check municipal or county records for evidence of ownership.

Use of a property map in connection with undertaking these procedures would also be helpful.

#### **.02 Examination of Assets of a Rental Company**

*Inquiry*—A lessor is in the business of leasing autos, large trucks, tractors, and trailers. Is it necessary for the auditors to make physical observations of

the rolling stock which is scattered across the country? What other audit procedures might be employed in the verification of this equipment? Must the titles to all equipment be examined?

*Reply*—It is not necessary, unless some extraordinary situation or circumstances were brought to light, to examine titles to all the equipment. Random test verifications of title certificates or proper registration of vehicles should be made. The fact that the client is receiving rent for the vehicles and is currently making payments on its time-purchase contracts would also be verified in regular course. Any tax and insurance payments which the client is required to make in connection with the vehicles can be checked. Also, test confirmations of possession of vehicles with the lessee should be made. Audit responsibility would not necessarily extend to physical observation of the equipment at its numerous shifting locations.

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[The next page is 8731.]

## Section 8340

### ***Evidential Matter: Confirmation Procedures***

#### **.03 Confirmation of Balances Due on Loans**

*Inquiry*—A bank arranges mortgage loans whereby the borrower instructs the bank to make payments to the contractor or developer. Payment booklets, which specify the periodic amounts due, are sent twice yearly to the borrower. In addition, each borrower receives an annual statement which shows his total yearly payments as well as the various yearly charges. Many of the debtors are unable to verify the correctness of the accrued charges and are unable to check the outstanding balances of their loans because of the complex interest rates. How can these loan balances be confirmed when the debtor cannot determine the total amount of the debt?

*Reply*—While the debtor may not be able to calculate the balance of the loan due, there are details of the loan which he should know and which can be confirmed. A request that the debtor confirm the original amount of the loan and the payments he has made would properly serve the purpose of a confirmation. Confirmation of the interest rate might also be requested as this affects the balance of the loan and should be known by the debtor.

#### **.09 Insurance Claims**

*Inquiry*—Should a CPA communicate with an insurance company, or the insurance company's attorneys, when trying to obtain evidence about insured claims outstanding against a client?

*Reply*—The CPA should obtain evidence about claims outstanding (1) from the client and (2) by communicating with the client's lawyer in accordance with SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU 337). The CPA may encounter situations where neither the client nor the client's lawyer is able to provide sufficient information regarding outstanding claims handled by insurance companies. In those situations, he or she may consider communicating directly with the insurance company or its attorneys appropriate. [Amended]

#### **.10 Letter of Inquiry to Client's Attorney**

*Inquiry*—When a CPA requested a client to send a letter of inquiry to the client's attorney, the client objected because the attorney would charge for answering the letter of inquiry. The client also believed that an inquiry about legal matters was not necessary because it had not used the services of its attorney in the current year for any matters concerning litigation, claims or assessments. Rather, the client paid fees to its attorney in connection with other matters such as corporate registrations. Do generally accepted auditing standards require that a letter of inquiry be sent to the attorney?

*Reply*—No. SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments* (AU 337), requires that a letter of inquiry be sent to those attorneys with whom management consulted concerning litigation, claims, and assessments. The auditor should obtain evidence about management's assertions by reviewing invoices received from the attorney and related

cash disbursements and correspondence files. If information contrary to management's assertion is discovered, the auditor should request management to send an inquiry letter to the attorney. Further, the auditor should consider the effects of the erroneous assertion on the ability to rely on other management representations.

In situations where no letter of inquiry is sent to the client's attorney, the auditor should consider including in the client representation letter a specific representation that no attorney had been consulted regarding litigation, claims, and assessments. [Amended]

### **.11 Receivables in Cash Basis Financial Statements**

*Inquiry*—If accounts receivable and escrow balances are included in modified cash basis financial statements, should the accounts receivable and escrow balances be confirmed?

*Reply*—The generally accepted auditing standards, including confirmation, that apply to financial statements prepared in conformity with generally accepted accounting principles apply to modified cash basis financial statements.

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[The next page is 8991.]

## Section 8900

### ***Predecessor/Successor Auditors***

#### **.01 Communications Between Predecessor Accountant and Successor Auditor**

*Inquiry*—An accountant is engaged to audit the current year's financial statements of a company. In the prior year, the company's financial statements were reviewed by another accountant. Is the successor auditor required to communicate with the predecessor accountant?

*Reply*—No. SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AU 315), footnote 3, states "When the most recent financial statements have been compiled or reviewed in accordance with the AICPA Statements on Standards for Accounting and Review Services, the accountant who reported on those financial statements is not a predecessor auditor. Although not required by this Statement, in these circumstances the successor auditor may find the matters described in paragraphs 8 and 9 useful in determining whether to accept the engagement."

#### **.02 Communications Between Predecessor and Successor Auditors**

*Inquiry*—A client has decided to restate, for comparative purposes, the statement of changes in financial position reported on by the predecessor auditor to a statement of cash flows. The predecessor's audit report will not be presented.

- (1) Must the successor auditor notify the predecessor auditor as part of his or her procedures to prepare or evaluate restatements permitted or mandated by new accounting standards?
- (2) How will the restatement affect the successor auditor's report?

*Reply*—SAS No. 84, *Communications Between Predecessor and Successor Auditors*, paragraph 21 (AU 315.21), states:

If during an audit, the successor auditor becomes aware of information that leads him or her to believe that financial statements reported on by the predecessor auditor may require revision, the successor auditor should request that the client inform the predecessor auditor of the situation and to arrange for the three parties to discuss this information and attempt to resolve the matter.

In cases where revisions result from an accounting change required or permitted by a new FASB or AICPA Pronouncement, the successor auditor is not required to consult with the predecessor auditor. However, the successor may find that communication with the predecessor auditor is desirable in order to obtain any additional information and/or workpapers that may be needed to prepare or evaluate the restatement. To maintain audit efficiency, such communications may be made as part of the successor auditor's routine request for review of selected workpapers.

SAS No. 58, *Reports on Audited Financial Statements*, paragraph 83, as amended by SAS No. 64, *Omnibus Statement on Auditing Standards—1990* (AU 508.83), provides guidance for the form and content of the successor auditor's report when the prior period statements have been restated. Additional language may also be included if the successor auditor wishes to comment on the appropriateness of the restatement. Additional illustrations may be found in the AICPA Financial Report Survey, "Illustrations of Departures From the New Standard Auditor's Report on Financial Statements of Business Enterprises" (June 1990), pages 49–50.

### **.03 Communications With a Predecessor Auditor Who Has Ceased Operations<sup>1</sup>**

*Inquiry*—SAS No. 84, *Communications Between Predecessor and Successor Auditors*, paragraph 3, requires a successor auditor to attempt certain communications with the predecessor auditor prior to acceptance of an engagement. How should a successor fulfill this responsibility when the predecessor has ceased operations?

*Reply*—Even when the predecessor has ceased operations, SAS No. 84 obligates a successor to attempt certain communications with the predecessor prior to acceptance of an engagement. The successor should attempt the required communications, about matters that the successor believes will assist him or her in determining whether to accept the engagement, with the individual who had final responsibility for the audit (for example, the engagement partner). If the successor is unable to communicate with that individual or receives a limited response, the successor should consider the implications in deciding whether to accept the engagement.

### **.04 Unavailability of the Working Papers of a Predecessor Auditor Who Has Ceased Operations**

*Inquiry*—A successor auditor must obtain sufficient competent evidential matter to afford a reasonable basis for expressing an opinion on the financial statements under audit. The successor's audit may be facilitated by reviewing the predecessor auditor's working papers. What is the effect on the successor's audit when the working papers of a predecessor who has ceased operations are not available for review?

*Reply*—Sufficient competent evidential matter to afford a reasonable basis for expressing an opinion on the financial statements includes sufficient evidence about matters of continuing audit and accounting significance, such as beginning balances, consistency in the application of accounting principles and contingencies. When the working papers of a predecessor who has ceased operations are not available, the evidence normally obtained by reviewing the working papers must be obtained by performing other audit procedures. If the successor is unable to obtain sufficient competent evidential matter to express an opinion on the financial statements, the successor should qualify or disclaim an opinion because of the inability to perform procedures that the successor considers necessary in the circumstances, not because of the unavailability of the predecessor's working papers.

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<sup>1</sup> SSARS 4, *Communication Between Predecessor and Successor Accountants*, provides guidance to a successor accountant who decides to communicate with a predecessor accountant regarding acceptance of an engagement to compile or review the financial statements of a nonpublic company. In situations in which the predecessor has ceased operations and the successor decides to engage in such communications, the guidance in this paragraph may be useful.



**.05 Significant Audit Procedures Performed by a Predecessor Auditor Who Has Ceased Operations**

*Inquiry*—If a predecessor auditor has performed significant audit procedures, such as the observation of inventory or the confirmation of accounts receivable, and subsequently has ceased operations, to what extent may this work be used by the successor auditor?

*Reply*—Because a report on the financial statements has not been issued by the predecessor and the successor cannot complete the procedures required by SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*, the successor can neither assume responsibility for the work of the predecessor nor issue a report that reflects divided responsibility for the audit, as described in SAS No. 1, section 543. The successor must perform audit procedures sufficient to afford a reasonable basis for an opinion on the financial statements under audit. However, review of the predecessor's working papers may have an effect on the nature, timing and extent of those procedures.

**.06 Successor Auditor Becomes Aware of Information That Leads Him or Her to Believe That Financial Statements Reported On by a Predecessor Auditor Who Has Ceased Operations May Be Materially Misstated**

*Inquiry*—What actions should a successor auditor take when he or she becomes aware of information that leads him or her to believe that financial statements reported on by a predecessor auditor who has ceased operations may be materially misstated?

*Reply*—When the successor becomes aware of information that leads him or her to believe that the financial statements reported on by a predecessor who has ceased operations may be materially misstated, the successor should advise management of the information and request that management determine whether the financial statements require restatement. In making such a determination, management may find it useful to discuss the information with the individual who had final responsibility for the audit of those financial statements (for example, the engagement partner). If management determines that the financial statements require restatement, the successor should request that management disclose the information to the party responsible for winding up the affairs of the predecessor firm. The successor also should request that management consider whether action should be taken to prevent future reliance on the financial statements.

If, in the successor's judgment, management does not respond appropriately to his or her requests, the successor should advise the audit committee, or others with equivalent authority and responsibility, regarding the information and management's response. If, in the successor's judgment, the audit committee does not respond appropriately to his or her communication, the successor should consider resigning as the entity's auditor. The successor would be well advised to consult with his or her attorney in determining an appropriate course of action.

**.07 Reports on Audited Financial Statements Presented With Prior-Period Financial Statements Audited by a Predecessor Auditor Who Has Ceased Operations**

*Inquiry*—If the prior-period financial statements audited by a predecessor auditor who has ceased operations are presented for comparative purposes with current-period audited financial statements, how is the successor auditor's report affected?

*Reply*—The answer depends on (1) whether the prior-period financial statements have been restated and (2) whether the entity files annual financial statements with the Securities and Exchange Commission (SEC).

- a. If the prior-period audited financial statements are *unchanged*, the successor should indicate in the introductory paragraph of his or her report (1) that the financial statements of the prior period were audited by another auditor, (2) the date of the predecessor's report, (3) the type of report issued by the predecessor, and (4) if the report was other than a standard report, the substantive reasons therefor. SAS No. 58, *Reports on Audited Financial Statements*, paragraph 74, indicates that the successor should not name the predecessor in the report. An example of the reference that would be added to the introductory paragraph of the successor's report is presented below.

The financial statements of ABC Company as of December 31, 19X1, were audited by other auditors whose report dated March 31, 19X2, expressed an unqualified opinion on those statements.

A reference to the predecessor's report should be included even when the predecessor's report on the prior-period financial statements is reprinted and accompanies the successor's report, because reprinting does not constitute reissuance of the predecessor's report in accordance with SAS No. 58, paragraph 71.

- b. If the prior-period financial statements *have been restated*, the successor should follow the guidance in the preceding point *a*, indicating that the predecessor reported on the financial statements of the prior period before restatement. In addition, the successor should consider the guidance in paragraph .06.

If the successor is engaged to audit and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor may report on the adjustments in accordance with the guidance in SAS No. 58, paragraph 74 (AU 508.74). In determining the nature, timing and extent of procedures, the successor should consider that a predecessor who has ceased operations cannot perform the procedures to evaluate the appropriateness of the restatement adjustments as described in SAS No. 1, section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

If the successor does not perform sufficient procedures to satisfy himself or herself as to the restatement adjustments, the note to the financial statements describing the restatement adjustments should be marked *unaudited*.

- c. If the entity files annual financial statements with the SEC, the SEC staff has indicated that, in annual reports (on Form 10-K and to shareholders), the predecessor's report on the prior-period financial statements should be reprinted with a legend, in lieu of the manual signature, indicating (1) that the report is a copy of the report issued by the predecessor and (2) that the predecessor has discontinued performing auditing and accounting services, and, if applicable, that it has filed for protection from creditors under the Bankruptcy Code. A sample legend, for cases in which the predecessor has filed for bankruptcy, is presented below.

The report that appears below is a copy of the report issued by the company's previous independent auditor [name of firm]. That firm has filed for protection from creditors under Chapter 11 of the Bankruptcy Code on [date], and has discontinued performing auditing and accounting services.

The successor should refer to the predecessor's report in his or her report, as described in the preceding point *a*. If the prior-period financial statements have been restated, the SEC staff has indicated that it is ordinarily sufficient for the successor to audit only the restatement adjustments and report on them in accordance with the guidance in the preceding point *b*; in unusual circumstances, the restated prior-period financial statements may have to be audited.

**.08 Reports on Audited Financial Statements of a Nonpublic Entity Presented With Prior-Period Financial Statements Compiled or Reviewed by a Predecessor Accountant Who Has Ceased Operations**

*Inquiry*—If the prior-period financial statements that have been compiled or reviewed by a predecessor accountant who has ceased operations are presented for comparative purposes with current-period audited financial statements, how is the successor auditor's report affected?

*Reply*—The answer depends on whether the prior-period financial statements have been restated.

- a.* If the prior-period financial statements are unchanged, the successor's report should make reference in a separate paragraph to the predecessor's report on the prior-period financial statements. This paragraph should include (1) a statement of the service performed in the prior period, (2) a statement that the predecessor has ceased operations, (3) the date of the report on the service performed, (4) a description of any modifications of that report, and (5) a statement that the service was less in scope than an audit and does not provide the basis for the expression of an opinion on the financial statements taken as a whole. Reference to the predecessor's report should not include the name of the predecessor. Examples of additional paragraphs for compiled and reviewed prior-period financial statements are presented below.

*Compiled Prior Period Financial Statements*

The 19X1 financial statements were compiled by other accountants who have ceased operations, and their report thereon, dated February 1, 19X2, stated they did not audit or review those financial statements and, accordingly, express no opinion or other form of assurance on them.

*Reviewed Prior-Period Financial Statements*

The 19X1 financial statements were reviewed by other accountants who have ceased operations, and their report thereon, dated March 1, 19X2, stated they were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

- b. If the prior-period financial statements *have been restated*, the restated prior-period financial statements should be compiled, reviewed, or audited and reported on accordingly. In addition, the successor should consider the guidance in paragraph .06.

**.09 Reports on Compiled or Reviewed Financial Statements Presented With Prior-Period Financial Statements Compiled, Reviewed, or Audited by a Predecessor Accountant Who Has Ceased Operations**

*Inquiry*—If prior-period financial statements that have been compiled, reviewed, or audited by a predecessor accountant who has ceased operations are presented for comparative purposes with current-period compiled or reviewed financial statements, how is the successor accountant's report affected?

*Reply*—The answer depends on whether the prior-period financial statements have been restated.

- a. If the prior-period financial statements were *compiled or reviewed and are unchanged*, the successor should add a paragraph to his or her report on the current-period financial statements that includes (1) a statement that the financial statements of the prior period were compiled or reviewed by another accountant who has ceased operations, (2) the date of the predecessor's report, (3) a description of the standard form of disclaimer or limited assurance, as applicable, included in the report, and (4) a description or a quotation of any modifications of the standard report and of any paragraphs emphasizing a matter regarding the financial statements. Reference to the predecessor's report should not include the name of the predecessor. Examples of additional paragraphs for compiled and reviewed prior-period financial statements are presented below.

*Compiled Prior-Period Financial Statements*

The 19X1 financial statements of XYZ Company were compiled by other accountants who have ceased operations and whose report dated February 1, 19X2, stated that they did not express an opinion or any other form of assurance on those statements.

*Reviewed Prior-Period Financial Statements*

The 19X1 financial statements of XYZ Company were reviewed by other accountants who have ceased operations and whose report dated March 1, 19X2, stated that they were not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles.

If the prior-period financial statements were *audited and are unchanged*, the successor should add a paragraph to his or her report on the current-period financial statements that indicates (1) that the financial statements of the prior period were audited by another accountant who has ceased operations, (2) the date of the predecessor's report, (3) the type of opinion issued by the predecessor, (4) if the opinion was other than unqualified, the substantive reasons therefor, and (5) that no auditing procedures were performed after the date of the predecessor's report. Reference to the predecessor's report should not include the name of the predecessor. An example of such a paragraph is presented below.

The financial statements for the year ended December 31, 19X1, were audited by other accountants who have ceased operations, and they expressed an unqualified opinion on them in their report dated March 1, 19X2, but they have not performed any auditing procedures since that date.

- b. If the prior-period financial statements *have been restated*, the restated prior-period financial statements should be compiled, reviewed or audited and reported on accordingly. In addition, the successor should consider the guidance in paragraph .10.

**.10 Successor Accountant's Responsibilities Under SSARSs When He or She Becomes Aware That Prior-Period Financial Statements Reported On by a Predecessor Accountant Who Has Ceased Operations May Require Revision**

*Inquiry*—SSARS No. 4, *Communications Between Predecessor and Successor Accountants*, paragraph 10, provides guidance to a successor accountant who, during an engagement to compile or review current-period financial statements, becomes aware of information that leads him or her to believe that financial statements reported on by a predecessor accountant may require revision. SSARS 4, paragraph 10 states that the successor should request that his or her client communicate this information to the predecessor. How may the successor fulfill this responsibility when the predecessor has ceased operations?

*Reply*—When the successor becomes aware of information that leads him or her to believe that financial statements reported on by a predecessor accountant may require revision, the successor should request that the client advise the party responsible for winding up the affairs of the predecessor firm. If the client refuses to communicate with the predecessor or if the successor is not satisfied with the predecessor's course of action, the successor would be well advised to consult with his or her attorney.

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# TIS Section 9000

## AUDITORS' REPORTS

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## Section 9210

### Accounting Changes

#### .02 Change in Accounting for Pre-Operating Costs

*Inquiry*—A client, whose stock is not presently traded publicly, anticipates making a public offering. The offering probably would occur sometime after the end of the fiscal year.

The client presently defers pre-operating costs of new retail stores. They wish to change the method of accounting for preoperating cost to expensing such costs as they are incurred.

May the client restate the prior year's financial statements under the provisions of APB Opinion No. 20, *Accounting Changes*, paragraph 29 (AC A06.125 and A35.114)?

*Reply*—The special exemption provisions of APB Opinion No. 20, paragraph 29 (AC A06.125 and A35.114), apply only to those cases where there is a "forthcoming public offering" of shares of equity security of a company. The Board concluded in such cases that the "financial statements for all prior periods presented may be restated retroactively . . ." The exemption is available only once for changes made at the time a company's financial statements are first used for any of the purposes stated in the paragraph.

If the client makes the change in its financial statements for the current year, the provisions of APB Opinion No. 20 (AC A06) which require cumulative effect reporting should be applied. APB Opinion No. 20, paragraph 29 (AC A06.125 and A35.114), would be applicable at the time the client began to prepare its financial statements in connection with the public offering. At that time, the prior years presented in the registration statement would have to be restated. In this connection, normally more than one prior year's income statement is required. The client would not be precluded from making the change in the current year, but accounting for the change would be different.

#### .03 Change in Service Lives of Fixed Assets

*Inquiry*—A reevaluation of the lives of depreciable property resulted in an increase in the remaining lives of certain properties. The company would like to include the cumulative, net of tax, effect of this change in income. Is this in accordance with generally accepted accounting principles?

*Reply*—APB Opinion No. 20, *Accounting Changes* (AC A06), is quite specific regarding the treatment of changes in estimated service lives of depreciable assets. Such a change is considered a change in an accounting estimate and should be recorded prospectively, that is, in the period of the change and future periods as appropriate. Therefore, the proposed accounting would not be in accordance with generally accepted accounting principles. If the change in service lives of depreciable property were accounted for as suggested, the independent auditors would have to issue a qualified or adverse opinion depending upon materiality of the item.

**.09 Change in Reporting Entity**

*Inquiry*—SAS No. 1, section 420, *Consistency of Application of Generally Accepted Accounting Principles*, paragraphs 7 through 9 (AU 420.07–.09), discusses the applicability of the consistency standard to a change in the reporting entity, which is a special type of change in accounting principle. Are SAS No. 1, section 420, paragraphs 7(b) and (c) (AU 420.07(b) and (c)), which state that a change in reporting entity results when there is a change in the specific entities included in consolidated or combined financial statements, and paragraph 9 (AU 420.09), which states that “a change in reporting entity does not result from the creation, cessation, purchase or disposition of a subsidiary,” contradictory?

*Reply*—No. The creation, cessation, purchase, or disposition of a subsidiary or other business unit is a factual change in the legal structure of the entity and therefore does not require recognition in the auditor’s report. Changes that require recognition in the auditor’s report are those that can be arbitrarily made by management.

**.10 Change From Generally Accepted Accounting Principles (GAAP) to An Other Comprehensive Basis of Accounting (OCBOA) or From OCBOA to GAAP**

*Inquiry*—A company that has previously issued financial statements prepared in accordance with GAAP has decided to change to the income tax basis (or vice versa). How should the change in accounting basis be accounted for and reported in the financial statements and how does the change impact the auditor’s or accountant’s report?

*Reply*—Accounting issues:

Authoritative literature does not address accounting for a change in accounting basis. APB Opinion No. 20, *Accounting Changes* (AC A06), provides guidance for reporting accounting changes within the same basis. However, the situation described above is considered to be a change in accounting basis rather than an accounting change.

When only current year financial statements are presented, it is common practice to present the effect of the change in the accounting basis by showing beginning retained earnings as previously reported with an adjustment to convert to the new basis. Although not as common in practice, precedent also exists for either showing opening retained earnings on the new basis or showing the effects of the change as a cumulative-effect adjustment in the income statement.

However, if comparative financial statements are presented, the prior year(s) should be restated and presented under the basis to which the company has changed. Restatement is necessary to ensure comparability with all periods presented.

In both cases, the change in accounting basis should be disclosed in the notes to the financial statements.

—Reporting issues:

Auditing literature states that a change in accounting basis does not represent a lack of consistency and, consequently, that report modification is not required. However, the literature allows for the inclusion of an explanatory paragraph in the auditor’s report to emphasize a matter regarding the financial statements.

A summary of the relevant authoritative references follows:

SAS No. 58, *Reports on Audited Financial Statements*, as amended, paragraph 16 (AU 508.16)—*Lack of Consistency*, indicates that the consistency reference in the auditor's report refers to consistent application of principles within a basis of presentation. The standards do not address the consistent use of a basis of presentation; therefore, a change in accounting basis does not require the auditor to modify the report for a lack of consistency.

Also, SAS No. 62, *Special Reports*, as amended, footnote 35 (AU 623.31, footnote 35)—*Circumstances Requiring Explanatory Language in an Auditor's Special Report*, indicates that a change from GAAP to an OCBOA does not represent a lack of consistency in accounting principles and states, in part, that an auditor may wish to add an explanatory paragraph to highlight a difference in the basis of presentation in the current year from that used in the prior year. Footnote 35 (AU 623.31, footnote 35) does not address changes from an OCBOA to GAAP or whether an explanatory paragraph is suggested for both single-period and comparative statements. However, the auditor may consider adding an explanatory paragraph in each of these situations.

SAS No. 58, paragraph 19 (AU 508.19), indicates that an auditor reporting on GAAP financial statements may wish to emphasize an accounting matter affecting the comparability of financial statements with those of the preceding period. SAS No. 62, paragraph 31 (AU 623.31) provides that an auditor reporting on OCBOA statements may wish to modify the report to emphasize a matter similar to reporting on GAAP statements.

A sample explanatory paragraph for an audit report on comparative financial statements in the year of change to an OCBOA follows:

(explanatory paragraph)

As discussed in Note A to the financial statements, in 19X4 the Company adopted a policy of preparing its financial statements on the accrual method of accounting used for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles. The financial statements for 19X3 have been restated to reflect the income tax basis of accounting accrual method adopted in 19X4.

Accountants performing review or compilation engagements may also consider adding an explanatory paragraph for these basis changes. [Amended February 1995.]

## **.12 Comparative Statements From Equity Method to Consolidation**

*Inquiry*—In 19X1, a nonpublic entity owned 40 percent of a subsidiary and accounted for the subsidiary using the equity method. During 19X2, the entity acquired an additional 30 percent of the subsidiary and prepared consolidated financial statements. When presenting comparative financial statements for 19X1 and 19X2, should the 19X1 statements be restated from the equity method to a consolidated basis for comparability with 19X2?

*Reply*—No. ARB No. 51, *Consolidated Financial Statements*, paragraph 10 (AC C51.111), discusses the accounting for step-acquisitions for nonpublic entities, and implies that consolidated financial statements are presented only in the year an entity obtains control of a subsidiary.

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[The next page is 9751.]





## Section 9320

### Uncertainties

#### .06 Possible Effect of Divorce Proceedings on Credit Rating

*Inquiry*—A client and his wife who are co-owners and co-managers of a business are involved in divorce proceedings. The auditor believes a divorce will adversely affect the business's credit rating. Is it necessary to include a reference in the financial statements to the divorce proceedings and their potentially adverse effects?

*Reply*—The auditor should not include references in his report to currently litigated divorce proceedings. The independent auditor should refrain from mentioning the client's involvements of a personal nature which might effectively disparage (or even stimulate the slander of) his business reputation or credit standing. It is possible that a divorce settlement could adversely affect the credit standing of the client, but in the absence of a final determination of the litigation or a determinative event which directly affects the financial condition of the entity under audit, the rule of informative disclosure does not compel the independent accountant to contribute in advance to a possible adverse effect on the client's credit standing.

#### .08 Going Concern Problem—Financial Statements Prepared on the Income Tax Basis of Accounting

*Inquiry*—A client prepares its financial statements on the income tax basis of accounting. The client is experiencing financial difficulties and its ability to continue as a going concern is questionable. Since the financial statements are prepared on "an other comprehensive basis of accounting," must the CPA's audit report include an explanatory paragraph that refers to this uncertainty?

*Reply*—Yes. SAS No. 62, *Special Reports*, paragraph 31b (AU 623.31b), states:

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

SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU 341), applies to audits of financial statements prepared either in accordance with generally accepted accounting principles (GAAP) or in accordance with other comprehensive bases of accounting. Therefore, when the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period, regardless of the basis of accounting, the auditor should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion. [Amended]

#### .09 Audit Report for Development Stage Enterprise

*Inquiry*—Is an explanatory paragraph in the auditor's report for a going concern uncertainty always required for a development stage enterprise because there is doubt as to recovery of costs from future operations?

*Reply*—No. A going concern uncertainty does not automatically arise because an enterprise is in the development stage. In accordance with SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU 341), the auditor should consider whether the results of the procedures performed (in planning, gathering evidence relative to the various audit objectives, and completing the audit) identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If such conditions or events are identified, the auditor should consider management's plan to deal with the adverse effects of the conditions and events (such as financing or additional capital infusion), and assess the likelihood that such plans can be effectively implemented.

If the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for one year after the balance sheet date remains after considering conditions, events and management's plans, the going concern issue should be adequately disclosed in the financial statements, and the auditor's report should include an explanatory paragraph to reflect this conclusion. [Amended]

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[The next page is 9851.]

## Section 9330

### ***Subsequent Events***

#### **.01 Failure to Remit Withholding Taxes in Subsequent Period**

*Inquiry*—In the course of an examination of the financial statements, the auditor has discovered that in the period subsequent to the balance sheet date the company has not remitted to the appropriate agencies the taxes currently withheld from employees' wages. Assuming the amount is material, is it necessary that this matter be disclosed in the auditor's report?

*Reply*—Section 560.03 of Statement on Auditing Standards No. 1 states in part:

The first type [of subsequent events] consists of those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements . . . . The financial statements should be adjusted . . . .

Section 560.05 of SAS No. 1 states in part:

The second type consists of those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements. Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading.

Even if it is determined that the financial statements are not directly affected, it is possible that the situation indicated future serious difficulties that might require disclosures.

If the delinquent obligations are not evidence of serious financial difficulties, there usually would be no reason why obligations incurred subsequent to the balance sheet date need be reported in financial statements as of such date. In such a case, it should be expected that the delinquent payments will soon be remitted. [Amended]

#### **.02 Disclosure of Note Receivable Covering Previous Account of Bankrupt Company**

*Inquiry*—Company A reports on a fiscal year ending January 31. Company A's accounts receivable include a material amount due from a bankrupt company. To avoid legal action, several individuals formed a new company. The new company and the individuals signed a note which would pay the accounts receivable of the bankrupt company over a three year period. The note was signed on March 1, subsequent to the balance sheet date. Should the note receivable, assumed to be collectible, be presented in the balance sheet at January 31?

*Reply*—Section 560 of Statement on Auditing Standards No. 1 deals with subsequent events. Paragraph 560.07 states, "Subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated liabilities ordinarily will require adjustment of the financial statements . . . because such events typically represent the culmination of condi-

tions that existed over a relatively long period of time." Accordingly, the accounts receivable should be reported as a note receivable at January 31, with adequate disclosure of the financial arrangements made after the balance sheet date.

### **.03 Discovery of Potential Liability in Subsequent Period**

*Inquiry*—In the period subsequent to the balance sheet date, the auditors discovered that an employee of the client had used a company purchase order to obtain merchandise for his personal business. This transaction resulted in a material potential liability of the client. Negotiations with the creditor ensued and the client's attorney was successful in securing a complete release from any obligation on the part of the client.

Is it necessary to disclose this matter on the client's financial statements?

*Reply*—According to section 560.03-.04 of Statement on Auditing Standards No. 1, the resolution of this matter appears to constitute a subsequent event which is evidence of a condition that existed at the balance sheet date, but since no transaction in fact occurred which involved the client, it is not necessary to disclose the matter in the financial statements. However, a condition which did affect the client and which did exist at the balance sheet date is the future legal costs of settling the matter. Provisions for these costs (if they are material) should be made on the financial statements, and the reasons for incurring these costs should be disclosed.

### **.04 Settlement of Pending Litigation in Subsequent Period**

*Inquiry*—The field work for an audit of financial statements for a year ended December 31 was completed on May 22. Pending litigation on December 31, in which the client was the plaintiff, was settled on May 10, resulting in a gain to the client. Should the settlement be recognized in the financial statements for the year ended December 31, in accordance with SAS No. 1, section 560, *Subsequent Events*, as a type I subsequent event?

*Reply*—No. SAS No. 1, section 560, applies only to loss contingencies, not gain contingencies. The settlement should be recognized on May 10, because the settlement occurred on that date. FASB Statement No. 5, *Accounting for Contingencies*, paragraph 17, states, "Contingencies that might result in gains usually are not recorded in the accounts since to do so might be to recognize revenue prior to its realization. Adequate disclosure shall be made of contingencies that might result in gains but care shall be exercised to avoid misleading implications as to likelihood of realization."

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[The next page is 10,151.]

## Section 9410

### ***Audited Financial Statements***

#### **.02   Going Concern Assumption for Venture With Limited Life**

*Inquiry*—A corporation has recently been organized with the sole purpose of constructing a shopping center which will take several years to complete, after which the company will be liquidated. The company uses the completed contract method to recognize income and will have only one operating cycle.

Should there be an explanatory paragraph in the auditor's report now or near the final years of operations on the assumption that after a certain fixed period it will no longer be a "going concern"?

*Reply*—SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires that an explanatory paragraph (following the opinion paragraph) be included in the audit report when the auditor concludes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. A reasonable period of time is defined as "a period of time not to exceed one year beyond the date of the financial statements being audited." Therefore, when the auditor has substantial doubt that the corporation will continue as a going concern for one year from the date of the financial statements under audit, an explanatory paragraph (following the opinion paragraph) reflecting that conclusion should be included in the audit report.

However, if the corporation has presented its financial statements on the assumption of liquidation, SAS No. 59 does not apply and therefore an explanatory paragraph reflecting the auditor's conclusion that substantial doubt exists about the corporation's ability to continue as a going concern is not necessary. [Amended]

#### **.03   Opinion on Balance Sheet Only**

*Inquiry*—Occasionally, a client will request from a CPA only an audited balance sheet with footnotes even though the CPA has examined and reported on all the financial statements. The usual purpose of this statement is for presentation by the client to a supplier for securing credit.

In complying with such a request, one CPA furnishes the client with the balance sheet, the notes to all the financial statements, and the following report:

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

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

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

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

Does such a practice satisfy the CPA's reporting obligation according to SAS No. 58, *Reports on Audited Financial Statements*?

*Reply*—SAS No. 58, paragraphs 33 and 34, permit the expression of an opinion on a balance sheet only. In expressing such an opinion, the explanatory and scope paragraphs need not refer to the audit of related statements which are not being presented. The only information necessary to the readers of this report would concern the audit of the balance sheet.

The notes to the financial statements which do not pertain to the balance sheet should be omitted. However, if depreciable property is a significant portion of assets, the disclosures required by APB Opinion No. 12, *Omnibus Opinion—1967*, paragraph 5, should be considered necessary for fair presentation of the balance sheet. Disclosure as to pension plans, except for the amount of expense for the current year, would also be appropriate. [Amended]

#### **.04 Opinion on Balance Sheet With Disclaimer on Income Statement**

*Inquiry*—A CPA firm has been engaged to perform the initial audit of a company. Since the firm did not observe the inventory taking at the beginning of the period and it is not practicable for it to satisfy itself by other means as to the beginning inventory, the firm plans to issue an opinion only on the balance sheet and disclaim an opinion on the income statement. Would this be in accordance with SAS No. 58, *Reports on Audited Financial Statements*, paragraph 33?

*Reply*—Since the engagement involves a scope limitation, SAS No. 58, paragraph 33, does not apply because that pertains to audits that are unrestricted. SAS No. 58, paragraph 5, however, would apply and concludes, "The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances warrant." If the independent auditor has not satisfied himself by means of other auditing procedures with respect to opening inventories, he should either qualify or disclaim an opinion on the income statement.

If an opinion is disclaimed on the income statement, a disclaimer on the statement of cash flows would also be required as illustrated in SAS No. 58, paragraph 67. [Amended]

#### **.06 Reference in Financial Statements to Auditor's Report**

*Inquiry*—Audited financial statements often contain a note such as:

The accompanying notes are an integral part of this financial statement.  
or a note sometimes reads

The accompanying notes and auditor's report are an integral part of this financial statement.

The only difference between the two notes is the inclusion of the phrase, "and auditor's report." Is a reference to the auditor's report necessary?

*Reply*—SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor*, paragraph 2, as amended by SAS No. 58, *Reports on Audited Financial Statements*, in discussing the distinction between responsibilities of the auditor and management states, “The financial statements are management’s responsibility.” Therefore, the auditor’s report cannot be an integral part of the financial statements, and it is inappropriate to include it by reference. [Amended]

#### **.09 Arrangement of References to Financial Statements in Auditor’s Report**

*Inquiry*—The examples of auditor’s opinions in the Statements on Auditing Standards all seem to refer to the statement of financial position first, followed by the statement of results of operations, and finally the statement of cash flows. Is it necessary that the financial statements be presented in this order and the statements be referred to in the auditor’s report in this order?

*Reply*—The order in which the financial statements are referred to in the independent auditor’s report need not follow the order in which the statements are physically arranged. The suggested standard report such as shown in SAS No. 58, *Reports on Audited Financial Statements*, paragraph 8 (AU 508.08), can be used regardless of the order in which the financial statements are presented. [Amended]

#### **.13 Classification of Certain Callable Obligations**

*Inquiry*—In some situations in which there is a violation of a debt agreement that makes a long-term obligation callable, management continues to classify the obligation as long-term because it asserts that it is probable that the violation will be cured during the grace period, while the auditor does not agree with that assertion. In such a situation, does an uncertainty exist that might cause the auditor to add an explanatory paragraph (after the opinion paragraph) to his report?

*Reply*—No. FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor* (AC B05), requires that long-term obligations be classified as current liabilities if they are, or will be, callable because of the debtor’s violation of a provision of the debt agreement unless certain conditions are met. These conditions occur when (1) the creditor waives or loses the right to demand payment for more than one year from the balance sheet date or (2) it is probable that the violation will be cured within the grace period specified in the loan agreement.

The circumstances described above do not constitute an uncertainty as described in SAS No. 58, *Reports on Audited Financial Statements* (AU 508), because they do not involve matters expected to be resolved at a future date (SAS No. 58, paragraph 29 (AU 508.29)). If the auditor, on the basis of evidence available to him, disagrees with management’s assertion, a qualified (“except for”) or adverse opinion because of a departure from generally accepted accounting principles should be considered. [Amended]

#### **.14 Compilation of Supplementary Schedules in Audited Financial Statements**

*Inquiry*—When supplementary schedules are included with audited financial statements in an auditor-submitted document, can these schedules be compiled in accordance with SSARS 1, *Compilation and Review of Financial Statements*, paragraph 43 (AR 100.43)?

*Reply*—No. It would not be appropriate to refer to the accounting and review services literature to report on the accompanying information in this situation. If such schedules accompany financial statements audited in accordance with generally accepted auditing standards, the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AU 551), should be followed. SAS No. 29, paragraph 6d (AU 551.06d), states that the auditor should either express or disclaim an opinion on the information, depending on whether it has been subjected to the auditing procedures applied in the audit of the basic financial statements.

### **.15 Condensed Financial Statements of a Nonpublic Entity**

*Inquiry*—A client prepares condensed financial statements that name the auditor and state that they have been derived from audited financial statements. The condensed statements incorporate the audited financial statements by reference and indicate such statements and auditor's report thereon may be obtained. Must the auditor report on the condensed financial statements?

*Reply*—SAS No. 42, *Reporting on Condensed Financial Statements and Selected Financial Data*, paragraph 7 (AU 552.07), states that an auditor need not report on the condensed financial statements provided they are included in a document containing audited financial statements or incorporating such statements by reference to information filed with a regulatory agency. Many accountants believe that if the condensed financial statements of a nonpublic entity refer to the audited statements and location where they may be obtained, an auditor need not report on such condensed statements.

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[The next page is 10,551.]



## Section 9430

### ***Signing and Dating Reports***

#### **.01 Use of Successor Firm Name in Signing Registration Statement**

*Inquiry*—A CPA firm has been requested to provide an opinion on the consolidated financial statements of a client covering a five-year period. During this five-year period, the CPA firm has undergone several changes in its organization and its name:

1. Opinions for the first two years were issued by John Doe & Co.
2. In the third year, the accounting practice merged with another firm and the opinions for years three and four were signed by Doe, Roe & Co. Primary responsibility for the client was retained by the partners of John Doe & Co.
3. This partnership was later dissolved and the opinion in year five was signed by John Doe & Co., who, under the dissolution agreement, retained the working papers for this client.

Since it is impracticable to obtain the consent of each partner of the dissolved partnership, may the opinion on the five-year statements be issued by John Doe & Co.?

*Reply*—This situation is discussed in Statement on Auditing Standards No. 58, *Reports on Audited Financial Statements*, footnote 21 (AU 508.65, footnote 21). Since the partners of John Doe & Co., as it presently exists, retained primary responsibility for the publicly held company in question during the merger period, and since the firm is a successor in interest to the engagement and has retained all working papers for this client, it appears that, after consideration of these circumstances, the statements of consolidated income for the five-year period may be released solely in the name of John Doe & Co. [Amended]

#### **.02 Reporting on Companies With Different Fiscal Years**

*Inquiry*—A CPA has a client whose fiscal year ends on June 30. A parent company of this client now wishes to go public and must file consolidated financial statements with the SEC. The parent company, however, observes a fiscal year ending on December 31.

The CPA has been asked by the parent to provide financial statements with an auditor's opinion for the year ending December 31, 19X3. To do this, the auditor must assemble figures for the period January 1, 19X3, to June 30, 19X3, from the financial statements for the year ended June 30, 19X3, and figures for the period July 1, 19X3, to December 31, 19X3, from the financial statements for the year ended June 30, 19X4.

The CPA has been having difficulty in segregating the financial information into these six-month periods because of the condition of the accounting records. Furthermore, the inventories were not observed nor were the receivables confirmed at the December 31 dates.

Under these conditions, should the CPA express his opinion for the year ended June 30, 19X3, and disclaim an opinion for the six months ended December 31, 19X3?

*Reply*—In order for an auditor to express an opinion on financial statements for prior periods, it is generally not necessary to observe all audit procedures required for the most recent financial statements. SAS No. 58, *Reports on Audited Financial Statements*, paragraph 24, footnote 13 (AU 508.24, footnote 13) (in referring to absence of confirmation of receivables and observation of inventories) indicates that the omission of these procedures at the beginning of the year is not required to be disclosed in situations where the independent auditor has satisfied himself by other auditing procedures. However, he may wish to disclose the circumstances of the engagement and briefly describe the other procedures.

Generally, if the client's records are reasonably well kept and the auditor has satisfied himself as to year-end financial statements, review of ratios of sales to cost of sales and determination that accruals have been properly recognized at the interim date will enable an auditor to satisfy himself that the financial statements at an intervening interim date are fairly presented. On the other hand, if no perpetual inventory records are kept and if the client has not prepared inventories as of the interim date, it may not be practicable to reconstruct such inventory, and a disclaimer of opinion must be expressed on the reconstructed statements. In such circumstances, it would appear necessary that the auditor indicate in a middle paragraph that, due to the fact that he was not engaged to make an audit of financial statements as of such date until June 30, 19X4, he was not in a position to observe the amount of inventory at such date and is unable to satisfy himself thereto by the application of other auditing procedures. If this be the case, the SEC would probably be willing to accept combined income statements based on statements of the subsidiary company as of a date six months different than the parent and to accept unconsolidated balance sheets, with the balance sheet of the subsidiary being presented as of its appropriate year-end. The absence of correspondence with debtors and creditors would probably not cause similar problems. [Amended]

## .05 Signing of Independent Auditor's Report

*Inquiry*—Should the independent auditor's report be manually signed?

*Reply*—SAS No. 58, *Reports on Audited Financial Statements*, paragraph 8 (AU 508.08), indicates that one of the basic elements of the report is "the manual or printed signature of the auditor's firm."

Although SAS No. 58 (AU 508) does not require a manual signature, Department of Labor and Securities and Exchange Commission regulations require manual signatures in certain circumstances.

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[The next page is 10,751.]

## Section 9510

### ***Special Reports***

#### **.01 Determination of Sales Price Based on Auditor's Report**

*Inquiry*—A CPA has been designated by a contract of sales to prepare a statement of “net current assets” and a statement of net income of the selling firm. Both are elements in the determination of the sales price.

A disagreement has arisen between the seller and the buyer as to the pricing of the inventory which represents the major portion of the “net current assets.” The seller relies on a formula represented as “heretofore agreed . . .” The buyer demands a formula “based upon good accounting practice.”

The CPA believes he may have to submit two inventory values to comply with the contract provisions—one to describe the “net current assets” which will use the formula set forth in the contract, and a second using the normal pricing methods of prior years. There is a major variation between the two. The formula in the contract was not represented as being based on good accounting methods but was developed by management after the date of their latest audit.

Can the CPA express an unqualified opinion on each of the two statements if different price bases are used provided full disclosure is made?

*Reply*—This is a special report situation and these are special circumstances in which the auditor may have a certain reporting latitude he might not otherwise have. Since seller and buyer were both parties to the contract, the CPA was designated by the contract to prepare specified statements, and the contract apparently describes a special formula to be used in pricing inventories, the CPA would ordinarily perform strictly according to the terms of the engagement and report on one set of statements as being fairly presented or correctly presented in accordance with the specified contractual formula.

However, since the CPA is aware of the basic disagreement between seller and buyer, he might be much more helpful towards ultimately resolving the issue if he were to prepare statements on both bases.

The auditor may properly report on the two statements prepared in accordance with different inventory pricing bases, full disclosure, of course, being assumed. A more significant question, under the circumstances, is whether he has (or can obtain) consent from both parties modifying the terms of the engagement to allow preparation of the statements on a dual basis.

#### **.03 Audit of Sales for Percentage-of-Sales Lease Agreements**

*Inquiry*—Tenants' lease agreements with a large shopping center provide for a minimum annual rental plus a percentage rent for sales in excess of a certain dollar amount. In accordance with the leases, the shopping center has engaged the services of a CPA to verify that sales exceeding the specified minimum base are being reported. If the CPA is satisfied that the internal control of a tenant is good, may he rely on copies of sales tax returns filed with the state as sufficient evidence for his examination? Is any further verification necessary if a tenant submits a written confirmation of its annual sales from its CPA?

*Reply*—The degree of reliance which the auditor can place on the work of a tenant's CPA will depend upon many considerations such as those described in section 543 of Statement on Auditing Standards No. 1. Comparison of the sales figure reported to the client with the figure reported on the tenant's sales tax return would not in itself be sufficient verification, and additional procedures will be necessary.

An audit program suitable for determining the annual sales of the tenants will have to be highly flexible. Flexibility is required so as to enable the field auditors involved to adjust the audit procedures employed from store to store, as dictated by changes in types of merchandise sold, selling policies employed, sufficiency of records maintained, adequacy of internal control, etc. Accordingly, the depth of the examination will vary to some extent with almost every tenant audited.

Procedures might include examining weekly cash reports submitted by store managers and comparing these reports with general ledger entries, bank statements, and state and federal tax returns, and test checking consecutively numbered sales invoices.

Perhaps the most important documents to play a role in such an examination of the tenants' sales will be the lease agreements which provide the very basis for such examination and which may well contain restrictions on the number and type of records and reports that each tenant will be required to make available.

#### **.07 Statement of Cash Receipts and Disbursements**

*Inquiry*—What is the appropriate language for audit, review, and compilation reports on a statement of cash receipts and disbursements?

*Reply*—Report language will vary depending on the level of service performed. A statement of cash receipts and disbursements is a financial statement prepared under an other comprehensive basis of accounting (see SAS No. 62, *Special Reports* (AU 623.04), and SSARS 1, *Compilation and Review of Financial Statements* (AR 100.04)). It is a pure cash-basis financial statement that summarizes cash activity of the entity, including the individual sources and uses of cash, and may be the only financial statement prepared for the period.

Audit reports on this financial statement should contain a separate paragraph that states the cash receipts and disbursements basis of accounting is being used and that it represents a comprehensive basis of accounting other than GAAP (see SAS No. 62, paragraph 5(d) [AU 623.05(d)]). This extra paragraph is not required for full-disclosure compilation and review reports as long as the notes state the basis of accounting used and describe how that basis differs from GAAP (see Interpretation No. 12 of SSARS 1 (AR 9100.42)). A compilation report on financial statements that omit substantially all disclosures must also describe the basis of accounting used if such disclosure is not provided on the face of the statements or in an attached note (see Interpretation No. 12 of SSARS 1 (AR 9100.43)).

Illustrations of audit, review, and compilation reports on statements of cash receipts and disbursements follow:

##### **A) Audit**

We have audited the accompanying statements of cash receipts and disbursements of XYZ Company for the years ended December 31, 19X2 and 19X1. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As described in Note X, the financial statements have been prepared on the cash receipts and disbursements basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the cash receipts and disbursements of XYZ Company for the years ended December 31, 19X2 and 19X1, on the basis of accounting described in Note X.

**B) *Review***

I (We) have reviewed the accompanying statements of cash receipts and disbursements of XYZ Company for the years ended December 31, 19X2 and 19X1, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

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

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

**C) *Compilation With Full Disclosure***

I (We) have compiled the accompanying statements of cash receipts and disbursements of XYZ Company for the years ended December 31, 19X2 and 19X1, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

**D) *Compilation With Substantially All Disclosures Omitted***

I (We) have compiled the accompanying statements of cash receipts and disbursements of XYZ Company for the years ended December 31, 19X2 and 19X1, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The financial statements have been prepared on the cash receipts and disbursements basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

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

Management has elected to omit substantially all of the informative disclosures ordinarily included in financial statements prepared on the cash receipts and disbursements basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user's conclusion about the Company's cash receipts and disbursements. Accordingly, these financial statements are not designed for those who are not informed about such matters.

[Amended February 1995.]

### **.08 Statutory Basis Financial Statements Differ From GAAP**

*Inquiry*—Financial statements filed with a state regulatory agency are prepared on a statutory basis which differs from generally accepted accounting principles (GAAP). How should the accountant report on the financial statements if he knows they will be distributed to third parties other than the regulatory agency?

*Reply*—A practical way of handling this situation can be found in SAS No. 62, *Special Reports*, paragraph 5, footnote 4 (AU 623.05, footnote 4), which refers to amended SAS No. 1, section 544, *Lack of Conformity With Generally Accepted Accounting Principles* (AU 544). In accordance with SAS No. 1, section 544, paragraph 4 (AU 544.04), the auditor's report would take the following format:

- The first paragraph would be the standard introductory paragraph.
- The second paragraph would be the standard scope paragraph.
- The third paragraph would be an explanation in full of the differences between GAAP and the state mandated policies, or alternatively, a brief description of the differences with a reference to a footnote identifying these differences in detail.
- The fourth paragraph would be the qualified or adverse opinion regarding the application of GAAP.
- The fifth paragraph would be an opinion stating whether the financial statements are presented in conformity with the prescribed basis of accounting mandated by the state regulatory agency.

[Amended]

### **.13 Report Distribution Restriction Related to Financial Statements Prepared on a Basis of Accounting Prescribed in an Agreement**

*Inquiry*—An auditor was asked to report on special purpose financial statements of a corporation prepared in conformity with a basis of accounting that departs from GAAP and that does not constitute an other comprehensive basis of accounting. Certain assets, such as receivables, inventories, and other properties, have been valued on a basis specified in the agreement (fair market value). Must the auditor issue a report containing a paragraph that restricts the distribution of the report?

*Reply*—Yes. SAS No. 62, *Special Reports*, paragraph 29(g) (AU 623.29(g)), states that in such circumstances, a paragraph restricting the distribution of the report to those within the entity, to the parties to the contract or agreement, for filing with a regulatory agency, or to those with whom the entity is negotiating directly is required.

**.14 Liquidation Basis Financial Statements**

*Inquiry*—The stockholders of a corporation adopted a plan of complete liquidation. The liquidation will occur over a period of three years. What constitutes the basic financial statements following the adoption of the plan, and on what basis should those statements be presented?

*Reply*—Auditing Interpretation No. 8 of SAS No. 58, "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting (AU 9508.33-.38)," states that a liquidation basis of accounting may be considered generally accepted accounting principles for entities in liquidation or for which liquidation appears imminent.

The financial statements of entities adopting a plan of liquidation may be presented with financial statements of a prior period that were prepared on a going concern assumption. The basic financial statements following the adoption of a plan of liquidation consist of a statement of net assets in liquidation, and the related statement of changes in net assets in liquidation.

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[The next page is 10,851.]





## Section 9520

### ***Reliance on Others***

#### **.01 Definition of “Principal Auditor”**

*Inquiry*—In the situation where one auditor relies on the work of another auditor, the term “principal auditor” is used. How is the term “principal auditor” defined?

*Reply*—The “principal auditor” is the auditor expressing an opinion on the financial statements of the parent company or on the consolidated financial statements of several companies, while the “other independent auditor” expresses an opinion on the financial statements of a subsidiary, division, or branch whose statements are being incorporated therein. The term “primary auditor” is also used in this connection as the equivalent of “principal auditor.”

#### **.02 Responsibility for Audit of Dividend Fund Managed by Agent**

*Inquiry*—A mutual fund employs a management company to act as its dividend disbursing agent and transfer agent. Dividend checks to the individual shareholders of the mutual fund are drawn from a “dividend disbursing agency fund.” This account, however, does not appear as an asset or liability on the books of either the mutual fund or the management company.

Is it the responsibility of the mutual fund’s auditors or the management company’s auditors to audit the dividend disbursing agency fund?

*Reply*—Since it is one of the primary responsibilities of the management company for the mutual fund, to draw and pay individual dividend checks to the fund’s shareholders, it would be appropriate for, if not incumbent upon, the management company’s auditors, in connection with their audit, to see that this function is being properly discharged, even though the account from which these checks are disbursed does not appear as an asset or liability on the books of either the fund or the management company.

#### **.04 Reliance on State Grain Inspectors for Inventory Measurements**

*Inquiry*—A grain company operates several storage elevators. The company maintains perpetual inventory records for all facilities—both at the elevators and the home office. State grain inspectors measure the stored grain and in effect perform the same audit functions as the CPA firm. Past experience has been that the differences between the measurements of the state inspectors, the CPA firm, and the perpetual inventory records are immaterial. The state inspectors are qualified with years of experience. Can the CPA firm accept the findings of the state inspectors as adequate inventory observation in accordance with generally accepted auditing standards?

*Reply*—Auditing Interpretation No. 1 of SAS No. 58, “Report of an Outside Inventory-Taking Firm as an Alternative Procedure for Observing Inventories,” especially paragraphs .05 and .06 can be applied to this situation: The CPA firm could use the measurements and calculations of the state grain inspectors but not as a complete substitute for its own independent inventory observation.

**.06 Use of Other Auditors' Work When They Are Not Independent**

*Inquiry*—SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*, provides guidance when part of the audit is performed by other independent auditors. How does the lack of independence of the other auditors affect the use of their work and reports by the principal auditor?

*Reply*—In these circumstances, the work and reports of the other auditors cannot be used in accordance with SAS No. 1, section 543. The responsibility for the audit report on the financial statements rests solely with the principal auditor.

Therefore, judgments about assessments of inherent and control risk, the materiality of misstatements, the sufficiency of tests performed, the evaluation of significant accounting estimates, and other matters affecting the auditor's report should always be those of the principal auditor.

The principal auditor, however, may use his or her judgment in evaluating the work of the other auditors who are lacking in independence in the way he or she would consider the work performed by internal auditors.

**.07 Reference to Other Auditors in Accompanying Information Report**

*Inquiry*—An audit report is based in part on the report of other auditors. If the principal auditor makes reference to other auditors' work in the audit report, must the report on accompanying information, which includes data audited by other auditors, include a reference to other auditors' work?

*Reply*—Yes. If a portion of the financial statements was audited by other auditors and the principal auditor's report refers to the other auditors, the principal auditor's report on the accompanying information, which includes data audited by other auditors, also should refer to other auditors' work.

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[The next page is 10,951.]

## Section 9530

### ***Limited Scope Engagements***

#### **.01 Auditor's Report if Inventories Not Observed—I**

*Inquiry*—Clients sometimes impose restrictions on their auditors with regard to the observation and testing of inventory because of the costs involved, yet they still want an opinion from the auditor. What type of opinion can be issued in such circumstances when the inventory is 10 percent or more of total assets?

*Reply*—SAS No. 58, *Reports on Audited Financial Statements*, paragraphs 20–26 (AU 508.20–26) and 61–63 (AU 508.61–63), indicates that if either confirmation of receivables or observation of inventories is omitted because of a restriction imposed by the client, and such inventories or receivables are material, the auditor should modify the scope paragraph and indicate clearly in an explanatory paragraph the limitations on his work and, generally, should disclaim an opinion on the financial statements taken as a whole.

The word “generally” may be interpreted to exclude those situations in which inventories or receivables are material, but are not sufficiently material to require a disclaimer of opinion. SAS No. 58, paragraph 23, would appear to govern in such situations. The materiality of inventory would depend on other factors than just the ratio of inventory to total assets, involving among others the ratio of inventory not examined to stockholders' equity for a statement of financial position and the ratio of inventory to income before taxes for a statement of operations. Unless circumstances are unusual, it is doubtful that inventories could be considered not material if they amount to as much as 10 percent of total assets.

It is conceivable that there might be circumstances where, although the scope of the audit omitted observation of inventories which were in excess of 10 percent of total assets, a qualified opinion on the financial statements might be appropriate. [Amended]

#### **.02 Auditor's Report if Inventories Not Observed—II**

*Inquiry*—An auditor has been engaged by a corporation on a limited scope basis. The engagement does not include any independent verification of the inventory. The auditor will not be present at any physical inventory taking and the pricing and clerical accuracy of the inventory will not be tested. The inventory is material in relation to the other accounts on the client's financial statements.

What type of opinion can the auditor give under these circumstances?

*Reply*—The disclaimer of opinion in SAS No. 58, *Reports on Audited Financial Statements*, paragraph 63 (AU 508.63), is appropriate when the scope limitation precludes inventory observation and any other audit tests of the inventories.

The example shown in SAS No. 58, paragraph 63 (AU 508.63), is as follows:

(Introductory paragraph)

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained

earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

(Second (scope) paragraph of standard report should be omitted)

(Explanatory paragraph)

The Company did not make a count of its physical inventory in 19X2 or 19X1, stated in the accompanying financial statements at \$..... as of December 31, 19X2, and at \$..... as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

(Disclaimer paragraph)

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

## .06 Distinctions Between Scope Limitations

*Inquiry*—SAS No. 58, *Reports on Audited Financial Statements*, paragraph 24 (AU 508.24), states in part: "When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements."

SAS No. 58, paragraph 24, footnote 13 (AU 508.24, footnote 13), states: "Circumstances such as the timing of his work may make it impracticable or impossible for the auditor to accomplish these procedures. In this case, if he is able to satisfy himself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of his work, and his report need not include a reference to the omission of the procedures or to the use of alternative procedures . . . ."

Based on the above excerpts, what is an appropriate auditor's report in each of the following situations:

Auditor is not permitted to confirm receivables but is able to satisfy himself by other means?

Auditor is not permitted to observe inventories but is able to satisfy himself by other means?

Is there a distinction between a client-imposed limitation regarding receivables or inventories and other client-imposed scope limitations?

*Reply*—If a client refuses to permit confirmation of receivables but the auditor is able to satisfy himself by other means, the auditor may express an unqualified opinion.

If a client refuses to permit observation of inventories but the auditor is able to satisfy himself (except as to physical quantities) by other means, the auditor cannot express an unqualified opinion. The client-imposed restriction does not enable the auditor to "make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions" in accordance with SAS No. 1, section 331, *Receivables and Inventories*, paragraph 12 (AU 331.12). SAS No. 58, paragraph 24, footnote 13 (AU 508.24, footnote 13), contemplates circumstances that are not related to any client-imposed restrictions, and are not within the control of either the client or the auditor.

SAS No. 58, paragraph 23 (AU 508.23), states: "The auditor's decision to qualify his opinion or disclaim an opinion because of a scope limitation depends on his assessment of the importance of the omitted procedure(s) to his ability to form an opinion on the financial statements being audited. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, this significance is likely to be greater than if only a limited number of items is involved." Client-imposed limitations on confirmation of receivables and observation of inventories, and scope limitations in other areas should be evaluated on the basis of SAS No. 58, paragraph 23 (AU 508.23). Since SAS No. 1, section 331, is still in effect, the evidential matter requirements for receivables and inventories would generally cause auditors to treat scope limitations on these items differently from other scope limitations. The final determination of how to report client-imposed scope limitations can only be made by the independent auditor involved after considering all the surrounding circumstances. [Amended]

### **.07 Inadequate Internal Control and Financial Records**

*Inquiry*—How should the auditor report that he has been unable, because of inadequate internal control and financial records, to satisfy himself that all transactions were recorded?

*Reply*—SAS No. 58, *Reports on Audited Financial Statements*, paragraph 22 (AU 508.22), which deals with scope limitations, states, in part:

Restrictions on the scope of his audit, whether imposed by the client or by circumstances such as the timing of his work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require him to qualify his opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report.

A disclaimer of opinion in this situation would be appropriate under SAS No. 58 (AU 508) if the effects of the inadequacy of internal control and the accounting records are sufficiently pervasive. Otherwise, a qualified opinion may be appropriate. [Amended]

### **.09 Letter of Audit Inquiry Not Sent to Client's Legal Counsel**

*Inquiry*—If a client refuses to send a letter of audit inquiry to its legal counsel, can the auditor express an unqualified opinion on the client's financial statements?

*Reply*—SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, paragraph 6 (AU 337.06), states:

... the auditor should request the client's management to send a letter of inquiry to those lawyers with whom they consulted concerning litigation, claims, and assessments.

SAS No. 12, paragraph 7 (AU 337.07), indicates certain other procedures that might also disclose litigation, claims, and assessments. Failure to send a letter of audit inquiry to legal counsel, when otherwise indicated, is a scope limitation which would ordinarily require the auditor to express other than an unqualified opinion.

**.10 Effect of Generally Accepted Accounting Principles (GAAP)  
Departures on Limited Scope Engagements**

*Inquiry*—The auditor of a company is unable to observe physical inventory at year end due to a restriction imposed by the client. Because the inventory is material, the auditor plans to issue a disclaimer of opinion on the financial statements in accordance with SAS No. 58, *Reports on Audited Financial Statements*, paragraph 61 (AU 508.61).

The auditor also discovers significant mathematical errors in the client's last-in, first-out (LIFO) provision in the prior year. The auditor advises the client to report the error as a prior period adjustment in accordance with APB Opinion No. 20, *Accounting Changes* and APB Opinion No. 9, *Reporting the Results of Operations* (as amended by FASB Statement No. 16, *Prior Period Adjustments*). If the client refuses to do so, the auditor is now faced with a GAAP departure and a disclaimer of opinion—both related to the company's inventory.

How would the GAAP departure affect the auditor's disclaimer of opinion?

*Reply*—Assuming the auditor decided not to withdraw from the engagement, the guidance in SAS No. 58, paragraph 61 (AU 508.61), should be followed. That paragraph discusses disclaimers of opinion and states that the auditor "... should also disclose any other reservations he has regarding fair presentation in conformity with generally accepted accounting principles."

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[The next page is 11,201.]

## Section 9600

# Compilation and Review Engagements

### .01 Compiled Financial Statements Not Adjusted

**Inquiry**—An accountant processes client input on a computer and produces monthly statements that do not include adjustments for changes in inventories, prepayments, and accruals, and do not include notes. Adjustments are recorded annually. Can the accountant state in his report that adjustments to make the statements not misleading have not been made?

**Reply**—No. The specific departures from GAAP must be disclosed. SSARS 1, *Compilation and Review of Financial Statements*, paragraphs 39 and 41 (AR 100.39 and .41), are clear that the accountant must consider whether a modified report is adequate to disclose the departures. SSARS 1, paragraph 40 (AR 100.40) describes the form of report when the accountant concludes that a modified report is appropriate. The departures should be disclosed in a separate paragraph, including the effects of the departures on the financial statements, if known to the accountant, or he should state that the effects have not been determined.

### .02 Inquiries for a Review Engagement

**Inquiry**—SSARS 1, *Compilation and Review of Financial Statements*, Appendix A (AR 100.52), lists certain suggested inquiries for a review engagements. Is a “yes” or “no” response sought?

**Reply**—Appendix A (AR 100.52) states that the list is not intended to serve as a checklist, but to describe the general areas in which inquiries might be made. The inquiries in Appendix A (AR 100.52) are presented for illustrative purposes only. They do not necessarily apply to every engagement, nor are they meant to be all-inclusive. The accountant has to bear in mind that he must achieve limited assurance about the financial statements. His inquiry and analytical procedures should be designed to provide him with that assurance. A review should not be treated as a mechanical exercise to obtain “yes” or “no” answers to the illustrative inquiries. The accountant should exercise professional judgment based on all relevant circumstances in designing his inquiries and evaluating responses. While some of the inquiries can be answered “yes” or “no,” others cannot because they are asking “what are the procedures . . .”

### .04 Financial Statements Marked As “Unaudited”

**Inquiry**—Should each page of compiled or reviewed financial statements of nonpublic companies be marked “unaudited”?

**Reply**—No. SSARS 1, *Compilation and Review of Financial Statements* (AR 100), does not require that each page of compiled or reviewed financial statements of a nonpublic entity be marked as “unaudited.” Before SSARS 1 (AR 100) was issued, it was common practice to mark each page as “unaudited”; however, this practice was discontinued after SSARS 1 (AR 100) was issued because the phrase “unaudited” does not communicate to the reader the financial statement service performed.

SSARS 1 (AR 100) does require, however, that each page of the financial statements include a reference such as "See Accountant's Compilation Report" (AR 100.16) or "See Accountant's Review Report" (AR 100.34), as appropriate. [Amended February 1995]

### **.08 Supplementary Information**

*Inquiry*—Are supporting schedules of balance sheet or income statement accounts considered supplementary information? If so, what are the reporting requirements in a review or compilation engagement?

*Reply*—SSARS 1, *Compilation and Review of Financial Statements*, paragraph 43 (AR 100.43), pertains to reporting on supplementary information that accompanies the basic financial statements in a review or compilation engagement. The basic financial statements are usually considered to be the balance sheet, statement of income, statement of retained earnings or changes in stockholders' equity, and statement of cash flows. Descriptions of accounting policies and notes to financial statements are also considered part of the basic financial statements and are usually identified as such, for example, by a legend on the balance sheet, etc., indicating that the notes are an integral part of the financial statements. If supporting schedules of balance sheet or income statement accounts are not identified as being part of the basic financial statements, they are considered supplementary information.

If the information does not accompany the basic financial statements, it is not supplementary information. Under SSARS 1, paragraph 4 (AR 100.04), it does not meet the definition of a financial statement, and therefore, the accountant does not have a reporting obligation. However, the accountant may want to issue a report to clarify his or her responsibility. This can be done by modifying the standard compilation report (SSARS 1, paragraph 17 (AR 100.17)) to refer to the schedules. [Amended]

### **.09 Application of SSARS 3 to Certain Companies Required to File With Regulatory Bodies**

*Inquiry*—Some nonpublic entities, as defined in SSARS 2, *Reporting on Comparative Financial Statements*, paragraph 1, footnote 2 (AR 200.01, footnote 2), such as privately owned brokers or dealers in securities, may be required to include unaudited financial statements in a form prescribed by a regulatory body concerned with the sale or trading of securities, such as the National Association of Securities Dealers or the New York Stock Exchange. Does the first sentence of SSARS 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms*, paragraph 2 (AR section 300.02), preclude an accountant from using the alternative form of report illustrated in SSARS 3 (AR 300) in those circumstances?

*Reply*—No. SSARS 3, paragraph 2, excludes from the definition of a prescribed form those forms "... concerned with the sale or trading of securities." In that context, "securities" refers to those issued or to be issued by the entity submitting the prescribed form. Accordingly, an accountant is not precluded in the circumstances described in this question from using the alternative form of compilation report illustrated in SSARS 3 if the entity is not submitting the prescribed form in connection with the actual or contemplated sale or trading of its own securities.



**.10 Review of Financial Statements Included in a Prescribed Form**

*Inquiry*—SSARS 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms*, paragraph 3, states that “in the absence of a requirement or a request for a review report on the financial statements included in a prescribed form, the following form of standard compilation report may be used when the unaudited financial statements of a nonpublic entity are included in a prescribed form that calls for departure from generally accepted accounting principles . . .” Can an accountant perform a review of financial statements included in a prescribed form that are presented on a basis other than generally accepted accounting principles?

*Reply*—A review can be performed on the financial statements included in a prescribed form prepared under any comprehensive basis of accounting (as defined in SAS No. 62, *Special Reports*, paragraph 4), but SSARS 1, *Compilation and Review of Financial Statements*, reporting standards would apply, not those in SSARS 3. SSARS 3, paragraph 1, states in part:

The requirements of SSARS 1 and SSARS 2 are applicable when the unaudited financial statements of a nonpublic entity are included in a prescribed form. This statement amends SSARS 1 and SSARS 2 to provide for an alternative form of standard compilation report when the prescribed form or related instructions call for departure from generally accepted accounting principles by specifying a measurement principle not in conformity with generally accepted accounting principles or by failing to request the disclosures required by generally accepted accounting principles.

Accordingly, where the prescribed form calls for the departures referred to above, a review report expressing limited assurance under SSARS 1 would be appropriate provided that, as required by SSARS 1, paragraph 40, the review report discloses the departures from generally accepted accounting principles, including the departures called for by the prescribed form.

**.11 Computer Generated Financial Statements**

*Inquiry*—A firm recently purchased a new computer which will enable it to have some of its clients access this computer via a phone terminal in their office. The client will input all information into the firm’s computer including journal entries and will be able to prepare its own financial statements which will be received via the client’s phone terminal. No one in the accounting firm directly inputs data into the computer or sees the financial statements. Is the accounting firm required to attach a compilation report for this type service?

*Reply*—No. If the client directly inputs data from its office into the computer and generates the financial statements in the client’s office directly from the computer, the firm does not have a reporting responsibility. However, if the financial statements are generated by the CPA in the firm’s office, there is a reporting responsibility as discussed in SSARS 1, *Compilation and Review of Financial Statements*, paragraph 7. [Amended]

**.12 Use of Other Comprehensive Basis of Accounting (OCBOA) for Interim Financial Statements and Generally Accepted Accounting Principles (GAAP) for Annual Financial Statements**

*Inquiry*—What are the reporting implications when a client uses OCBOA for interim financial statements and GAAP for annual statements?

*Reply*—A privately-held company may use OCBOA for interim financial statements and GAAP for annual financial statements. However, the report on interim financial statements should be prepared in accordance with the requirements of SAS No. 62, *Special Reports* (AU 623).

For publicly-traded companies, APB Opinion No. 28, *Interim Financial Reporting*, paragraph 10, states in part, "the results for each interim period shall be based on the accounting principles and practices used by an enterprise in the preparation of the latest annual financial statements unless a change in an accounting practice or policy has been adopted in the current year." Therefore, for publicly-held companies, OCBOA reporting for interim financial statements would not be allowed. [Amended]

#### **.14 Uncertainties/Going Concern Problems**

*Inquiry*—SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU 341), provides guidance on that subject as it would affect the auditor's report under SAS No. 58, *Reports on Audited Financial Statements* (AU 508). What is the appropriate guidance on how to deal with uncertainties under the statements on standards for accounting and review services?

*Reply*—SSARS 1, *Compilation and Review of Financial Statements*, footnote 18 (AR 100.40, footnote 18), states that "normally, neither an uncertainty nor an inconsistency in the application of accounting principles would cause the accountant to modify the standard report provided the financial statements appropriately disclose such matters." Accordingly, disclosure of this uncertainty in a footnote to the financial statements would satisfy this requirement. SSARS 1, footnote 18 (AR 100.40, footnote 18), further states, "nothing in this statement, however, is intended to preclude the accountant from emphasizing in a separate paragraph of his report a matter regarding the financial statements."

The last two paragraphs of Interpretation No. 11 of SSARS 1 (AR 9100.33 through .40), "Reporting on Uncertainties," indicates there is no requirement to disclose an uncertainty in the accountant's report, under certain conditions, when management has elected to omit substantially all disclosures required by generally accepted accounting principles. [Amended]

#### **.15 Consistency**

*Inquiry*—A correction of an error in previously issued financial statements is treated as a prior period adjustment, in accordance with FASB Statement No. 16, *Prior Period Adjustments* (AC A35). SAS No. 1, section 420, *Consistency of Application of Generally Accepted Accounting Principles*, paragraph 11 (AU 420.11), discusses a correction of an error in principle and states that a change from an accounting principle that is not generally accepted to one that is generally accepted, including correction of a mistake in the application of a principle, is a correction of an error. Although this type of change in accounting principle should be accounted for as the correction of an error, the change requires recognition in the auditor's report through the addition of an explanatory paragraph. How is this consistency issue treated in compilation and review engagements?

*Reply*—SSARS 1, *Compilation and Review of Financial Statements*, footnote 18 (AR 100.40, footnote 18), states that "Normally, neither an uncertainty, including an uncertainty about an entity's ability to continue as a going con-

cern, nor an inconsistency in the application of accounting principles would cause the accountant to modify the standard report provided the financial statements appropriately disclose such matters." Accordingly, disclosure of this inconsistency in a footnote to the financial statements would satisfy this requirement. SSARS 1, footnote 18 (AR 100.40, footnote 18), further states, "... nothing in this statement, however, is intended to preclude an accountant from emphasizing in a separate paragraph of his or her report a matter regarding the financial statements." [Amended]

#### **.16 Reference to Accountant's Report in Notes to Financial Statements**

*Inquiry*—SSARS 1, *Compilation and Review of Financial Statements*, paragraphs 16 and 34 (AR 100.16 and .34), requires that each page of the financial statements compiled or reviewed by the accountant include a reference such as "See Accountant's Compilation (or Review) Report."

Does this requirement extend to the related notes to the financial statements?

*Reply*—The application of this requirement varies in practice.

Some accountants believe that since the related notes to financial statements are an integral part of the basic financial statements, at least the first page of the notes should include a reference to the accountant's report.

Other accountants believe that if the basic financial statements, other than footnote disclosures, contain a statement indicating that the notes to financial statements are an integral part of the statements, it is not necessary to include a reference to the accountant's report on note pages.

#### **.18 Bank Engaged a CPA Firm to Compile a Financial Statement of Another Entity**

*Inquiry*—A bank has engaged a CPA firm to compile a balance sheet for another entity. The bank has possession of the books and records of the entity. Can the firm issue a compilation report under such circumstances?

*Reply*—There is nothing in the Statements on Standards for Accounting and Review Services which precludes the CPA firm from issuing a compilation report under such circumstances. However, SSARS 1, *Compilation and Review of Financial Statements*, paragraph 11 (AR 100.11), states: "To compile financial statements, the accountant should possess a general understanding of the nature of the entity's business transactions, the form of its accounting records, the stated qualifications of its accounting personnel, the accounting basis on which the financial statements are to be presented, and the form and content of the financial statements." Due to the nature of the engagement, the CPA firm may not be able to attain a sufficient level of understanding of the entity's business as required by SSARS 1, paragraph 11 (AR 100.11), to issue a compilation report on the balance sheet, nor obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed, as required by Rule 201(D) of the AICPA Code of Professional Conduct (ET 201.01D). (See SSARS 1, paragraph 3 (AR 100.03)). [Amended]

#### **.19 Issuance of an Audit Report on Financial Statements Which Have Already Been Reviewed**

*Inquiry*—If an accountant has issued a review report on a set of financial statements may he later issue an audit report on the same set of financial statements?

*Reply*—Yes. Interpretation No. 3 of SSARS 1, *Compilation and Review of Financial Statements* (AR 9100.06 through .12), states that SSARS 1 does not prohibit the accountant from accepting an engagement to perform a higher level of service with respect to financial statements that have been previously compiled or reviewed.

## **.20 Reissuance When Not Independent**

*Inquiry*—An accountant performed a review in the prior year and a compilation in the current year. He was independent in the prior year but impaired his independence in the current year. May he reissue his review report on the prior year financial statements?

*Reply*—Yes. SSARS 2, *Reporting on Comparative Financial Statements*, paragraph 8 (AR 200.08), states in part, "A continuing accountant who performs a lower level of service with respect to the financial statements of the current period should either (a) include as a separate paragraph of his report a description of the responsibility assumed for the financial statements of the prior period . . . or (b) reissue his report on the financial statements of the prior period." The separate paragraph referred to in item (a), above, includes a statement that the accountant has not performed any procedures in connection with the prior period review engagement after the date of his review report as reflected in the example in SSARS 2, paragraph 12 (AR 200.12).

## **.22 Reporting on Financial Statements Submitted by Management**

*Inquiry*—A corporation's chief financial officer has been asked to prepare and submit his employer's financial statements to a bank. May the CFO use the standard compilation report?

*Reply*—No. The compilation report is inappropriate. A compilation report is used by an outside accountant to report upon financial statements that are the representation of another party, namely, the management of a nonpublic company. The compilation report describes the outside accountant's limited responsibility and inability to express an opinion or any other form of assurance based on the limited procedures performed. The CFO, on the other hand, is a part of management and is intimately involved in the preparation of the financial statements. A CFO has direct responsibility for the design and operation of the accounting system, the design and operation of most control procedures and much of the control environment.

There are no standards on how a company's CFO should report on the company's financial statements when those statements are transmitted to third parties. However, it seems appropriate for a CFO to issue a report stating management's responsibility for the financial statements. Such a report might be modeled after the management responsibility letter typically contained in annual reports and may be worded as follows:

The accompanying balance sheet of Company X as of December 31, 19XX and the related statements of income, retained earnings and cash flows for the year then ended have been prepared by management who is responsible for their integrity and objectivity. These statements have not been compiled, reviewed or audited by outside accountants.

Company X maintains an internal control structure designed to provide reasonable assurance that assets are safeguarded and that transactions are properly executed, recorded and summarized to produce reliable records and reports.

To the best of management's knowledge and belief, the statements and related information were prepared in conformity with generally accepted accounting principles, and are based on recorded transactions and management's best estimates and judgments.

Signature as chief financial officer

## **.24 Issuing a Compilation Report With Substantially All Disclosures Omitted After Issuing a Report on Financial Statements Containing Full Disclosure**

*Inquiry*—A client wants to submit financial statements with substantially all disclosures omitted to one of its vendors. May the accountant issue a compilation report on those financial statements with substantially all disclosures omitted, if he or she previously issued an audit, review, or compilation report on financial statements with full disclosure for the same reporting period?

*Reply*—Generally, yes. This issue is not specifically addressed by the authoritative literature. However, SSARS 1, paragraph 19 (AR 100.19), provides indirect guidance on this matter. It states that an accountant may compile financial statements that omit substantially all disclosures provided the omission of the disclosure is clearly indicated in the report and is not, to the accountant's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use the financial statements.

If the accountant believes that the client's intent is to mislead users, the accountant should *not* comply with the request. However, if the accountant concludes that it is not the client's intent to mislead users, it would be appropriate to compile financial statements with substantially all disclosures omitted after having compiled, reviewed, or audited full-disclosure financial statements.

Some practitioners are reluctant to compile financial statements they have previously audited or reviewed because the accountant's compilation report will read:

I have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

They conclude that the disclaimer in the report would be misleading to financial statement users in these circumstances because the accountant has, in fact, audited or reviewed the financial statements. They believe the aforementioned disclaimer precludes the accountant from compiling financial statements after auditing or reviewing them. The disclaimer in the compilation report, however, is intended to be engagement-specific and, therefore, refers only to the financial statements that accompany the accountant's report. Therefore, the disclaimer language does not present a reporting problem for the current engagement.

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## Section 9900

### Other Reporting Issues

#### .02 Furnishing Unbound Reports to Clients

*Inquiry*—A CPA gets numerous requests from clients for a set of unbound financial statements along with the usual bound sets. The unbound copy is usually reproduced on their copying machines for periodic distribution to suppliers and others. Should the CPA continue to provide these unbound statements?

*Reply*—This practice is dangerous since the CPA is assisting in the reproduction of his report without control over such reproduced copies. It would be preferable if he agreed to provide any additional copies of the report which may be required, thus controlling the assembly of the reproduced reports.

#### .03 Dates on Cover for Financial Statements

*Inquiry*—SAS No. 26, *Association With Financial Statements*, paragraph 15, specifies that an auditor's report disclose that prior year financial statements presented for comparative purposes are unaudited. Is it appropriate to include the dates of both the current year and prior year financial statements on the cover of the financial statements?

*Reply*—Both years may be included on the cover if the financial statements for the prior year are referred to as unaudited. [Amended]

#### .06 Break-Even Financial Statements

*Inquiry*—Company A requested compiled financial statements with an inventory reported so that the financial statements would reflect no profit or loss ("break-even financial statements"). How would this affect the accountant's compilation report?

*Reply*—"Break-even financial statements" are not in accordance with generally accepted accounting principles. Accordingly, the independent accountant would have to express a reservation in his compilation report because of the departure from generally accepted accounting principles as required by SSARS 1, *Compilation and Review of Financial Statements*, paragraph 40.

#### .07 Financial Statements Cover Period Longer Than Twelve Months

*Inquiry*—Is it acceptable for an auditor to express an opinion on financial statements covering a period longer than twelve months?

*Reply*—It is acceptable provided the title of the financial statements is descriptive of the period covered and the auditor's report clearly indicates the period covered by the financial statements.

#### .08 Title of Auditors' Report

*Inquiry*—Does the auditor's opinion require a title?

*Reply*—SAS No. 58, *Reports on Audited Financial Statements*, paragraph 8 (AU 508.08), states, "... The basic elements of the report are the following: a. A title that includes the word independent . . ." Footnote 3 of SAS No. 58 (AU 508.08, footnote 3) states, "This Statement does not require a title for an auditor's report if the auditor is not independent . . ." Therefore, if the auditor is independent, the auditor's opinion must have a title which includes the word independent.

**.09 Compilation of Pro Forma Information**

*Inquiry*—Statement on Standards for Attestation Engagements, *Reporting on Pro Forma Financial Information*, provides guidance on the examination and review of pro forma financial information. May an accountant issue a compilation report on pro forma information if the related historical financial statements are compiled?

*Reply*—Yes. Although the Statement on Standards for Attestation Engagement is silent with regard to compilation of pro forma information, it does not proscribe issuance of a compilation report on pro forma information.

**.10 Distinction Between Internal and General Use of Financial Statements**

*Inquiry*—Are financial statements differentiated between internal and general use in the professional reporting literature?

*Reply*—Internal use by management and general use of financial statements are no longer differentiated for historical financial statements. However, the distinction between general and internal use is made for financial forecasts and projections.

**.14 Part of Audit Performed by Another Independent Auditor Who Has Ceased Operations**

*Inquiry*—If an auditor who has ceased operations audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in an entity's financial statements, may the principal auditor make reference in his or her report to the audit of that auditor or assume responsibility for that auditor's work in accordance with SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*?

*Reply*—The principal auditor may make reference to the audit of another auditor, or assume responsibility for that auditor's work, only if the other auditor has issued an audit report and the principal auditor has completed the procedures required by SAS No. 1, section 543 prior to the time that the other auditor ceased operations. The procedures described in SAS No. 1, section 543 cannot be appropriately performed after the other auditor has ceased operations. In situations in which the principal auditor cannot use the work of the other auditor in accordance with SAS No. 1, section 543, the principal must perform audit procedures sufficient to afford a reasonable basis for an opinion on the financial statements under audit. However, review of the other auditor's working papers may have an effect on the nature, timing, and extent of those procedures.

**.21 Fiscal Years for Tax and Financial Reporting Purposes Differ**

*Inquiry*—Can an entity have different fiscal years for tax and reporting purposes?

*Reply*—There is no requirement in the accounting literature for the tax and the financial reporting year-end to be the same. However, having different fiscal years complicates further any interperiod tax allocation the entity may have.

**.22 Location Where Report is Issued**

*Inquiry*—Is there a requirement to indicate the city and state where an accountant's report is issued?



*Reply*—The AICPA professional standards do not include such a requirement. However, some SEC regulations require the disclosure. For example, SEC Regulation S-X, section 210.2-02, states, in part, “. . . the Accountant’s Report shall indicate the city and state where issued.”

## **.23 Distinction Between Supplemental Information and Basic Financial Statement Information in an Auditor-Submitted Document**

*Inquiry*—What is an appropriate means of distinguishing between information to be considered a part of the basic financial statements and supplementary information in an auditor-submitted document?

*Reply*—If the basic financial statements refer to specific information (i.e., ‘See Exhibit A—Schedule of Operating Expenses’), such information is considered to be a part of the basic statements and is presumed to have been subjected to the auditing procedures applied to the basic financial statements. This information is therefore not required to be reported on separately and should not be referred to in the auditors’ report. Any additional information presented with the basic financial statements, but not referred to in such statements, should be considered supplementary information unless described otherwise. Such supplementary information should be reported on in accordance with the requirements of SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AU 551).

## **.24 Required Presentation of the Statement of Stockholders’ Equity**

*Inquiry*—Is the statement of stockholders’ equity required when financial position and results of operations are presented?

*Reply*—Disclosure of changes in capital accounts and retained earnings is required. According to APB Opinion No. 12, *Omnibus Opinion—Capital Changes*, paragraph 10 (AC C08.102), “when both financial position and results of operations are presented, disclosure of changes in the separate accounts comprising stockholders’ equity (in addition to retained earnings) . . . is required to make the financial statements sufficiently informative. Disclosure of such changes may take the form of separate statements or may be made in the basic financial statements of notes thereto.”

## **.25 Use of Singular v. Plural Terminology for Accountants and Auditors**

*Inquiry*—In reporting on audited, reviewed, or compiled financial statements, should accountants use singular or plural terminology when referring to themselves?

*Reply*—Use of plural or singular terminology is not addressed in the professional standards. Illustrative auditors’ reports in Statements on Auditing Standards use plural terminology, while the accountants’ reports in Statements on Standards for Accounting and Review Services use both singular and plural.

In practice, sole practitioners often use singular terms; firms that have one partner with professional staff use both singular and plural; and firms that have more than one partner most often use plural. However, the use of singular or plural references to the accountant or auditor is purely discretionary. For ease of report preparation, firms should be consistent in their use of singular or plural in all reports.

**.26 Compilation and Review—Comparative Financial Statements**

*Inquiry*—A nonpublic entity's financial statements for the year ended December 31, 19X1 were compiled by a predecessor accountant. Management had elected to omit substantially all of the disclosures and the statement of cash flows required by generally accepted accounting principles (GAAP).

A successor auditor is engaged to audit the 19X2 financial statements, and the client has asked the auditor to include the 19X1 compiled financial statements for comparative purposes with the 19X2 financial statements.

Is the successor auditor permitted to do this?

*Reply*—No. SSARS 2, *Reporting on Comparative Financial Statements*, paragraph 5 (AR 200.05), states that compiled financial statements that omit substantially all of the disclosures required by GAAP are not comparable to financial statements that include such disclosures.

The 19X1 financial statements would need to be revised to include the statement of cash flows and all disclosures required by GAAP. Either the predecessor or the successor accountant would then need to at least compile the full disclosure financial statements for 19X1.

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# STATEMENTS OF POSITION ACCOUNTING

## Introduction

Statements of Position of the Accounting Standards Division present the conclusions of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. SAS No. 69 is effective for audits of financial statements for periods ending after March 15, 1992. An entity following an accounting treatment as of March 15, 1992, need not change to an accounting treatment specified in a Statement of Position whose effective date is before March 15, 1992. For Statements of Position whose effective date is subsequent to March 15, 1992, and for entities initially applying an accounting principle after March 15, 1992, the accounting treatment specified by that Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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**Section 10,060*****Statement of Position 75-2  
Accounting Practices of Real Estate  
Investment Trusts***

[Recommendation to Financial Accounting Standards Board]

**AICPA**

American Institute of Certified Public Accountants  
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

June 27, 1975

Marshall S. Armstrong, CPA  
Chairman  
Financial Accounting Standards Board  
High Ridge Park  
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on *Accounting Practices of Real Estate Investment Trusts*. It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate. The scope of the Statement is restricted to REITs, although it is acknowledged that the conclusions therein may also be appropriate for companies which are not REITs.

The Statement takes the position that the allowance for losses on loans and foreclosed properties should now be determined based on an evaluation of the recoverability of individual loans and properties and, in this evaluation, the principle of providing for all losses when they become evident should now require the inclusion of all holding costs, including interest, in determining such losses.

The individual evaluation of the loans and foreclosed properties should be made, according to the Statement, as of the close of all annual and interim stockholder reporting periods. This may well result in a need to increase or decrease the allowance for losses with a corresponding charge or credit to income. However, in the case of foreclosed property which the REIT elects to hold as a long-term investment, the Statement concludes that the net realizable value of such property at the date of foreclosure becomes its new basis, and sub-

sequent increases in market values of such properties should generally not be recorded until the time of a later exchange transaction which confirms the amount of any increase.

The Statement also takes the position that recognition of interest revenue should be discontinued when it is not reasonable to expect that the revenue will be received and enumerates conditions which should now be regarded as establishing a presumption that the recording of interest should be discontinued.

Finally, the Statement concludes that commitment fees should be amortized over the combined commitment and loan period, and provides guidance with respect to appropriate accounting by a REIT for operating support from its adviser.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

STANLEY J. SCOTT  
Chairman  
Accounting Standards Division

cc: Securities and Exchange Commission

**NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

## **ACCOUNTING PRACTICES OF REAL ESTATE INVESTMENT TRUSTS<sup>[\*]</sup>**

### **INTRODUCTION**

.01 Real estate investment trusts (REITs) have in recent years assumed an increasingly important role in the real estate industry. REITs are business trusts and are generally publicly-held. They employ equity capital, coupled with substantial amounts of debt financing, in making real estate loans and investments.

.02 A REIT, if it so elects, will not be required to pay Federal corporate income taxes (other than that on "tax preference" items) if, among other things, at least 90% of its taxable income, as defined, is distributed to its shareholders. This Statement, however, is not restricted to those REITs which have elected such tax treatment.

.03 The accounting problems discussed in this Statement of Position may also be encountered by other companies which are not REITs but which are engaged in the business of making loans on or investing in real estate. The conclusions in this Statement of Position may, therefore, also be appropriate for those companies. However, the accounting practices of companies which are not REITs are beyond the scope of this Statement of Position.

.04 REITs have engaged in a variety of lending and investing activities, some of which are listed below.

*Construction loans* are generally short-term first mortgage loans to finance the construction of residential, commercial or industrial properties. Interest revenue on such loans is usually accrued and added to the loan balance, which is paid from the proceeds of permanent financing.

*Development loans* are short-term first mortgage loans to finance site development costs. They are usually paid from proceeds of a construction loan.

*Land acquisition loans* are first mortgage loans to finance the acquisition (not the development) of sites.

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<sup>[\*]</sup> [Footnote deleted.]

*Long and intermediate term loans* are generally conventional mortgage loans to finance completed properties.

*Purchase leasebacks* consist of the simultaneous purchase and leaseback to the seller of real estate properties.

*Equity investments in real estate* are direct ownership interests, under a variety of forms, in improved or unimproved real estate.

*Junior mortgage loans* are real estate loans subject to the lien of a prior mortgage.

*Wrap-around loans* are junior mortgage loans to provide an owner with funds without disturbing a prior first mortgage loan which, for various reasons, is not liquidated.

*Gap loans* are junior mortgage loans to finance a temporary spread between amounts advanced and amounts committed under a prior first mortgage loan.

*Warehousing loans* are short-term loans secured by the pledge of mortgage loans.

.05 In connection with real estate loans, a REIT may issue a commitment, which is an agreement to make a mortgage loan in the future at specified terms.

.06 A REIT's financial success is often dependent upon external factors, among which are the operations of its contractor-borrowers, the availability to those contractors of long-term mortgage funds when projects are completed, and the general condition of the real estate industry. The success of the REIT is also dependent upon its ability to obtain financing at rates less than that earned on its portfolio of investments.

.07 Considerable attention has recently been given to the accounting practices of REITs, particularly those which relate to loans which are in default or may become in default. This Statement of Position addresses certain of those practices.

## LOSSES FROM LOANS

[.08-.29] [Effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.*]<sup>[1], [2]</sup>

## ASSETS AFFECTED BY TROUBLED DEBT RESTRUCTURINGS

[.29A-.29C] [Effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.*]

## DISCONTINUANCE OF INTEREST REVENUE RECOGNITION

.30 While some REITs argue that recognition of interest revenue should never be discontinued, it seems clear that there is no sound basis in theory or

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<sup>[1]</sup> [Footnote deleted.]

<sup>[2]</sup> [Footnote deleted.]

practice for such a position, since it is well established in accounting that if sufficient doubt or uncertainty exists as to realization, recognition may not be appropriate.

.31 In practice, the recognition of interest revenue has usually been discontinued at one of the following points:

- (1) When the amount of any final loss can be determined with a high degree of precision (e.g., upon final settlement).
- (2) Upon the occurrence of certain specified events (e.g., interest or principal is a certain number of days past due, cost overruns are at a certain percentage, foreclosure proceedings are being initiated, etc.)
- (3) When judgment—often involving an evaluation of total loan recoverability, including estimated recoverability from foreclosure and sale—indicates that any additional interest would not be realized.

.32 Postponing the discontinuance of interest recognition until a loss can be determined with a high degree of precision is in conflict with general practice and theory.

.33 A common practice is to discontinue the recognition of interest upon the occurrence of certain specified events. Its attractiveness lies in the ability to determine objectively if the criteria have been met and, as a result, it is presumed there would be a greater uniformity in the reported results of REITs following this practice.

.34 Opponents of this practice acknowledge that specific criteria may be useful in identifying potential problem loans but believe that arbitrary rules cannot be a substitute for management's judgment. It is argued that even though a loan may meet an established criterion for the discontinuance of interest recognition, it is still possible that the loan and the interest will ultimately be collected; thus, to discontinue recognition in such a situation is as incorrect as recognizing interest when it is clear it will not be collected.

.35 The Division believes that the recognition of interest revenue should be discontinued when it is not reasonable to expect that the revenue will be received. The Division also believes that certain conditions, such as any one of the following, should now be regarded as establishing a presumption (which may be overcome if other facts clearly refute the presumption) that the recording of interest should be discontinued.

- (1) Payments of principal or interest are past due.
- (2) The borrower is in default under the terms of the loan agreement.
- (3) Foreclosure proceedings have been or are expected to be initiated.
- (4) The credit-worthiness of the borrower is in doubt because of pending or actual bankruptcy proceedings, the filing of liens against his assets, etc.
- (5) Cost overruns and/or delays in construction cast doubt on the economic viability of the project.
- (6) The loan has been renegotiated.

These conditions may also be an indication that an allowance for losses should be provided.

.36 The Division supports the view that the discontinuance of interest revenue recognition is related to the question of realization and, consequently,

such recognition should not be resumed, nor should unrecorded interest be recognized, until it is evident that the principal and interest will be collected.

.37 Some believe that even though the recognition of interest is discontinued, interest revenue should be “grossed up” with an offsetting charge to an expense account. They believe that this presentation will more clearly reflect the planned income from the portfolio as well as the deviations, in the form of provisions for possible losses, from that plan.

.38 Others maintain that since the interest recognition was discontinued because realization was doubtful, it would not be appropriate to include such amounts in interest revenue in the financial statements because such a presentation would contradict economic reality. The Division supports this view.

### COMMITMENT FEES

[.39-.46] [Effectively superseded by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.]<sup>[3]</sup>

### OPERATING SUPPORT OF THE REIT BY THE ADVISER

.47 Various methods are or have been employed by advisers to insure a certain return to the REIT for certain periods. Some of these methods are summarized below.

- (1) Purchasing a loan or a property at an amount in excess of market value
- (2) Forgiving indebtedness
- (3) Reducing advisory fees
- (4) Providing required compensating balances
- (5) Making outright cash payments

.48 In situations of this type, few would challenge the need for disclosure of the nature of the relationship between the REIT and its adviser and the nature and amount of the transactions between them. The accounting for the transaction, however, is not quite as clear.

.49 Some believe that operating support given to a REIT by its adviser can be determined to be either income or a contribution to capital on the basis of the form of the transaction.

.50 Others hold that such support should always be accounted for as income since it is difficult, if not impossible, to distinguish items of income from capital contributions. In some cases, for example, determining what the terms of an “arms-length” transaction would be might pose significant problems. Distinguishing between the types of operating support would also pose problems—why, for example, should a loan purchased at more than market value by the adviser be viewed differently from a reduction in the advisory fee?

.51 The Division believes that in the present framework of generally accepted accounting principles, appropriate accounting by a REIT for operating support from its adviser would include the following:

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[3] [Footnote renumbered and deleted.]



- (1) Adjustment of any assets (or liabilities) which will be transferred between the companies to current market value as of the date of the transaction.
- (2) Recognition, as income or as a reduction of advisory fees, of the operating support effectively obtained, with full disclosure of (a) the relationship between the parties and (b) the nature and amount of the transactions.

.52 The effect of such transactions, when material, should be reported separately in the income statement.

\* \* \* \* \*

[.53] **APPENDIX A: ILLUSTRATION A**

**Purpose of Illustration**

[Effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.]

[.54] **APPENDIX B: ILLUSTRATION B**

[Effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.]

[.55] **APPENDIX C: PRESENT VALUE FACTORS**

[Effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.]<sup>[\*]</sup>

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[\*] [Footnote deleted.]

## ACCOUNTING STANDARDS DIVISION

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[The next page is 18,231.]

## Section 10,130

# ***Statement of Position 76-3 Accounting Practices for Certain Employee Stock Ownership Plans***

[Recommendation to the Financial Accounting Standards Board]

## **AICPA**

American Institute of Certified Public Accountants  
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 20, 1976

Marshall S. Armstrong, CPA  
Chairman  
Financial Accounting Standards Board  
High Ridge Park  
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on *Accounting Practices for Certain Employee Stock Ownership Plans* (ESOPs). It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement deals primarily with accounting and reporting issues that have arisen with respect to those ESOPs that borrow funds from a bank or other lender to acquire shares of stock in the employer company or that issue notes to existing shareholders in exchange for shares of stock. However, certain conclusions in the Statement are also applicable to ESOPs that have not entered into such transactions.

The Statement's major recommendations are briefly summarized below:

- An obligation of an ESOP should be recorded as a liability in the financial statements of the employer when the obligation is covered by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the debt service requirements.
- The offsetting debit to the liability recorded by the employer should be accounted for as a reduction of shareholders' equity.
- The liability recorded by the employer and the offsetting debit should both be reduced as the ESOP makes payments on the debt.

- The amount contributed or committed to be contributed to an ESOP with respect to a given year should be charged to expense by the employer; the compensation and interest elements of the contribution should be separately reported.
- All shares held by an ESOP should be treated as outstanding shares in the determination of earnings per share. Dividends paid on those shares should be charged to retained earnings.
- Any additional investment tax credit should be accounted for as a reduction of income tax expense in the year in which the contribution to the ESOP is charged to expense.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

Raymond C. Lauver  
Chairman  
Accounting Standards Division

cc: Securities and Exchange Commission

**NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

## **ACCOUNTING PRACTICES FOR CERTAIN EMPLOYEE STOCK OWNERSHIP PLANS**

### **INTRODUCTION**

.01 The Employee Retirement Income Security Act of 1974 describes an Employee Stock Ownership Plan (ESOP) as a qualified stock bonus plan, or a combination stock bonus and money purchase pension plan, designed to invest primarily in "qualifying employer securities."<sup>1</sup> Qualifying employer securities include the employer's stock and its other marketable obligations. The essential differences between an ESOP and other qualified stock bonus plans are that (a) an ESOP is permitted, in certain circumstances, to incur liabilities in the acquisition of employer securities and (b) the employer may be permitted to increase his maximum allowable investment tax credit by as much as an additional 1½% if that amount is contributed to an ESOP.

.02 In some cases, funds are borrowed from a bank or other lender by the ESOP and are used to acquire shares of stock in the employer company. The stock may be outstanding shares, treasury shares, or newly issued shares, and is held by the ESOP until it is distributed to the employees. (In some cases, an ESOP may issue notes to existing shareholders in exchange for qualifying employer securities.) The stock may be allocated to individual employees even though it may not be distributed to them until a future date. The debt of the ESOP is usually collateralized by a pledge of the stock and by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the debt service requirements. The employer company makes annual contributions to the ESOP that are deductible for tax purposes, subject to the limitations of the Internal Revenue Code. Cash contributions and dividends received are used by the ESOP to:

- (a) Satisfy the annual amortization of the outstanding debt principal.
- (b) Satisfy the annual interest costs on such debt.
- (c) Obtain short-term investments to provide for liquidity.
- (d) Pay other expenses.

<sup>1</sup> Employee Retirement Income Security Act of 1974, Title II, Subtitle B, Section 2003.

- (e) Acquire additional shares of the employer company's stock, to the extent of the excess, if any, over that required by (a) through (d) above.

.03 Several accounting and reporting issues have arisen with respect to those ESOPs that borrow funds from a bank or other lender to acquire shares of stock in the employer company, or that issue notes to existing shareholders in exchange for shares of stock.<sup>2</sup> These issues are being dealt with in practice in different ways. This Statement of Position has been issued because the Division believes it is desirable to narrow the range of alternative accounting practices in this area.

.04 Final regulations clarifying the rights and duties of the parties affected by an ESOP have not been issued by the Internal Revenue Service. Readers of this Statement of Position should also be cognizant of the content of such regulations, when they are issued.

## **ACCOUNTING FOR AN OBLIGATION OF AN ESOP GUARANTEED BY THE EMPLOYER**

### **Recording an ESOP's Obligation in the Employer's Financial Statements**

.05 The Division believes that an obligation of an ESOP should be recorded as a liability in the financial statements of the employer when the obligation is covered by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the debt service requirements. The employer's guarantee or commitment is, in substance, the assumption of the ESOP's debt and the related obligation to reduce that debt. The employer has assumed these obligations either (a) to buy back its own shares (in the case where the ESOP uses the loan proceeds to acquire previously outstanding shares) or (b) to finance additional working capital or other fund needs (in the case where the ESOP uses the loan proceeds to acquire previously unissued or treasury shares from the employer).

.06 It does not follow from the above that assets held by an ESOP should be included in the financial statements of the employer. Ownership of these assets rests in the employees, not in the employer.

### **Recording the Offsetting Debit to the Recorded Liability**

.07 The Division believes that the offsetting debit to the liability recorded by the employer should be accounted for as a reduction of shareholders' equity. Therefore, when new shares are issued to the ESOP by the employer, an increase in shareholders' equity should be reported only as the debt that financed that increase is reduced. (The offsetting debit in shareholders' equity in this case is akin to the unearned compensation discussed in APB Opinion No. 25, paragraph 14.) When outstanding shares, as opposed to unissued shares, are acquired by the ESOP, shareholders' equity should similarly be reduced by the offsetting debit until the debt is repaid.

### **Reducing the Recorded Liability**

.08 The Division believes that the liability recorded by the employer should be reduced as the ESOP makes payments on the debt. The liability is

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<sup>2</sup> This Statement of Position does not deal directly with ESOPs that might invest in qualifying employer securities other than equity securities.

initially recorded because the guarantee or commitment is in substance the employer's debt. Therefore, it should not be reduced until payments are actually made. Similarly, the amount reported as a reduction of shareholders' equity should be reduced only when the ESOP makes payments on the debt. These two accounts should move symmetrically.

### **MEASURING COMPENSATION EXPENSE**

.09 The Division believes that the amount contributed or committed to be contributed to an ESOP with respect to a given year should be the measure of the amount to be charged to expense by the employer.<sup>3</sup> Such contributions measure the amount of expense irrevocably incurred whether or not they are used concurrently to reduce the debt guaranteed by the employer.

.10 Since the debt of the ESOP is, in substance, the employer's debt, the Division believes that the employer should report separately the compensation element and the interest element of the annual contribution, and should disclose the related interest rate and debt terms in the footnotes to the financial statements. However, a significant minority within the Division believes that the entire annual contribution should be reported as compensation expense.

### **REPORTING DIVIDENDS PAID AND EARNINGS PER SHARE**

.11 The Division believes that all shares held by an ESOP should be treated as outstanding shares in the determination of earnings per share. An ESOP is a legal entity holding shares issued by the employer, whether or not those shares have been allocated to employee accounts.

.12 Dividends paid on shares held by an ESOP should be charged to retained earnings. Such dividends should not be included at any time in compensation expense.

.13 A minority within the Division believes that when trust debt proceeds are transferred to the employer corporation, a transaction of a predominantly financing nature has occurred. The minority believes that shares should be considered outstanding for earnings per share calculations only to the extent that they become constructively unencumbered by repayments of debt principal. To do otherwise, according to this minority view, would result in an inconsistent and initially excessive effect on earnings per share in that the total number of shares purchased by the ESOP would be immediately included in the calculation of earnings per share, even though the related compensation expense would be spread over a period of time on the basis of the employer's contribution to the trust. Consistent with this position, the minority would also charge dividends to retained earnings only to the extent that trust shares are unencumbered. Any remaining balance would be reported as additional compensation expense in the period the dividends were declared.

### **OTHER MATTERS**

#### **Investment Tax Credit**

.14 The Division believes that the additional investment tax credit should be accounted for (to the extent that it is available and utilized) as a reduction of income tax expense in the same year in which the contribution to the ESOP

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<sup>3</sup> This conclusion is also applicable to ESOPs that have not borrowed funds from a bank or other lender (or issued notes to existing shareholders) to acquire shares of stock in the employer company.

is charged to expense, irrespective of the accounting for the normal investment tax credit on property acquisitions.<sup>4</sup> This additional credit arises from the contribution to the ESOP, not solely from the property acquisitions of the employer.<sup>5</sup>

### **Applicability of APB Opinion No. 11**

[.15] [Effectively superseded by FASB Statement No. 109, *Accounting for Income Taxes*.]<sup>[6]</sup>

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<sup>4</sup> See footnote 3.

<sup>5</sup> See also Section 101(c) of the Revenue Act of 1971.

<sup>[6]</sup> [Footnote deleted.]



## **ACCOUNTING STANDARDS DIVISION**

### **Accounting Standards Executive Committee**

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**[The next page is 18,551.]**



**Section 10,240*****Statement of Position 78-9  
Accounting for Investments in  
Real Estate Ventures***

[Proposal to Financial Accounting Standards Board]

**AICPA****American Institute of Certified Public Accountants**

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 29, 1978

Donald J. Kirk, CPA  
Chairman  
Financial Accounting Standards Board  
High Ridge Park  
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying statement of position, *Accounting for Investments in Real Estate Ventures*, has been prepared on behalf of the division by the AICPA Committee on Real Estate Accounting and approved by the AICPA Accounting Standards Executive Committee.

The statement presents the division's recommendations on accounting for investments in real estate ventures (corporate joint ventures, general and limited partnerships, and undivided interests). The recommendations are primarily an application of the existing authoritative accounting literature to the specialized accounting problems related to such investments and are intended to narrow the range of alternative practices.

Representatives of the division are available to discuss this proposal with you or your staff at your convenience.

Sincerely,

Arthur R. Wyatt  
Chairman  
Accounting Standards Division

cc: Securities and Exchange Commission

[The next page is 18,553.]



**NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

## **ACCOUNTING FOR INVESTMENTS IN REAL ESTATE VENTURES**

### **INTRODUCTION**

**.01** 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. *A corporate joint venture*—a corporation owned and operated by a small group of ventures to accomplish a mutually beneficial venture or project, as described in paragraph 3 of APB Opinion 18, *The Equity Method of Accounting for Investments in Common Stock*.
- b. *A general partnership*—an association in which each partner has unlimited liability.
- c. *A limited partnership*—an association in which one or more general partners have unlimited liability and one or more partners have limited liability. A limited partnership is usually managed by the general partner or partners, subject to limitations, if any, imposed by the partnership agreement.
- d. *An undivided interest*—an ownership arrangement in which two or more parties jointly own property, and title is held individually to the extent of each party's interest.

In this statement of position, the terms *real estate venture* and *venture* apply to all of the ownership arrangements described in this paragraph.

**.02** These forms of ownership differ in legal form and economic substance, and the authoritative accounting literature dealing with the specialized accounting problems related to such investments is limited. In practice, those accounting problems are dealt with in a variety of ways, and the division believes narrowing the range of those alternative practices is desirable.

**.03** This statement of position presents the division's recommendations on accounting for investments in real estate ventures in financial statements prepared in conformity with generally accepted accounting principles. It does not apply to regulated investment companies and other entities that are required to account for investments at quoted market value or fair value.

## THE APPLICABILITY OF THE EQUITY METHOD OF ACCOUNTING

### Corporate Joint Ventures

.04 APB Opinion 18 requires investments in corporate joint ventures to be accounted for by the equity method and includes guidance for applying that method in the financial statements of the investor. That opinion applies to corporate joint ventures created to own or operate real estate projects.

.05 Paragraph 3 of APB Opinion 18 states that "an entity which is a subsidiary of one of the 'joint venturers' is not a corporate joint venture." A subsidiary, according to that opinion, refers to

... a corporation which is controlled, directly or indirectly, by another corporation. The usual condition for control is ownership of a majority (over 50 percent) of the outstanding voting stock. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

Accordingly, 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. 115, *Accounting for Certain Investments in Debt and Equity Securities*. [Revised, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

### General Partnerships

.06 The staff of the American Institute of Certified Public Accountants issued an interpretation of APB Opinion 18 in November, 1971, which concludes that many of the provisions of APB Opinion 18 are appropriate in accounting for investments in certain unincorporated entities. The division believes that the principal difference, aside from income tax considerations, between corporate joint ventures and general partnerships is that the individual investors in general partnerships usually assume joint and several liability. The division believes, however, that the equity method enables non-controlling investors in general partnerships to reflect the underlying nature of their investments in those ventures as well as it does for investors in corporate joint ventures. Accordingly, the division believes that investments in noncontrolled real estate general partnerships should be accounted for and reported under the equity method. This recommendation requires the one-line equity method of presentation in both the balance sheet and the statement of income.<sup>1</sup> Paragraph 19 of APB Opinion 18 should be used as a guide in applying the equity method. Investors in general partnerships should provide for income taxes on the profits accrued on their investment in the partnership regardless of the tax basis used in the partnership return. Differences between the investor's tax basis of the investment and the reported amount of the investment in the financial statements of the investor that will result in taxable or deductible amounts in future years (temporary differences) should be accounted for in conformity with FASB Statement No. 109, *Accounting for Income Taxes*. [Revised, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

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<sup>1</sup> Pro rata consolidation is not appropriate except in the limited circumstances described in paragraph .11.

.07 The division believes a general partnership that is controlled, directly or indirectly, by an investor is, in substance, a subsidiary of the investor. APB Opinion 18 states that the usual condition for control of a corporation is ownership of a majority (over 50 percent) of the outstanding voting stock. However, if partnership voting interests are not clearly indicated, a condition that would usually indicate control is ownership of a majority (over 50 percent) of the financial interests in profits or losses (see paragraph .25). The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other partners, or by court decree. On the other hand, majority ownership may not constitute control if major decisions such as the acquisition, sale, or refinancing of principal partnership assets must be approved by one or more of the other partners. The division believes that a controlling investor should account for its investment under the principles of accounting applicable to investments in subsidiaries. Accordingly, intercompany profits and losses on assets remaining within the group should be eliminated. A noncontrolling investor in a general partnership should account for its investment by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion 18.

### Limited Partnerships

.08 The division believes that the accounting recommendations for use of the equity method of accounting for investments in general partnerships are generally appropriate for accounting by limited partners for their investments in limited partnerships. A limited partner's interest may be so minor that the limited partner may have virtually no influence over partnership operating and financial policies. Such a limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, accounting for the investment using the cost method may be appropriate. Under the cost method, income recognized by the investor is limited to distributions received, except that distributions that exceed the investor's share of earnings after the date of the investment are applied to reduce the carrying value of the investment. Differences between the investor's tax basis of the investment and the reported amount of the investment in the financial statements of the investor that will result in taxable or deductible amounts in future years (temporary differences) should be accounted for in conformity with FASB Statement No. 109, *Accounting for Income Taxes*. [Revised, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.09 The rights and obligations of the general partners in a limited partnership are different from those of the limited partners. Some believe that general partners should be deemed to have the controlling interest in a limited partnership. However, if limited partners have important rights, such as the right to replace the general partner or partners, approve the sale or refinancing of principal assets, or approve the acquisition of principal partnership assets, the partnership may not be under the control, directly or indirectly, of the general partnership interests. The division believes that the general partners are in control and should account for their investments in accordance with the recommendations in paragraph .07 only if the substance of the partnership or other agreements provides for control by the general partners.

.10 The division believes that if the substance of the partnership arrangement is such that the general partners are not in control of the major operating and financial policies of the partnership, a limited partner may be in control. An example could be a limited partner holding over 50 percent of the total part-

nership interest. A controlling limited partner should be guided in accounting for its investment by the principles for investments in subsidiaries. Noncontrolling limited partners should account for their investments by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion 18, as discussed in paragraphs .06 and .07, or by the cost method, as discussed in paragraph .08, as appropriate.

### **Undivided Interests**

.11 In an interpretation of APB Opinion 18 issued by the staff of the American Institute of Certified Public Accountants in November, 1971, the staff concluded that most of the provisions of paragraph 19 of APB Opinion 18 generally would be appropriate in accounting for partnerships and unincorporated ventures, but that if

... the investor-venturer owns an undivided interest in each asset and is proportionately (i.e., severally) liable for its share of each liability, the provisions of the equity method set forth in paragraph 19(c) of the Opinion may not apply in some industries. For example, where it is the established industry practice ... , the investor-venturer may account in its financial statements for its *pro rata* share of the assets, liabilities, revenues, and expenses of the venture.

If real property owned by undivided interests is subject to joint control by the owners, the division believes that 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 property is subject to joint control if decisions regarding the financing, development, sale, or operations require the approval of two or more of the owners. Most real estate ventures with ownership in the form of undivided interests are subject to some level of joint control. Accordingly, the division believes that such investments should be presented in the same manner as investments 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.

## **GENERAL MATTERS**

### **Disclosure**

.12 The division believes that investors in real estate ventures should be guided by the provisions of paragraph 20 of APB Opinion 18 in determining the disclosures to be made in their financial statements.

### **Statement of Cash Flows**

.13 FASB Statement No. 95, *Statement of Cash Flows*, governs the form and content of statements of cash flows. [Revised, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

## **INVESTOR ACCOUNTING FOR LOSSES**

### **General**

.14 Some investors have suggested that their equity in losses of a real estate venture need not be recorded under the equity method of accounting as



long as the value of their investment has not been impaired; for example, if it is expected that the venture's assets can be sold for more than their carrying value. The division believes that investors should record their share of the real estate venture's losses, determined in conformity with generally accepted accounting principles, without regard to unrealized increases in the estimated fair value of the venture's assets.

**Accounting for an Investor's Share of Losses in Excess of Its Investment, Including Loans and Advances**

.15 The division believes that an investor that is liable for the obligations of the venture or is otherwise committed to provide additional financial support to the venture should record its equity in real estate venture losses in excess of its investment, including loans and advances.<sup>2</sup> The following are examples of such circumstances:

- a. The investor has a legal obligation as a guarantor or general partner.
- b. The investor has indicated a commitment, based on considerations such as business reputation, intercompany relationships, or credit standing, to provide additional financial support. Such a commitment might be indicated by previous support provided by the investor or statements by the investor to other investors or third parties of the investor's intention to provide support.

.16 An investor in a real estate venture should report its recorded share of losses in excess of its investment, including loans and advances, as a liability in its financial statements.

.17 If an investor does not recognize venture losses in excess of its investment, loans, and advances and the venture subsequently reports net income, the investor should resume applying the equity method only after its share of such net income equals the share of net losses not recognized during the period in which equity accounting was suspended.

.18 If it is probable that one or more investors cannot bear their share of losses, the remaining investors should record their proportionate shares of venture losses otherwise allocable to investors considered unable to bear their share of losses.<sup>3</sup> When the venture subsequently reports income, those remaining investors should record their proportionate share of the venture's net income otherwise allocable to investors considered unable to bear their share of losses until such income equals the excess losses they previously recorded. The division also believes that an investor who is deemed by other investors to be unable to bear its share of losses should continue to record its contractual share of losses unless it is relieved from the obligation to make payment by agreement or operation of law.

.19 The division believes that the accounting by an investor for losses otherwise allocable to other investors should be governed by the provisions of

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<sup>2</sup> An investor, though not liable or otherwise committed to provide additional financial support, should provide for losses in excess of investment when the imminent return to profitable operations by the venture appears to be assured. For example, a material nonrecurring loss of an isolated nature, or start-up losses, may reduce an investment below zero through the underlying profitable pattern of an investee is unimpaired.

<sup>3</sup> This recommendation does not apply for real property jointly owned and operated as undivided interests in assets if the claims or liens of investor's creditors are limited to investors' respective interests in such property.

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, the division believes that 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.<sup>4</sup> However, there may be satisfactory alternative evidence of an ability and willingness of other investors to bear their allocable share of losses. Such evidence might be, for example, that those investors previously made loans or contributions to support cash deficits, possess satisfactory financial standing (as may be evidenced by satisfactory credit ratings), or have provided adequately collateralized guarantees.

#### **Loss in Value of an Investment, Including Loans and Advances, Other Than a Temporary Decline**

.20 A loss in value of an investment other than a temporary decline should be recognized. Such a loss in value may be indicated, for example, by a decision by other investors to cease providing support or reduce their financial commitment to the venture. Loans and advances should be evaluated under FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*. [Revised, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

### **OTHER ACCOUNTING MATTERS RELATED TO THE USE OF THE EQUITY METHOD**

#### **Eliminating Interentity Profits and Losses**

.21 As noted elsewhere in this statement, APB Opinion 18 should be used as a guide when applying the equity method. Paragraph 19(a) of that opinion provides that, in applying the equity method, intercompany profits and losses should be eliminated until realized by the investor or investee as if the investee company were consolidated. The division believes that intercompany profit should be eliminated by the investor in relation to the investor's ownership interest in the investee, except that an investor that controls the investee and enters into a transaction with the investee should eliminate all of the intercompany profit on assets remaining within the group.

.22 The AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*,<sup>\*</sup> sets out similar rules in paragraph 58:

A sale of property in which the seller holds or acquires an equity interest in the buyer should result in recognizing only the part of the profit proportionate to the outside interest in the buyer. No profit should be recognized if the seller controls the buyer . . . until realized from transactions with outside parties through sale or operations of the property.

.23 The division believes that if a transaction with a real estate venture confirms that there has been a loss in the value of the asset sold that is other

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<sup>4</sup> An investor may not be able to apply the general rule to an investment in an undivided interest because the extent to which the interests of other investors are encumbered by liens may not be known.

<sup>\*</sup> The Financial Accounting Standards Board has extracted the specialized accounting and reporting principles and practices contained in this AICPA Accounting Guide, see FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

than temporary and that has not been recognized previously, the loss should be recognized on the books of the transferor.

### **Accounting Principles Used by the Venture**

.24 In the real estate industry, the accounts of a venture may reflect accounting practices, such as those used to prepare tax basis data for investors, that vary from generally accepted accounting principles. If the financial statements of the investor are to be prepared in conformity with generally accepted accounting principles, such variances that are material should be eliminated in applying the equity method.

### **Allocation Ratios for the Determination of Investor Income**

.25 Venture agreements may designate different allocations among the investors of the venture's (a) profits and losses, (b) specified costs and expenses, (c) distributions of cash from operations, and (d) distributions of cash proceeds from liquidation. Such agreements may also provide for changes in the allocations at specified times or on the occurrence of specified events. Accounting by the investors for their equity in the venture's earnings under such agreements requires careful consideration of substance over form and consideration of underlying values as discussed in paragraph .19. The division believes that in order to determine the investor's share of venture net income or loss, such agreements or arrangements should be analyzed to determine how an increase or decrease in net assets of the venture (determined in conformity with generally accepted accounting principles) will affect cash payments to the investor over the life of the venture and on its liquidation. The division believes that 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 are determined on some other basis. For example, if a venture agreement between two investors purports to allocate all depreciation expense to one investor and to allocate all other revenues and expenses equally, but further provides that irrespective of such allocations, distributions to the investors will be made simultaneously and divided equally between them, there is no substance to the purported allocation of depreciation expense.

### **Accounting for a Difference Between the Carrying Amount of an Investment in a Real Estate Venture and the Underlying Equity in Net Assets**

.26 Differences between the carrying amount of an investment in a real estate venture and the investor's equity in the underlying net assets recorded by the venture may arise, for example, from unrecognized profit on transfers of real estate to the venture or differences in accounting methods. In addition, differences may arise from the acquisition of an investment in a venture at a price different from the investor's share of the net assets as recorded on the books of the venture.

.27 Differences that arise from a business combination with a venture accounted for as a purchase should be accounted for in accordance with the provisions of APB Opinion 16. The division believes that an excess of the cost of the investment acquired over the equity in the underlying net assets usually would be ascribed to the fair values of real property interest owned by the venture. Any cost in excess of amounts assigned to identifiable tangible or intangible assets acquired is an intangible asset that should be amortized in a systematic manner related to the purpose of the venture. Because of the limited life and limited purpose usually inherent in real estate ventures, the division believes that the benefits from such an intangible asset generally decline as the property is sold or depreciated, and therefore amortization of

that intangible asset should be recorded in relation to cost of sales or depreciation. The period of amortization should not, however, exceed forty years.

.28 Paragraph 19(b) of APB Opinion 18 provides that the difference between the cost of an investment and the amount of the underlying equity in net assets of the investee "should affect the determination of the amount of the investor's share of earnings or losses of an investee as if the investee were a consolidated subsidiary." The differences should be recognized by the investor as an adjustment to the amount of the venturer's depreciation, cost of sales, or other expenses, as appropriate, in recording income or loss from the venture on the equity basis.

### ACCOUNTING BY THE INVESTOR FOR CERTAIN TRANSACTIONS WITH A REAL ESTATE VENTURE

#### Capital Contributions

.29 *Contribution of Cash.* If all investors contribute cash at the formation of the real estate venture, each investor should record its investment at the amount of the cash contributed.

.30 *Contribution of Real Estate.* The division believes an investor that contributes real estate 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. The division believes that 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. The division understands, however, that some transactions, structured in the form of capital contributions, may in economic substance be sales. The recommendations in paragraph .36 of this statement on accounting for sales of real estate to a venture by an investor apply to those transactions. An example of such a transaction is one in which investor A contributes to a venture real estate with a fair value of \$2,000 and investor B contributes cash in the amount of \$1,000 which is immediately withdrawn by investor A, and, following such contributions and withdrawals, each investor has a 50 percent interest in the venture (the only asset of which is the real estate). Assuming investor A is not committed to reinvest the \$1,000 in the venture, the substance of this transaction is a sale by investor A of a one-half interest in the real estate in exchange for cash. A minority of the division disagrees with the conclusion that an investor contributing real estate to a real estate venture should record its investment at the cost of the real estate contributed. They believe that profit recognition by such an investor to the extent of the other investors' interests in the profits and losses of the venture may be appropriate if the other investors contribute cash or other hard assets (such as marketable securities) for their interests and the investor contributing the real estate has no continuing involvement with the real estate that would require deferral of profit under the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*.<sup>\*</sup> The majority of the division believes that unless the investor that contributes real estate to the venture withdraws cash (or other hard assets) and has no commitment to reinvest, such a transaction is not the culmination of an earnings process.

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<sup>\*</sup> The Financial Accounting Standards Board has extracted the specialized accounting and reporting principles and practices contained in this AICPA Accounting Guide, see FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

.31 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.

.32 *Contribution of Services or Intangibles.\** The division believes the accounting considerations that apply to real property contributed to a partnership or joint venture also apply to contributions of services or intangibles. The investor's cost of such services or intangibles to be allocated to the cost of the investment should be determined by the investor in the same manner as for an investment in a wholly owned real estate project.

### Income From Loans or Advances to a Venture

.33 Interest on loans and advances that are in substance capital contributions (for example, if all the investors are required to make loans and advances proportionate to their equity interests) should be accounted for as distributions rather than as interest income by the investors.

.34 An investor-lender that does not capitalize interest on its own real estate construction and development projects should account for interest on loans and advances that are not in substance capital contributions in accordance with the recommendations in this paragraph.

- a. All interest income on the investor's loans or advances to the venture should be deferred if either of the following conditions is present.
  - (i) Collectibility of the principal or interest is in doubt. This condition may exist if adequate collateral and other terms normally required by an independent lender are not present.
  - (ii) There is a reasonable expectation that the other investors will not bear their shares of losses, resulting in uncertainty as to the lender's share of the venture's related interest expense.
- b. If neither of the conditions in (a) is present and either the venture has recorded interest as an expense or the venture has capitalized the interest but in order to conform to the investor's accounting policies, the investor has recorded its equity in the income or loss of the venture as if the venture had charged the interest to expense, the entire interest income accrued on loans or advances to a venture should be recorded as earned.
- c. If the conditions in (a) or (b) are not present, a portion of interest income from loans and advances to a venture should be deferred based on the investor's percentage interest in the profits and losses of the venture. However, an evaluation similar to that discussed in paragraphs .18 and .19 for recording the investor's share of losses should be made to avoid recording as interest income amounts that may ultimately be borne as losses by the investor making the loan.

[.35] [Effectively superseded by FASB Statement No. 34, *Capitalization of Interest Cost*.]

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\* The provisions of this paragraph do not apply to real estate syndication activities in which the syndicators receive or retain partnership interests. Such activities are discussed in SOP 92-1, *Accounting for Real Estate Syndication Income* [section 10,500].

### **Sales of Real Estate to a Venture**

.36 Sales of real estate by an investor to a real estate venture are subject to all of the provisions set forth in the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*.

### **Sales of Services to a Venture**

.37 If services are performed for a venture by an investor and their cost is capitalized by the venture, profit may be recognized by the investor to the extent attributable to the outside interests in the venture if the following conditions are met:

- a. The substance of the transaction does not significantly differ from its form.
- b. There are no substantial uncertainties about the ability of the investor to complete performance (as may be the case if the investor lacks experience in the business of the venture) or the total cost of services to be rendered.
- c. There is a reasonable expectation that the other investors will bear their share of losses, if any.

The method of recognizing income from services rendered should be consistent with the method followed for services performed for unrelated parties.

### **Purchases of Real Estate or Services From a Venture**

.38 An investor should not record as income its equity in the venture's profit from a sale of real estate to that investor; the investor's share of such profit should be recorded as a reduction in the carrying amount of the purchased real estate and recognized as income on a pro rata basis as the real estate is depreciated or when it is sold to a third party. Similarly, if a venture performs services for an investor and the cost of those services is capitalized by the investor, the investor's share of the venture's profit in the transaction should be recorded as a reduction in the carrying amount of the capitalized cost.

## **ACCOUNTING FOR THE SALE OF AN INTEREST IN A REAL ESTATE VENTURE**

.39 The division believes that a sale of an investment in a real estate venture (including the sale of stock in a corporate real estate venture) is the equivalent of a sale of an interest in the underlying real estate and should be evaluated under the guidelines set forth in the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*.

[.40] [Effectively superseded by FASB Statement No. 66, *Accounting for Sales of Real Estate*.]

## **TRANSITION**

.41 The division recommends applying this statement of position to financial statements issued for fiscal years and interim periods beginning after De-

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\* The Financial Accounting Standards Board has extracted the specialized accounting and reporting principles and practices contained in this AICPA Accounting Guide, see FASB Statement No. 66, *Accounting for Sales of Real Estate*, October 1982.

cember 24, 1978. Adjustments resulting from a change in accounting method to comply with the recommendations in this statement should be applied retroactively, if material, and, to enhance comparability between periods, financial statements presented for the periods affected should be restated for as many periods as is practicable to give retroactive effect to such adjustments and to changes in presentation. The division encourages earlier application of the recommendations in this statement for fiscal years beginning before December 25, 1978, in financial statements not previously issued.

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**Section 10,330****Statement of Position 81-1  
Accounting for Performance of  
Construction-Type and Certain  
Production-Type Contracts**

July 15, 1981

[Proposal to the Financial Accounting Standards Board]

**NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

**Introduction**

.01 This statement of position provides guidance on the application of generally accepted accounting principles in accounting for the performance of contracts for which specifications are provided by the customer for the construction of facilities or the production of goods or for the provision of related services. Changes in the business environment have increased significantly the variety and uses of those types of contracts and the types of business enterprises that use them. In the present business environment, diverse types of contracts, ranging from relatively simple to highly complex and from relatively short- to long-term, are widely used in many industries for construction, production, or provision of a broad range of goods and services. However, existing principles related to accounting for contracts were written in terms of long-term construction-type contracts, and they are not stated in sufficient detail for the scope of activities to which they presently are applied. Those activities range far beyond the traditional construction-type activity (the design and physical construction of facilities such as buildings, roads, dams, and bridges) to include, for example, the development and production of military and commercial aircraft, weapons delivery systems, space exploration hardware, and computer software. The accounting standards division believes that guidance is now needed in this area of accounting.

## The Basic Accounting Issue

.02 The determination of the point or points at which revenue should be recognized as earned and costs should be recognized as expenses is a major accounting issue common to all business enterprises engaged in the performance of contracts of the types covered by this statement. Accounting for such contracts is essentially a process of measuring the results of relatively long-term events and allocating those results to relatively short-term accounting periods. This involves considerable use of estimates in determining revenues, costs, and profits and in assigning the amounts to accounting periods. The process is complicated by the need to evaluate continually the uncertainties inherent in the performance of contracts and by the need to rely on estimates of revenues, costs, and the extent of progress toward completion.

## Present Accounting Requirements and Practices

.03 The pervasive principle of realization and its exceptions and modifications are central factors underlying accounting for contracts. APB Statement 4\* states:

Revenue is generally recognized when both of the following conditions are met: (1) the earnings process is complete or virtually complete, and (2) an exchange has taken place. [Paragraph 150]

Revenue is sometimes recognized on bases other than the realization rule. For example, on long-term construction contracts revenue may be recognized as construction progresses. This exception to the realization principle is based on the availability of evidence of the ultimate proceeds and the consensus that a better measure of periodic income results. [Paragraph 152]

The exception to the usual revenue realization rule for long-term construction-type contracts, for example, is justified in part because strict adherence to realization at the time of sale would produce results that are considered to be unreasonable. The judgment of the profession is that revenue should be recognized in this situation as construction progresses. [Paragraph 174]

.04 Accounting Research Bulletin No. 45 (ARB No. 45), *Long-Term Construction-Type Contracts*, issued by the AICPA Committee on Accounting Procedure in 1955, describes the two generally accepted methods of accounting for long-term construction-type contracts for financial reporting purposes:

- *The percentage-of-completion method* recognizes income as work on a contract progresses; recognition of revenues and profits generally is related to costs incurred in providing the services required under the contract.
- *The completed-contract method* recognizes income only when the contract is completed, or substantially so, and all costs and related revenues are reported as deferred items in the balance sheet until that time.

The units-of-delivery is a modification of the percentage-of-completion method of accounting for contracts.

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\* Statement of Position 93-3, *Rescission of Accounting Principles Board Statements*, rescinds APB Statement No. 4. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, discusses matters similar to those in APB Statement No. 4. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

- *The units-of-delivery method* recognizes as revenue the contract price of units of a basic production product delivered during a period and as the cost of earned revenue the costs allocable to the delivered units; costs allocable to undelivered units are reported in the balance sheet as inventory or work in progress. The method is used in circumstances in which an entity produces units of a basic product under production-type contracts in a continuous or sequential production process to buyers' specifications.

The use of either of the two generally accepted methods of accounting involves, to a greater or lesser extent, three key areas of estimates and uncertainties: (a) the extent of progress toward completion, (b) contract revenues, and (c) contract costs. Although the ultimate amount of contract revenue is often subject to numerous uncertainties, the accounting literature has given little attention to the difficulties of estimating contract revenue. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.05 ARB No. 45, paragraph 15, describes the circumstances in which each method is preferable as follows:

The committee believes that in general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable.

Both of the two generally accepted methods are widely used in practice. However, the two methods are frequently applied differently in similar circumstances. The division believes that the two methods should be used in specified circumstances and should not be used as acceptable alternatives for the same circumstances. Accordingly, identifying the circumstances in which either of the methods is preferable and the accounting that should be followed in the application of those methods are among the primary objectives of this statement of position. This statement provides guidance on the application of ARB No. 45 and does not amend that bulletin.

.06 In practice, methods are sometimes found that allocate contract costs and revenues to accounting periods on (a) the basis of cash receipts and payments or (b) the basis of contract billings and costs incurred. Those practices are not generally accepted methods of accounting for financial reporting purposes. However, those methods are appropriate for other purposes, such as the measurement of income for income tax purposes, for which the timing of cash transactions is a controlling factor. Recording the amounts billed or billable on a contract during a period as contract revenue of the period, and the costs incurred on the contract as expenses of the period, is not acceptable for financial reporting purposes because the amounts billed or billable on a contract during a period are determined by contract terms and do not necessarily measure performance on the contract. Only by coincidence might those unacceptable methods produce results that approximate the results of the generally accepted method of accounting for contracts that are appropriate in the circumstances.

## **Other Pronouncements and Regulations Affecting Contract Accounting**

.07 Accounting Research Bulletin No. 43, chapter 11, "Government Contracts," prescribes generally accepted principles in three areas of accounting

for government contracts. Section A of that chapter deals with accounting problems arising under cost-plus-fixed-fee contracts. Section B deals with certain aspects of the accounting for government contracts and subcontracts that are subject to renegotiation. Section C deals with problems involved in accounting for certain terminated war and defense contracts. Those pronouncements govern accounting for contracts in the areas indicated.

.08 The pricing and costing of federal government contracts are governed by cost principles contained in procurement regulations such as the Federal Procurement Regulation (FPR) and the Defense Acquisition Regulation (DAR). Also, most major government contractors are subject to cost accounting standards issued by the Cost Accounting Standards Board (CASB). CASB standards apply to the cost accounting procedures that government contractors use to allocate costs to contracts; CASB standards are not intended for financial reporting.

.09 Accounting for contracts for income tax purposes is prescribed by the Internal Revenue Code and the related rules and regulations. The methods of accounting for contracts under those requirements are not limited to the two generally accepted methods for financial reporting. For numerous historical and practical reasons, tax accounting rules and regulations differ from generally accepted accounting principles. Numerous nonaccounting considerations are appropriate in determining income tax accounting. This statement deals exclusively with the application of generally accepted accounting principles to accounting for contracts in financial reporting. It does not apply to income tax accounting and is not intended to influence income tax accounting.

## Need for Guidance

.10 Because of the complexities and uncertainties in accounting for contracts, the increased use of diverse types of contracts for the construction of facilities, the production of goods, or the provision of related services, and present conditions and practices in industries in which contracts are performed for those purposes, additional guidance on the application of generally accepted accounting principles is needed. This statement of position provides that guidance. Appendix A contains a schematic chart showing the organization of the statement.

## Scope of Statement of Position

.11 This statement of position applies to accounting for performance of contracts for which specifications are provided by the customer for the construction of facilities or the production of goods or the provision of related services that are reported in financial statements prepared in conformity with generally accepted accounting principles.<sup>1</sup> Existing authoritative accounting literature uses the terms "long-term" and "construction-type" in identifying the types of contracts that are the primary focus of interest. The term "long-term" is not used in this statement of position as an identifying characteristic because

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<sup>1</sup> This statement is not intended to apply to "service transactions" as defined in the FASB's October 23, 1978 Invitation to Comment, *Accounting for Certain Service Transactions*. However, it applies to separate contracts to provide services essential to the construction or production of tangible property, such as design, engineering, procurement, and construction management (see paragraph .13 for examples).

other characteristics are considered more relevant for identifying the types of contracts covered. However, accounting for contracts by an entity that primarily has relatively short-term contracts is recommended in paragraph .31 of this statement. The scope of the statement is not limited to construction-type contracts.

## Contracts Covered

.12 Contracts covered by this statement of position are binding agreements between buyers and sellers in which the seller agrees, for compensation, to perform a service to the buyer's specifications.<sup>2</sup> Contracts consist of legally enforceable agreements in any form and include amendments, revisions, and extensions of such agreements. Performance will often extend over long periods, and the seller's right to receive payment depends on his performance in accordance with the agreement. The service may consist of designing, engineering, fabricating, constructing, or manufacturing related to the construction or the production of tangible assets. Contracts such as leases and real estate agreements, for which authoritative accounting literature provides special methods of accounting, are not covered by this statement.

.13 Contracts covered by this statement include, but are not limited to, the following:

- Contracts in the construction industry, such as those of general building, heavy earth moving, dredging, demolition, design-build contractors, and specialty contractors (for example, mechanical, electrical, or paving).
- Contracts to design and build ships and transport vessels.
- Contracts to design, develop, manufacture, or modify complex aerospace or electronic equipment to a buyer's specification or to provide services related to the performance of such contracts.
- Contracts for construction consulting service, such as under agency contracts or construction management agreements.
- Contracts for services performed by architects, engineers, or architectural or engineering design firms.

.14 Contracts not covered by this statement include, but are not limited to, the following:

- Sales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels if such sales are normally recognized as revenue in accordance with the realization principle for sales of products and if their costs are accounted for in accordance with generally accepted principles of inventory costing.
- Sales or supply contracts to provide goods from inventory or from homogeneous continuing production over a period of time.
- Contracts included in a program and accounted for under the program method of accounting. For accounting purposes, a program consists of

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<sup>2</sup> Specifications imposed on the buyer by a third party (for example, a government or regulatory agency or a financial institution) or by conditions in the marketplace are deemed to be "buyer's specifications."

a specified number of units of a basic product expected to be produced over a long period in a continuing production effort under a series of existing and anticipated contracts.<sup>[3]</sup>

- Service contracts of health clubs, correspondence schools, and similar consumer-oriented organizations that provide their services to their clients over an extended period.
- Magazine subscriptions.
- Contracts of nonprofit organizations to provide benefits to their members over a period of time in return for membership dues.

**.15** Contracts covered by this statement may be classified into four broad types based on methods of pricing: (a) fixed-price or lump-sum contracts, (b) cost-type (including cost-plus) contracts, (c) time-and-material contracts, and (d) unit-price contracts. A fixed-price contract is an agreement to perform all acts under the contract for a stated price. A cost-type contract is an agreement to perform under a contract for a price determined on the basis of a defined relationship to the costs to be incurred, for example, the costs of all acts required plus a fee, which may be a fixed amount or a fixed percentage of the costs incurred. A time-and-material contract is an agreement to perform all acts required under the contract for a price based on fixed hourly rates for some measure of the labor hours required (for example, direct labor hours) and the cost of materials. A unit-price contract is an agreement to perform all acts required under the contract for a specified price for each unit of output. Each of the various types of contracts may have incentive, penalty, or other provisions that modify their basic pricing terms. The pricing features of the various types are discussed in greater detail in Appendix B.

## Definition of a Contractor

**.16** The term “contractor” as used in this statement refers to a person or entity that enters into a contract to construct facilities, produce goods, or render services to the specifications of a buyer either as a general or prime contractor, as a subcontractor to a general contractor, or as a construction manager.

## Definition of a Profit Center

**.17** For the purpose of this statement, a “profit center” is the unit for the accumulation of revenues and costs and the measurement of income. For business enterprises engaged in the performance of contracts, the profit center for accounting purposes is usually a single contract; but under some specified circumstances it may be a combination of two or more contracts, a segment of a contract or of a group of combined contracts. This statement of position provides guidance on the selection of the appropriate profit center. The accounting recommendations, usually stated in terms of a single contract, also apply to alternative profit centers in circumstances in which alternative centers are appropriate.

## Application and Effect on Existing Audit Guides and SOPs

**.18** This statement of position presents the division’s recommendations on accounting for contracts (as specified in paragraphs .11 to .17) in all indus-

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<sup>[3]</sup> [Footnote deleted to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

tries. The recommendations in this statement need not be applied to immaterial items. Two existing AICPA Audit and Accounting Guides, *Construction Contractors* and *Audits of Federal Government Contractors*, provide additional guidance on the application of generally accepted accounting principles to the construction industry and to federal government contracts, respectively. The recommendations in this statement take precedence in those areas. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.19 The guidance on contract accounting and financial reporting in *Audits of Federal Government Contractors* is essentially consistent with the recommendations in this statement. Since the recommendations in this statement provide more comprehensive and explicit guidance on the application of generally accepted accounting principles to contract accounting than does the guide, *Audits of Federal Government Contractors*, the guide incorporates this statement as an appendix. The provisions of that guide should be interpreted and applied in the context of the recommendations in this statement. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.20 This statement is not intended to supersede recommendations on accounting in other AICPA industry accounting or audit guides or in other statements of position.

## The Division's Conclusions

### Determining a Basic Accounting Policy for Contracts

.21 In accounting for contracts, the basic accounting policy decision is the choice between the two generally accepted methods: the percentage-of-completion method including units of delivery and the completed-contract method. The determination of which of the two methods is preferable should be based on a careful evaluation of circumstances because the two methods should not be acceptable alternatives for the same circumstances. The division's recommendations on basic accounting policy are set forth in the sections on "The Percentage-of-Completion Method" and "The Completed-Contract Method," which identify the circumstances appropriate to the methods, the bases of applying the methods, and the reasons for the recommendations. The recommendations apply to accounting for individual contracts and to accounting for other profit centers in accordance with the recommendations in the section on "Determining the Profit Center." As a result of evaluating individual contracts and profit centers, a contractor should be able to establish a basic policy that should be followed in accounting for most of his contracts. In accordance with the requirements of APB Opinion No. 22, *Disclosure of Accounting Policies*, a contractor should disclose in the note to the financial statements on accounting policies the method or methods of determining earned revenue and the cost of earned revenue including the policies relating to combining and segmenting, if applicable. Appendix C contains a summary of the disclosure requirements in this statement.

### The Percentage-of-Completion Method

.22 This section sets forth the recommended basis for using the percentage-of-completion method and the reasons for the recommendation. Under most

contracts for construction of facilities, production of goods, or provision of related services to a buyer's specifications, both the buyer and the seller (contractor) obtain enforceable rights. The legal right of the buyer to require specific performance of the contract means that the contractor has, in effect, agreed to sell his rights to work-in-progress as the work progresses. This view is consistent with the contractor's legal rights; he typically has no ownership claim to the work-in-progress but has lien rights. Furthermore, the contractor has the right to require the buyer, under most financing arrangements, to make progress payments to support his ownership investment and to approve the facilities constructed (or goods produced or services performed) to date if they meet the contract requirements. The buyer's right to take over the work-in-progress at his option (usually with a penalty) provides additional evidence to support that view. Accordingly, the business activity taking place supports the concept that in an economic sense performance is, in effect, a continuous sale (transfer of ownership rights) that occurs as the work progresses. Also under most contracts for the production of goods and the provision of related services that are accounted for on the basis of units delivered, both the contractor and the customer obtain enforceable rights as the goods are produced or the services are performed. As units are delivered, title to and the risk of loss on those units normally transfer to the customer, whose acceptance of the items indicates that they meet the contractual specifications. For such contracts, delivery and acceptance are objective measurements of the extent to which the contracts have been performed. The percentage-of-completion method recognizes the legal and economic results of contract performance on a timely basis. Financial statements based on the percentage-of-completion method present the economic substance of a company's transactions and events more clearly and more timely than financial statements based on the completed-contract method, and they present more accurately the relationships between gross profit from contracts and related period costs. The percentage-of-completion method informs the users of the general purpose financial statements of the volume of economic activity of a company.

### ***Circumstances Appropriate to the Method***

.23 The use of the percentage-of-completion method depends on the ability to make reasonably dependable estimates. For the purposes of this statement, "the ability to make reasonably dependable estimates" relates to estimates of the extent of progress toward completion, contract revenues, and contract costs. The division believes that the percentage-of-completion method is preferable as an accounting policy in circumstances in which reasonably dependable estimates can be made and in which all the following conditions exist:

- Contracts executed by the parties normally include provisions that clearly specify the enforceable rights regarding goods or services to be provided and received by the parties, the consideration to be exchanged, and the manner and terms of settlement.
- The buyer can be expected to satisfy his obligations under the contract.
- The contractor can be expected to perform his contractual obligations.

.24 For entities engaged on a continuing basis in the production and delivery of goods or services under contractual arrangements and for whom contracting represents a significant part of their operations, the presumption is that they have the ability to make estimates that are sufficiently dependable



to justify the use of the percentage-of-completion method of accounting.<sup>4</sup> Persuasive evidence to the contrary is necessary to overcome that presumption. The ability to produce reasonably dependable estimates is an essential element of the contracting business. For a contract on which a loss is anticipated, generally accepted accounting principles require recognition of the entire anticipated loss as soon as the loss becomes evident. An entity without the ability to update and revise estimates continually with a degree of confidence could not meet that essential requirement of generally accepted accounting principles.

**.25** Accordingly, the division believes that entities with significant contracting operations generally have the ability to produce reasonably dependable estimates and that for such entities the percentage-of-completion method of accounting is preferable in most circumstances. The method should be applied to individual contracts or profit centers, as appropriate.

- a. Normally, a contractor will be able to estimate total contract revenue and total contract cost in single amounts. Those amounts should normally be used as the basis for accounting for contracts under the percentage-of-completion method.
- b. For some contracts, on which some level of profit is assured, a contractor may only be able to estimate total contract revenue and total contract cost in ranges of amounts. If, based on the information arising in estimating the ranges of amounts and all other pertinent data, the contractor can determine the amounts in the ranges that are most likely to occur, those amounts should be used in accounting for the contract under the percentage-of-completion method. If the most likely amounts cannot be determined, the lowest probable level of profit in the range should be used in accounting for the contract until the results can be estimated more precisely.
- c. However, in some circumstances, estimating the final outcome may be impractical except to assure that no loss will be incurred. In those circumstances, a contractor should use a zero estimate of profit; equal amounts of revenue and cost should be recognized until results can be estimated more precisely. A contractor should use this basis only if the bases in (a) or (b) are clearly not appropriate. A change from a zero estimate of profit to a more precise estimate should be accounted for as a change in an accounting estimate.

An entity using the percentage-of-completion method as its basic accounting policy should use the completed-contract method for a single contract or a group of contracts for which reasonably dependable estimates cannot be made or for which inherent hazards make estimates doubtful. Such a departure from the basic policy should be disclosed.

### ***Nature of Reasonable Estimates and Inherent Hazards***

**.26** In practice, contract revenues and costs are estimated in a wide variety of ways ranging from rudimentary procedures to complex methods and

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<sup>4</sup> The division recognizes that many contractors have informal estimating procedures that may result in poorly documented estimates and marginal quality field reporting and job costing systems. Those conditions may influence the ability of an entity to produce reasonably dependable estimates. However, procedures and systems should not influence the development of accounting principles and should be dealt with by management as internal control, financial reporting, and auditing concerns.

systems. Regardless of the techniques used, a contractor's estimating procedures should provide reasonable assurance of a continuing ability to produce reasonably dependable estimates.<sup>5</sup> Ability to estimate covers more than the estimating and documentation of contract revenues and costs; it covers a contractor's entire contract administration and management control system. The ability to produce reasonably dependable estimates depends on all the procedures and personnel that provide financial or production information on the status of contracts. It encompasses systems and personnel not only of the accounting department but of all areas of the company that participate in production control, cost control, administrative control, or accountability for contracts. Previous reliability of a contractor's estimating process is usually an indication of continuing reliability, particularly if the present circumstances are similar to those that prevailed in the past.

.27 Estimating is an integral part of contractors' business activities, and there is a necessity to revise estimates on contracts continually as the work progresses. The fact that circumstances may necessitate frequent revision of estimates does not indicate that the estimates are unreliable for the purpose for which they are used. Although results may differ widely from original estimates because of the nature of the business, the contractor, in the conduct of his business, may still find the estimates reasonably dependable. Despite these widely recognized conditions, a contractor's estimates of total contract revenue and total contract costs should be regarded as reasonably dependable if the minimum total revenue and the maximum total cost can be estimated with a sufficient degree of confidence to justify the contractor's bids on contracts.

.28 ARB No. 45 discourages the use of the percentage-of-completion method of accounting in circumstances in which inherent hazards make estimates doubtful. "Inherent hazards" relate to contract conditions or external factors that raise questions about contract estimates and about the ability of either the contractor or the customer to perform his obligations under the contract. Inherent hazards that may cause contract estimates to be doubtful usually differ from inherent business risks. Business enterprises engaged in contracting, like all business enterprises, are exposed to numerous business risks that vary from contract to contract. The reliability of the estimating process in contract accounting does not depend on the absence of such risks. Assessing business risks is a function of users of financial statements.

.29 The present business environment and the refinement of the estimating process have produced conditions under which most business entities engaged in contracting can deal adequately with the normal, recurring business risks in estimating the outcome of contracts. The division believes that inherent hazards that make otherwise reasonably dependable contract estimates doubtful involve events and conditions that would not be considered in the ordinary preparation of contract estimates and that would not be expected to recur frequently, given the contractor's normal business environment. Such hazards are unrelated to, or only incidentally related to, the contractor's typical activities. Such hazards may relate, for example, to contracts whose validity is seriously in question (that is, which are less than fully enforceable), to contracts whose completion may be subject to the outcome of pending legislation

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<sup>5</sup> The type of estimating procedures appropriate in a particular set of circumstances depends on a careful evaluation of the costs and benefits of developing the procedures. The ability to produce reasonably dependable estimates that would justify the use of the percentage-of-completion method as recommended in paragraph .25 does not depend on the elaborateness of the estimating procedures used.

or pending litigation, or to contracts exposed to the possibility of the condemnation or expropriation of the resulting properties. Reasonably dependable estimates cannot be produced for a contract with unrealistic or ill-defined terms or for a contract between unreliable parties. However, the conditions stated in paragraph .23 for the use of the percentage-of-completion method of accounting, which apply to most bona fide contracts, make the existence of some uncertainties, including some of the type described in ARB No. 45, paragraph 15, unlikely for contracts that meet those conditions. Therefore, the division believes that there should be specific, persuasive evidence of such hazards to indicate that use of the percentage-of-completion method on one of the bases in paragraph .25 is not preferable.

## **The Completed-Contract Method**

.30 This section sets forth the recommended basis for using the completed-contract method and the reasons for the recommendation. Under the completed-contract method, income is recognized only when a contract is completed or substantially completed. During the period of performance, billings and costs are accumulated on the balance sheet, but no profit or income is recorded before completion or substantial completion of the work. This method precludes reporting on the performance that is occurring under the enforceable rights of the contract as work progresses. Although the completed-contract method is based on results as finally determined rather than on estimates for unperformed work, which may involve unforeseen costs and possible losses, it does not reflect current performance when the period of a contract extends beyond one accounting period, and it therefore may result in irregular recognition of income. Financial statements based on this method may not show informative relationships between gross profit reported on contracts and related period costs.

### ***Circumstances of Use***

.31 The completed-contract method may be used as an entity's basic accounting policy in circumstances in which financial position and results of operations would not vary materially from those resulting from use of the percentage-of-completion method (for example, in circumstances in which an entity has primarily short-term contracts). Although this statement does not formally distinguish on the basis of length between long-term and short-term contracts, the basis for recording income on contracts of short duration poses relatively few problems. In accounting for such contracts, income ordinarily is recognized when performance is substantially completed and accepted. Under those circumstances, revenues and costs in the aggregate for all contracts would be expected to result in a matching of gross profit with period overhead or fixed costs similar to that achieved by use of the percentage-of-completion method. For example, the completed-contract method, as opposed to the percentage-of-completion method, would not usually produce a material difference in net income or financial position for a small plumbing contractor that performs primarily relatively short-term contracts during an accounting period; performance covers such a short span of time that the work is somewhat analogous to the manufacture of shelf production items for sale. An entity using the completed-contract method as its basic accounting policy should depart from that policy for a single contract or a group of contracts not having the features described in this paragraph and use the percentage-of-completion method on one of the bases described in paragraph .25. Such a departure should be disclosed.

.32 The completed-contract method is preferable in circumstances in which estimates cannot meet the criteria for reasonable dependability discussed in the section on the percentage-of-completion method or in which there are inherent hazards of the nature of those discussed in that section. An entity using the percentage-of-completion method as its basic accounting policy should depart from that policy and use the completed-contract method for a single contract or a group of contracts only in the circumstances described in paragraph .25.

.33 The use of the completed-contract method is recommended for the circumstances described in paragraphs .31 and .32. However, for circumstances in which there is an assurance that no loss will be incurred on a contract (for example, when the scope of the contract is ill-defined but the contractor is protected by a cost-plus contract or other contractual terms), the percentage-of-completion method based on a zero profit margin, rather than the completed-contract method, is recommended until more precise estimates can be made. The significant difference between the percentage-of-completion method applied on the basis of a zero profit margin and the completed-contract method relates to the effects on the income statement. Under the zero profit margin approach to applying the percentage-of-completion method, equal amounts of revenue and cost, measured on the basis of performance during the period, are presented in the income statement; whereas, under the completed-contract method, performance for a period is not reflected in the income statement, and no amount is presented in the income statement until the contract is completed. The zero profit margin approach to applying the percentage-of-completion method gives users of general purpose financial statements an indication of the volume of a company's business and of the application of its economic resources.

### **Determining the Profit Center**

.34 The basic presumption should be that each contract is the profit center for revenue recognition, cost accumulation, and income measurement. That presumption may be overcome only if a contract or a series of contracts meets the conditions described for combining or segmenting contracts. A group of contracts (combining), and a phase or segment of a single contract or of a group of contracts (segmenting) may be used as a profit center in some circumstances. Since there are numerous practical implications of combining and segmenting contracts, evaluation of the circumstances, contract terms, and management intent are essential in determining contracts that may be accounted for on those bases.

### **Combining Contracts**

.35 A group of contracts may be so closely related that they are, in effect, parts of a single project with an overall profit margin, and accounting for the contracts individually may not be feasible or appropriate. Under those circumstances, consideration should be given to combining such contracts for profit recognition purposes. The presumption in combining contracts is that revenue and profit are earned, and should be reported, uniformly over the performance of the combined contracts. For example, a group of construction-type contracts may be negotiated as a package with the objective of achieving an overall profit margin, although the profit margins on the individual contracts may vary. In those circumstances, if the individual contracts are performed and reported in different periods and accounted for separately, the reported profit margins in those periods will differ from the profit margin contemplated in the negotiations for reasons other than differences in performance.

**.36** Contracts may be combined for accounting purposes only if they meet the criteria in paragraphs .37 and .38.

**.37** A group of contracts may be combined for accounting purposes if the contracts

- a. Are negotiated as a package in the same economic environment with an overall profit margin objective. Contracts not executed at the same time may be considered to have been negotiated as a package in the same economic environment only if the time period between the commitments of the parties to the individual contracts is reasonably short. The longer the period between the commitments of the parties to the contracts, the more likely it is that the economic circumstances affecting the negotiations have changed.
- b. Constitute in essence an agreement to do a single project. A project for this purpose consists of construction, or related service activity with different elements, phases, or units of output that are closely interrelated or interdependent in terms of their design, technology, and function or their ultimate purpose or use.
- c. Require closely interrelated construction activities with substantial common costs that cannot be separately identified with, or reasonably allocated to, the elements, phases, or units of output.
- d. Are performed concurrently or in a continuous sequence under the same project management at the same location or at different locations in the same general vicinity.
- e. Constitute in substance an agreement with a single customer. In assessing whether the contracts meet this criterion, the facts and circumstances relating to the other criteria should be considered. In some circumstances different divisions of the same entity would not constitute a single customer if, for example, the negotiations are conducted independently with the different divisions. On the other hand, two or more parties may constitute in substance a single customer if, for example, the negotiations are conducted jointly with the parties to do what in essence is a single project.

Contracts that meet all of these criteria may be combined for profit recognition and for determining the need for a provision for losses in accordance with ARB No. 45, paragraph 6. The criteria should be applied consistently to contracts with similar characteristics in similar circumstances.

**.38** Production-type contracts that do not meet the criteria in paragraph .37 or segments of such contracts may be combined into groupings such as production lots or releases for the purpose of accumulating and allocating production costs to units produced or delivered on the basis of average unit costs in the following circumstances:<sup>[6]</sup>

- a. The contracts are with one or more customers for the production of substantially identical units of a basic item produced concurrently or sequentially.
- b. Revenue on the contracts is recognized on the units-of-delivery basis of applying the percentage-of-completion method.

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<sup>[6]</sup> [Footnote deleted to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

### ***Segmenting a Contract***

**.39** A single contract or a group of contracts that otherwise meet the test for combining may include several elements or phases, each of which the contractor negotiated separately with the same customer and agreed to perform without regard to the performance of the others. If those activities are accounted for as a single profit center, the reported income may differ from that contemplated in the negotiations for reasons other than differences in performance. If the project is segmented, revenues can be assigned to the different elements or phases to achieve different rates of profitability based on the relative value of each element or phase to the estimated total contract revenue. A project, which may consist of a single contract or a group of contracts, with segments that have different rates of profitability may be segmented if it meets the criteria in paragraph .40, paragraph .41, or paragraph .42. The criteria for segmenting should be applied consistently to contracts with similar characteristics and in similar circumstances.

**.40** A project may be segmented if all the following steps were taken and are documented and verifiable:

- a. The contractor submitted bona fide proposals on the separate components of the project and on the entire project.
- b. The customer had the right to accept the proposals on either basis.
- c. The aggregate amount of the proposals on the separate components approximated the amount of the proposal on the entire project.

**.41** A project that does not meet the criteria in paragraph .40 may be segmented only if it meets all the following criteria:

- a. The terms and scope of the contract or project clearly call for separable phases or elements.
- b. The separable phases or elements of the project are often bid or negotiated separately.
- c. The market assigns different gross profit rates to the segments because of factors such as different levels of risk or differences in the relationship of the supply and demand for the services provided in different segments.
- d. The contractor has a significant history of providing similar services to other customers under separate contracts for each significant segment to which a profit margin higher than the overall profit margin on the profit is ascribed.<sup>7</sup>
- e. The significant history with customers who have contracted for services separately is one that is relatively stable in terms of pricing policy rather than one unduly weighted by erratic pricing decisions (responding, for example, to extraordinary economic circumstances or to unique customer-contractor relationships).

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<sup>7</sup> In applying the criterion in paragraph .41(d), values assignable to the segments should be on the basis of the contractor's normal historical prices and terms of such services to other customers. The division considered but rejected the concept of allowing a contractor to segment on the basis of prices charged by other contractors, since it does not follow that those prices could have been obtained by a contractor who has no history in the market.

- f. The excess of the sum of the prices of the separate elements over the price of the total project is clearly attributable to cost savings incident to combined performance of the contract obligations (for example, cost savings in supervision, overhead, or equipment mobilization). Unless this condition is met, segmenting a contract with a price substantially less than the sum of the prices of the separate phases or elements would be inappropriate even if the other conditions are met. Acceptable price variations should be allocated to the separate phases or elements in proportion to the prices ascribed to each. In all other situations a substantial difference in price (whether more or less) between the separate elements and the price of the total project is evidence that the contractor has accepted different profit margins. Accordingly, segmenting is not appropriate, and the contracts should be the profit centers.
- g. The similarity of services and prices in the contract segments and services and the prices of such services to other customers contracted separately should be documented and verifiable.

.42 A production-type contract that does not meet the criteria in paragraphs .40 or .41 may also be segmented and included in groupings such as production lots or releases for the purpose of accumulating and allocating production costs to units produced or delivered on the basis of average unit cost under the conditions specified in paragraph .38.

## **Measuring Progress on Contracts**

.43 This section describes methods of measuring the extent of progress toward completion under the percentage-of-completion method and sets forth criteria for selecting those methods and for determining when a contract is substantially completed. Meaningful measurement of the extent of progress toward completion is essential since this factor is used in determining the amounts of estimated contract revenue and estimated gross profit that will be recognized as earned in any given period.

### **Methods of Measuring Extent of Progress Toward Completion**

.44 In practice, a number of methods are used to measure the extent of progress toward completion. They include the cost-to-cost method, variations of the cost-to-cost method, efforts-expended methods, the units-of-delivery method, and the units-of-work-performed method. Those practices are intended to conform to ARB No. 45, paragraph 4.<sup>8</sup> Some of the measures are sometimes made and certified by engineers or architects, but management should review and understand the procedures used by those professionals.

.45 Some methods used in practice measure progress toward completion in terms of costs, some in terms of units of work, and some in terms of values

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<sup>8</sup> ARB No. 45, paragraph 4, states:

The committee recommends that the recognized income [under the percentage-of-completion method] be that percentage of estimated total income, either:

(a) that incurred costs to date bear to estimated total costs after giving effect to estimates of costs to complete based upon most recent information, or

(b) that may be indicated by such other measure of progress toward completion as may be appropriate having due regard to work performed.

Costs as here used might exclude, especially during the early stages of a contract, all or a portion of the cost of such items as materials and subcontracts if it appears that such an exclusion would result in a more meaningful periodic allocation of income.

added (the contract value of total work performed to date). All three of these measures of progress are acceptable in appropriate circumstances. The division concluded that other methods that achieve the objective of measuring extent of progress toward completion in terms of costs, units, or value added are also acceptable in appropriate circumstances. However, the method or methods selected should be applied consistently to all contracts having similar characteristics. The method or methods of measuring extent of progress toward completion should be disclosed in the notes to the financial statements. Examples of circumstances not appropriate to some methods are given within the discussion of input and output measures.

### ***Input and Output Measures***

.46 The several approaches to measuring progress on a contract can be grouped into input and output measures. Input measures are made in terms of efforts devoted to a contract. They include the methods based on costs and on efforts expended. Output measures are made in terms of results achieved. They include methods based on units produced, units delivered, contract milestones, and value added. For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed. In other circumstances, progress may be measured, for example, on the basis of cubic yards of excavation for foundation contracts or on the basis of cubic yards of pavement laid for highway contracts.

.47 Both input and output measures have drawbacks in some circumstances. Input is used to measure progress toward completion indirectly, based on an established or assumed relationship between a unit of input and productivity. A significant drawback of input measures is that the relationship of the measures to productivity may not hold, because of inefficiencies or other factors. Output is used to measure results directly and is generally the best measure of progress toward completion in circumstances in which a reliable measure of output can be established. However, output measures often cannot be established, and input measures must then be used. The use of either type of measure requires the exercise of judgment and the careful tailoring of the measure to the circumstances.

.48 The efforts-expended method is an input method based on a measure of the work, such as labor hours, labor dollars, machine hours, or material quantities. Under the labor-hours method, for example, extent of progress is measured by the ratio of hours performed to date to estimated total hours at completion. Estimated total labor hours should include (a) the estimated labor hours of the contractor and (b) the estimated labor hours of subcontractors engaged to perform work for the project, if labor hours of subcontractors are a significant element in the performance of the contract. A labor-hours method can measure the extent of progress in terms of efforts expended only if substantial efforts of subcontractors are included in the computation. If the contractor is unable to obtain reasonably dependable estimates of subcontractors' labor hours at the beginning of the project and as work progresses, he should not use the labor-hours method.

.49 The various forms of the efforts-expended method generally are based on the assumption that profits on contracts are derived from the contractor's efforts in all phases of operations, such as designing, procurement, and management. Profit is not assumed to accrue merely as a result of the acquisition of material or other tangible items used in the performance of the contract or the awarding of subcontracts. As previously noted, a significant drawback of



efforts-expended methods is that the efforts included in the measure may not all be productive.

.50 Measuring progress toward completion based on the ratio of costs incurred to total estimated costs is also an input method. Some of the costs incurred, particularly in the early stages of the contract, should be disregarded in applying this method because they do not relate to contract performance. These include the costs of items such as uninstalled materials not specifically produced or fabricated for the project or of subcontracts that have not been performed. For example, for construction projects, the cost of materials not unique to the project that have been purchased or accumulated at job sites but that have not been physically installed do not relate to performance.<sup>9</sup> The costs of such materials should be excluded from costs incurred for the purpose of measuring the extent of progress toward completion. Also, the cost of equipment purchased for use on a contract should be allocated over the period of its expected use unless title to the equipment is transferred to the customer by terms of the contract. For production-type contracts, the complement of expensive components (for example, computers, engines, radars, and complex "black boxes") to be installed into the deliverable items may aggregate a significant portion of the total cost of the contract. In some circumstances, the costs incurred for such components, even though the components were specifically purchased for the project, should not be included in the measurement before the components are installed if inclusion would tend to overstate the percentage of completion otherwise determinable.

.51 The acceptability of the results of input or output measures deemed to be appropriate to the circumstances should be periodically reviewed and confirmed by alternative measures that involve observation and inspection. For example, the results provided by the measure used to determine the extent of progress may be compared to the results of calculations based on physical observations by engineers, architects, or similarly qualified personnel. That type of review provides assurance somewhat similar to that provided for perpetual inventory records by periodic physical inventory counts.

### ***Completion Criteria Under the Completed-Contract Method***

.52 As a general rule, a contract may be regarded as substantially completed if remaining costs and potential risks are insignificant in amount. The overriding objectives are to maintain consistency in determining when contracts are substantially completed and to avoid arbitrary acceleration or deferral of income. The specific criteria used to determine when a contract is substantially completed should be followed consistently and should be disclosed in the note to the financial statements on accounting policies. Circumstances to be considered in determining when a project is substantially completed include, for example, delivery of the product, acceptance by the customer, departure from the site, and compliance with performance specifications.

## **Income Determination—Revenue Elements**

.53 Estimating the revenue on a contract is an involved process, which is affected by a variety of uncertainties that depend on the outcome of a series of

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<sup>9</sup> The cost of uninstalled materials specifically produced, fabricated, or constructed for a project should be included in the costs used to measure extent of progress. Such materials consist of items unique to a project that a manufacturer or supplier does not carry in inventory and that must be produced or altered to meet the specifications of the project.

future events. The estimates must be periodically revised throughout the life of the contract as events occur and as uncertainties are resolved.

.54 The major factors that must be considered in determining total estimated revenue include the basic contract price, contract options, change orders, claims, and contract provisions for penalties and incentive payments, including award fees and performance incentives. All those factors and other special contract provisions must be evaluated throughout the life of a contract in estimating total contract revenue to recognize revenues in the periods in which they are earned under the percentage-of-completion method of accounting.

### ***Basic Contract Price—General***

.55 The estimated revenue from a contract is the total amount that a contractor expects to realize from the contract. It is determined primarily by the terms of the contract and the basic contract price. Contract price may be relatively fixed or highly variable and subject to a great deal of uncertainty, depending on the type of contract involved. Appendix B describes basic contract types and major variations in the basic types. The total amount of revenue that ultimately will be realized on a contract is often subject to a variety of changing circumstances and accordingly may not be known with certainty until the parties to the contract have fully performed their obligations. Thus, the determination of total estimated revenue requires careful consideration and the exercise of judgment in assessing the probabilities of future outcomes.

.56 Although fixed-price contracts usually provide for a stated contract price, a specified scope of the work to be performed, and a specified performance schedule, they sometimes have adjustment schedules based on application of economic price adjustment (escalation), price redetermination, incentive, penalty, and other pricing provisions. Determining contract revenue under unit-price contracts generally involves the same factors as under fixed-price contracts. Determining contract revenue from a time-and-material contract requires a careful analysis of the contract, particularly if the contract includes guaranteed maximums or assigns markups to both labor and materials; and the determination involves consideration of some of the factors discussed below in regard to cost-type contracts.

### ***Basic Contract Price—Cost-Type Contracts***

.57 Cost-type contracts have a variety of forms (see Appendix B). The various forms have differing contract terms that affect accounting, such as provisions for reimbursable costs (which are generally spelled out in the contract), overhead recovery percentages, and fees. A fee may be a fixed amount or a percentage of reimbursable costs or an amount based on performance criteria.<sup>10</sup> Generally, percentage fees may be accrued as the related costs are incurred, since they are a percentage of costs incurred, and profits should therefore be recognized as costs are incurred. Cost-type contracts often include provisions for guaranteed maximum total reimbursable costs or target penalties and rewards relating to underruns and overruns of predetermined target prices, completion dates, plant capacity on completion of the project, or other criteria.

.58 One problem peculiar to cost-type contracts involves the determination of the amounts of reimbursable costs that should be reflected as revenue. Under some contracts, particularly service-type contracts, a contractor acts sol-

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<sup>10</sup> Cost-type government contracts with fees based on a percentage of cost are no longer granted under government regulations.

ely in the capacity of an agent (construction manager) and has no risks associated with costs managed. This relationship may arise, for example, if an owner awards a construction management contract to one entity and a construction contract to another. If the contractor, serving as the construction manager, acts solely as an agent, his revenue should include only the fee and should exclude subcontracts negotiated or managed on behalf of the owner and materials purchased on behalf of the owner.

**.59** In other circumstances, a contractor acts as an ordinary principal under a cost-type contract. For example, the contractor may be responsible to employees for salaries and wages and to subcontractors and other creditors for materials and services, and he may have the discretionary responsibility to procure and manage the resources in performing the contract. The contractor should include in revenue all reimbursable costs for which he has risk or on which his fee was based at the time of bid or negotiation. In addition, revenue from overhead percentage recoveries and the earned fee should be included in revenue.

### ***Customer-Furnished Materials***

**.60** Another concern associated with measuring revenue relates to materials furnished by a customer or purchased by the contractor as an agent for the customer. Often, particularly for large, complex projects, customers may be more capable of carrying out the procurement function or may have more leverage with suppliers than the contractor. In those circumstances, the contractor generally informs the customer of the nature, type, and characteristics or specifications of the materials required and may even purchase the required materials and pay for them, using customer purchase orders and checks drawn against the customer's bank account. If the contractor is responsible for the nature, type, characteristics, or specifications of material that the customer furnishes or that the contractor purchases as an agent of the customer, or if the contractor is responsible for the ultimate acceptability of performance of the project based on such material, the value of those items should be included as contract price and reflected as revenue and costs in periodic reporting of operations. As a general rule, revenues and costs should include all items for which the contractor has an associated risk, including items on which his contractual fee was based.

### ***Change Orders***

**.61** Change orders are modifications of an original contract that effectively change the provisions of the contract without adding new provisions. They may be initiated by either the contractor or the customer, and they include changes in specifications or design, method or manner of performance, facilities, equipment, materials, sites, and period for completion of the work. Many change orders are unpriced; that is, the work to be performed is defined, but the adjustment to the contract price is to be negotiated later. For some change orders, both scope and price may be unapproved or in dispute. Accounting for change orders depends on the underlying circumstances, which may differ for each change order depending on the customer, the contract, and the nature of the change. Change orders should therefore be evaluated according to their characteristics and the circumstances in which they occur. In some circumstances, change orders as a normal element of a contract may be numerous, and separate identification may be impractical. Such change orders may be evaluated statistically on a composite basis using historical results as modified by current conditions. If such change orders are considered by the parties to be a normal element within the original scope of the contract, no

change in the contract price is required. Otherwise, the adjustment to the contract price may be routinely negotiated. Contract revenue and costs should be adjusted to reflect change orders approved by the customer and the contractor regarding both scope and price.

.62 Accounting for unpriced change orders depends on their characteristics and the circumstances in which they occur. Under the completed-contract method, costs attributable to unpriced change orders should be deferred as contract costs if it is probable that aggregate contract costs, including costs attributable to change orders, will be recovered from contract revenues. For all unpriced change orders, recovery should be deemed probable if the future event or events necessary for recovery are likely to occur. Some of the factors to consider in evaluating whether recovery is probable are the customer's written approval of the scope of the change order, separate documentation for change order costs that are identifiable and reasonable, and the entity's favorable experience in negotiating change orders, especially as it relates to the specific type of contract and change order being evaluated. The following guidelines should be followed in accounting for unpriced change orders under the percentage-of-completion method.

- a. Costs attributable to unpriced change orders should be treated as costs of contract performance in the period in which the costs are incurred if it is *not* probable that the costs will be recovered through a change in the contract price.
- b. If it is probable that the costs will be recovered through a change in the contract price, the costs should be deferred (excluded from the cost of contract performance) until the parties have agreed on the change in contract price, or, alternatively, they should be treated as costs of contract performance in the period in which they are incurred, and contract revenue should be recognized to the extent of the costs incurred.
- c. If it is probable that the contract price will be adjusted by an amount that exceeds the costs attributable to the change order and the amount of the excess can be reliably estimated, the original contract price should also be adjusted for that amount when the costs are recognized as costs of contract performance if its realization is probable. However, since the substantiation of the amount of future revenue is difficult, revenue in excess of the costs attributable to unpriced change orders should only be recorded in circumstances in which realization is assured beyond a reasonable doubt, such as circumstances in which an entity's historical experience provides such assurance or in which an entity has received a bona fide pricing offer from a customer and records only the amount of the offer as revenue.

.63 If change orders are in dispute or are unapproved in regard to both scope and price, they should be evaluated as claims (see paragraphs .65 to .67).

### ***Contract Options and Additions***

.64 An option or an addition to an existing contract should be treated as a separate contract in any of the following circumstances:

- a. The product or service to be provided differs significantly from the product or service provided under the original contract.
- b. The price of the new product or service is negotiated without regard to the original contract and involves different economic judgments.

- c. The products or services to be provided under the exercised option or amendment are similar to those under the original contract, but the contract price and anticipated contract cost relationship are significantly different.

If an option or addition to an existing contract does not meet any of the above conditions, it may be combined with the original contract if it meets the criteria in paragraph .37 or .38. Exercised options or additions that do not meet the criteria for treatment as separate contracts or for combining with the original contracts should be treated as change orders on the original contracts.

### **Claims**

.65 Claims are amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or others for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs. Recognition of amounts of additional contract revenue relating to claims is appropriate only if it is probable that the claim will result in additional contract revenue and if the amount can be reliably estimated. Those two requirements are satisfied by the existence of all the following conditions:

- a. The contract or other evidence provides a legal basis for the claim; or a legal opinion has been obtained, stating that under the circumstances there is a reasonable basis to support the claim.
- b. Additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance.
- c. Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed.
- d. The evidence supporting the claim is objective and verifiable, not based on management's "feel" for the situation or on unsupported representations.

If the foregoing requirements are met, revenue from a claim should be recorded only to the extent that contract costs relating to the claim have been incurred. The amounts recorded, if material, should be disclosed in the notes to the financial statements. Costs attributable to claims should be treated as costs of contract performance as incurred.

.66 However, a practice such as recording revenues from claims only when the amounts have been received or awarded may be used. If that practice is followed, the amounts should be disclosed in the notes to the financial statements.

.67 If the requirements in paragraph .65 are not met or if those requirements are met but the claim exceeds the recorded contract costs, a contingent asset should be disclosed in accordance with FASB Statement No. 5, paragraph 17.

### **Income Determination—Cost Elements**

.68 Contract costs must be identified, estimated, and accumulated with a reasonable degree of accuracy in determining income earned. At any time during the life of a contract, total estimated contract cost consists of two components: costs incurred to date and estimated cost to complete the contract. A company should be able to determine costs incurred on a contract with a relatively high degree of precision, depending on the adequacy and effectiveness of its cost accounting system. The procedures or systems used in accounting for

costs vary from relatively simple, manual procedures that produce relatively modest amounts of detailed analysis to sophisticated, computer-based systems that produce a great deal of detailed analysis. Despite the diversity of systems and procedures, however, an objective of each system or of each set of procedures should be to accumulate costs properly and consistently by contract with a sufficient degree of accuracy to assure a basis for the satisfactory measurement of earnings.

### **Contract Costs**

.69 Contract costs are accumulated in the same manner as inventory costs and are charged to operations as the related revenue from contracts is recognized. Contract costs generally include all direct costs, such as materials, direct labor, and subcontracts, and indirect costs identifiable with or allocable to the contracts. However, practice varies for certain types of indirect costs considered allocable to contracts, for example, support costs (such as central preparation and processing of job payrolls, billing and collection costs, and bidding and estimating costs).

.70 Authoritative accounting pronouncements require costs to be considered period costs if they cannot be clearly related to production, either directly or by an allocation based on their discernible future benefits.

.71 Income is recognized over the term of the contract under the percentage-of-completion method or is recognized as units are delivered under the units-of-delivery modification and is deferred until performance is substantially complete under the completed-contract method. None of the characteristics peculiar to those methods, however, require accounting for contract costs to deviate in principle from the basic framework established in existing authoritative literature applicable to inventories or business enterprises in general.

.72 A contracting entity should apply the following general principles in accounting for costs of construction-type and those production-type contracts covered by this statement. The principles are consistent with generally accepted accounting principles for inventory and production costs in other areas, and their application requires the exercise of judgment.

- a. All direct costs, such as material, labor, and subcontracting costs, should be included in contract costs.
- b. Indirect costs allocable to contracts include the costs of indirect labor, contract supervision, tools and equipment, supplies, quality control and inspection, insurance, repairs and maintenance, depreciation and amortization, and, in some circumstances, support costs, such as central preparation and processing of payrolls. For government contractors, other types of costs that are allowable or allocable under pertinent government contract regulations may be allocated to contracts as indirect costs if otherwise allowable under GAAP.<sup>11</sup> Methods of allocating indirect costs should be systematic and rational. They include, for example, allocations based on direct labor costs, direct

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<sup>11</sup> The AICPA Audit and Accounting Guide *Audits of Federal Government Contractors*, states, "Practice varies among government contractors concerning the extent to which costs are included in inventory. Some contractors include in inventory all direct costs and only certain indirect costs. . . . Other contractors record as inventory all costs identified with the contract, including an allocation of general and administrative . . . expenses." The guide points out that many accountants believe that the practice of allocating general and administrative expenses to contract costs, which is permitted under the completed-contract method by ARB No. 45, paragraph 10, may appropriately be extended to government contracts because they believe that "costs incurred pursuant to a government contract are associated directly with the contract's revenue, and both should be recognized in the same period." [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

labor hours, or a combination of direct labor and material costs. The appropriateness of allocations of indirect costs and of the methods of allocation depend on the circumstances and involve judgment.

- c. General and administrative costs ordinarily should be charged to expense as incurred but may be accounted for as contract costs under the completed-contract method of accounting<sup>12</sup> or, in some circumstances, as indirect contract costs by government contractors.<sup>13</sup>
- d. Selling costs should be excluded from contract costs and charged to expense as incurred unless they meet the criteria for precontract costs in paragraph .75.
- e. Costs under cost-type contracts should be charged to contract costs in conformity with generally accepted accounting principles in the same manner as costs under other types of contracts because unrealistic profit margins may result in circumstances in which reimbursable cost accumulations omit substantial contract costs (with a resulting larger fee) or include substantial unallocable general and administrative costs (with a resulting smaller fee).
- f. In computing estimated gross profit or providing for losses on contracts, estimates of cost to complete should reflect all of the types of costs included in contract costs.
- g. Inventoriable costs should not be carried at amounts that when added to the estimated cost to complete are greater than the estimated realizable value of the related contracts.

Interest costs should be accounted for in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*.

### **Precontract Costs**

.73 In practice, costs are deferred in anticipation of future contract sales in a variety of circumstances. The costs may consist of (a) costs incurred in anticipation of a specific contract that will result in no future benefit unless the contract is obtained (such as the costs of mobilization, engineering, architectural, or other services incurred on the basis of commitments or other indications of interest in negotiating a contract), (b) costs incurred for assets to be used in connection with specific anticipated contracts (for example, costs for the purchase of production equipment, materials, or supplies), (c) costs incurred to acquire or produce goods in excess of the amounts required under a contract in anticipation of future orders for the same item, and (d) learning, start-up, or mobilization costs incurred for anticipated but unidentified contracts.

.74 Learning or start-up costs are sometimes incurred in connection with the performance of a contract or a group of contracts. In some circumstances, follow-on or future contracts for the same goods or services are anticipated. Such costs usually consist of labor, overhead, rework, or other special costs that must be incurred to complete the existing contract or contracts in progress and

<sup>12</sup> Paragraph 10 of ARB No. 45, *Long-Term Construction-Type Contracts*, states:

When the completed-contract method is used, it may be appropriate to allocate general and administrative expenses to contract costs rather than to periodic income. This may result in a better matching of costs and revenues than would result from treating such expenses as period cost, particularly in years when no contracts were completed.

<sup>13</sup> See the discussion of the AICPA Audit and Accounting Guide *Audits of Federal Government Contractors*, in footnote 11. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

are distinguished from research and development costs.<sup>14</sup> A direct relationship between such costs and the anticipated future contracts is often difficult to establish, and the receipt of future contracts often cannot reasonably be anticipated.

.75 The division recommends the following accounting for precontract costs:

- a. Costs that are incurred for a specific anticipated contract and that will result in no future benefits unless the contract is obtained should not be included in contract costs or inventory before the receipt of the contract. However, such costs may be otherwise deferred, subject to evaluation of their probable recoverability, but only if the costs can be directly associated with a specific anticipated contract and if their recoverability from that contract is probable.\*
- b. Costs incurred for assets, such as costs for the purchase of materials, production equipment, or supplies, that are expected to be used in connection with anticipated contracts may be deferred outside the contract cost or inventory classification if their recovery from future contract revenue or from other dispositions of the assets is probable.
- c. Costs incurred to acquire or produce goods in excess of the amounts required for an existing contract in anticipation of future orders for the same items may be treated as inventory if their recovery is probable.
- d. Learning or start-up costs incurred in connection with existing contracts and in anticipation of follow-on or future contracts for the same goods or services should be charged to existing contracts.<sup>[15]</sup>
- e. Costs appropriately deferred in anticipation of a contract should be included in contract costs on the receipt of the anticipated contract.
- f. Costs related to anticipated contracts that are charged to expenses as incurred because their recovery is not considered probable should not be reinstated by a credit to income on the subsequent receipt of the contract.

### **Cost Adjustments Arising from Back Charges**

.76 Back charges are billings for work performed or costs incurred by one party that, in accordance with the agreement, should have been performed or incurred by the party to whom billed. These frequently are disputed items. For example, owners bill back charges to general contractors, and general contractors bill back charges to subcontractors. Examples of back charges include charges for cleanup work and charges for a subcontractor's use of a general contractor's equipment.

.77 A common practice is to net back charges in the estimating process. The division recommends the following procedures in accounting for back charges:

- Back charges to others should be recorded as receivables and, to the extent considered collectible, should be applied to reduce contract costs.

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<sup>14</sup> FASB Statement No. 2, *Accounting for Research and Development Costs*, requires that research and development costs be charged to expense when incurred.

\* SOP 98-5, *Reporting on the Costs of Start-Up Activities*, amends this SOP by requiring precontract costs that are start-up costs to be expensed as incurred. SOP 98-5 is effective for financial statements for fiscal years beginning after December 15, 1998. This SOP will be updated to reflect the provisions of SOP 98-5 nearer to the pronouncement's effective date. See section 10,750.

<sup>[15]</sup> [Footnote deleted to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]



However, if the billed party disputes the propriety or amount of the charge, the back charge is in effect a claim, and the criteria for recording claims apply.

- Back charges from others should be recorded as payables and as additional contract costs to the extent that it is probable that the amounts will be paid.

### ***Estimated Cost to Complete***

.78 The estimated cost to complete, the other component of total estimated contract cost, is a significant variable in the process of determining income earned and is thus a significant factor in accounting for contracts. The latest estimate may be determined in a variety of ways and may be the same as the original estimate. Practices in estimating total contract costs vary, and guidance is needed in this area because of the impact of those practices on accounting. The following practices should be followed:

- a. Systematic and consistent procedures that are correlated with the cost accounting system should be used to provide a basis for periodically comparing actual and estimated costs.
- b. In estimating total contract costs, the quantities and prices of all significant elements of cost should be identified.
- c. The estimating procedures should provide that estimated cost to complete includes the same elements of cost that are included in actual accumulated costs; also, those elements should reflect expected price increases.
- d. The effects of future wage and price escalations should be taken into account in cost estimates, especially when the contract performance will be carried out over a significant period of time. Escalation provisions should not be blanket overall provisions but should cover labor, materials, and indirect costs based on percentages or amounts that take into consideration experience and other pertinent data.
- e. Estimates of cost to complete should be reviewed periodically and revised as appropriate to reflect new information.

### **Computation of Income Earned for a Period Under the Percentage-of-Completion Method**

.79 Total estimated gross profit on a contract, the difference between total estimated contract revenue and total estimated contract cost, must be determined before the amount earned on the contract for a period can be determined. The portion of total revenue earned or the total amount of gross profit earned to date is determined by the measurement of the extent of progress toward completion using one of the methods discussed in paragraphs .44 to .51 of this statement. The computation of income earned for a period involves a determination of the portion of total estimated contract revenue that has been earned to date (earned revenue) and the portion of total estimated contract cost related to that revenue (cost of earned revenue). Two different approaches to determining earned revenue and cost of earned revenue are widely used in practice. Either of the alternative approaches may be used on a consistent basis.<sup>16</sup>

<sup>16</sup> The use of Alternative A in the discussion and in the presentation of some of the provisions of this statement is for convenience and consistency and is not intended to imply that Alternative A is the preferred approach.

**Alternative A**

.80 The advocates of this method believe that the portion of total estimated contract revenue earned to date should be determined by the measurement of the extent of progress toward completion and that, in accordance with the matching concept, the measurement of extent of progress toward completion should also be used to allocate a portion of total estimated contract cost to the revenue recognized for the period. They believe that this procedure results in reporting earned revenue, cost of earned revenue, and gross profit consistent with the measurement of contract performance. Moreover, they believe that, if there are no changes in estimates during the performance of a contract, the procedure also results in a consistent gross profit percentage from period to period. However, they recognize that a consistent gross profit percentage is rarely obtained in practice because of the need to be responsive in the accounting process to changes in estimates of contract revenues, costs, earned revenue, and gross profits. In accordance with this procedure, earned revenue, cost of earned revenue, and gross profit should be determined as follows:

- a. *Earned Revenue* to date should be computed by multiplying total estimated contract revenue by the percentage of completion (as determined by one of the acceptable methods of measuring the extent of progress toward completion). The excess of the amount over the earned revenue reported in prior periods is the earned revenue that should be recognized in the income statement for the current period.
- b. *Cost of Earned Revenue* for the period should be computed in a similar manner. Cost of earned revenue to date should be computed by multiplying total estimated contract cost by the percentage of completion on the contract. The excess of that amount over the cost of earned revenue reported in prior periods is the cost of earned revenue that should be recognized in the income statement for the current period. The difference between total cost incurred to date and cost of earned revenue to date should be reported on the balance sheet.
- c. *Gross Profit* on a contract for a period is the excess of earned revenue over the cost of earned revenue.

**Alternative B**

.81 The advocates of this method believe that the measurement of the extent of progress toward completion should be used to determine the amount of gross profit earned to date and that the earned revenue to date is the sum of the total cost incurred on the contract and the amount of gross profit earned. They believe that the cost of work performed on a contract for a period, including materials, labor, subcontractors, and other costs, should be the cost of earned revenue for the period. They believe that the amount of costs incurred can be objectively determined, does not depend on estimates, and should be the amount that enters into the accounting determination of income earned. They recognize that, under the procedure that they advocate, gross profit percentages will vary from period to period unless the cost-to-cost method is used to measure the extent of progress toward completion. However, they believe that varying profit percentages are consistent with the existing authoritative literature when costs incurred do not provide an appropriate measure of the extent of progress toward completion. In accordance with Alternative B, earned revenue, cost of earned revenue, and gross profit are determined as follows:

- a. *Earned Revenue* is the amount of gross profit earned on a contract for a period plus the costs incurred on the contract during the period.
- b. *Cost of Earned Revenue* is the cost incurred during the period, excluding the cost of materials not unique to a contract that have not been used for the contract and costs incurred for subcontracted work that is still to be performed.
- c. *Gross Profit* earned on a contract should be computed by multiplying the total estimated gross profit on the contract by the percentage of completion (as determined by one of the acceptable methods of measuring extent of progress toward completion). The excess of that amount over the amount of gross profit reported in prior periods is the earned gross profit that should be recognized in the income statement for the current period.

## Revised Estimates

.82 Adjustments to the original estimates of the total contract revenue, total contract cost, or extent of progress toward completion are often required as work progresses under the contract and as experience is gained, even though the scope of the work required under the contract may not change. The nature of accounting for contracts is such that refinements of the estimating process for changing conditions and new developments are continuous and characteristic of the process. Additional information that enhances and refines the estimating process is often obtained after the balance sheet date but before the issuance of the financial statements; such information should result in an adjustment of the unissued financial statements. Events occurring after the date of the financial statements that are outside the normal exposure and risk aspects of the contract should not be considered refinements of the estimating process of the prior year but should be disclosed as subsequent events.

.83 Revisions in revenue, cost, and profit estimates or in measurements of the extent of progress toward completion are changes in accounting estimates as defined in APB Opinion No. 20, *Accounting Changes*.<sup>17</sup> That opinion has been interpreted to permit the following two alternative methods of accounting for changes in accounting estimates:

- *Cumulative Catch-up*. Account for the change in estimate in the period of change so that the balance sheet at the end of the period of change and the accounting in subsequent periods are as they would have been if the revised estimate had been the original estimate.
- *Reallocation*. Account for the effect of the change ratably over the period of change in estimate and subsequent periods.

Although both methods are used in practice to account for changes in estimates of total revenue, total costs, or extent of progress under the percentage-of-completion method, the cumulative catch-up method is more widely used. Accordingly, to narrow the areas of differences in practice, such changes should be accounted for by the cumulative catch-up method.

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<sup>17</sup> Paragraph 31 of APB Opinion No. 20, *Accounting Changes*, requires that "the effect of a change in accounting estimate should be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both."

.84 Although estimating is a continuous and normal process for contractors, the second sentence of APB Opinion No. 20, paragraph 33, recommends disclosure of the effect of significant revisions if the effect is material.<sup>18</sup>

### Provisions for Anticipated Losses on Contracts

.85 When the current estimates of total contract revenue and contract cost indicate a loss, a provision for the entire loss on the contract should be made. Provisions for losses should be made in the period in which they become evident under either the percentage-of-completion method or the completed-contract method. If a group of contracts are combined based on the criteria in paragraph .37 or .38, they should be treated as a unit in determining the necessity for a provision for a loss. If contracts are segmented based on the criteria in paragraph .40, .41, or .42 of this statement, the individual segments should be considered separately in determining the need for a provision for a loss.

.86 Losses on cost-type contracts, although less frequent, may arise if, for example, a contract provides for guaranteed maximum reimbursable costs or target penalties. In recognizing losses for accounting purposes, the contractor's normal cost accounting methods should be used in determining the total cost overrun on the contract, and losses should include provisions for performance penalties.

.87 The costs used in arriving at the estimated loss on a contract should include all costs of the type allocable to contracts under paragraph .72 of this statement. Other factors that should be considered in arriving at the projected loss on a contract include target penalties and rewards, nonreimbursable costs on cost-plus contracts, change orders, and potential price redeterminations. In circumstances in which general and administrative expenses are treated as contract costs under the completed-contract method of accounting, the estimated loss should include the same types of general and administrative expenses.

.88 The provision for loss arises because estimated cost for the contract exceeds estimated revenue. Consequently, the provision for loss should be accounted for in the income statement as an additional contract cost rather than as a reduction of contract revenue, which is a function of contract price, not cost. Unless the provision is material in amount or unusual or infrequent in nature, the provision should be included in contract cost and need not be shown separately in the income statement. If it is shown separately, it should be shown as a component of the cost included in the computation of gross profit.

.89 Provisions for losses on contracts should be shown separately as liabilities on the balance sheet, if significant, except in circumstances in which related costs are accumulated on the balance sheet, in which case the provisions may be deducted from the related accumulated costs. In a classified balance sheet, a provision shown as a liability should be shown as a current liability.

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<sup>18</sup> APB Opinion No. 20, paragraph 33, states, "The effect on income before extraordinary items, net income and related per share amounts of the current period should be disclosed for a change in estimate that affects several future periods, such as a change in service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence; however, disclosure is recommended if the effect of a change in the estimate is material."

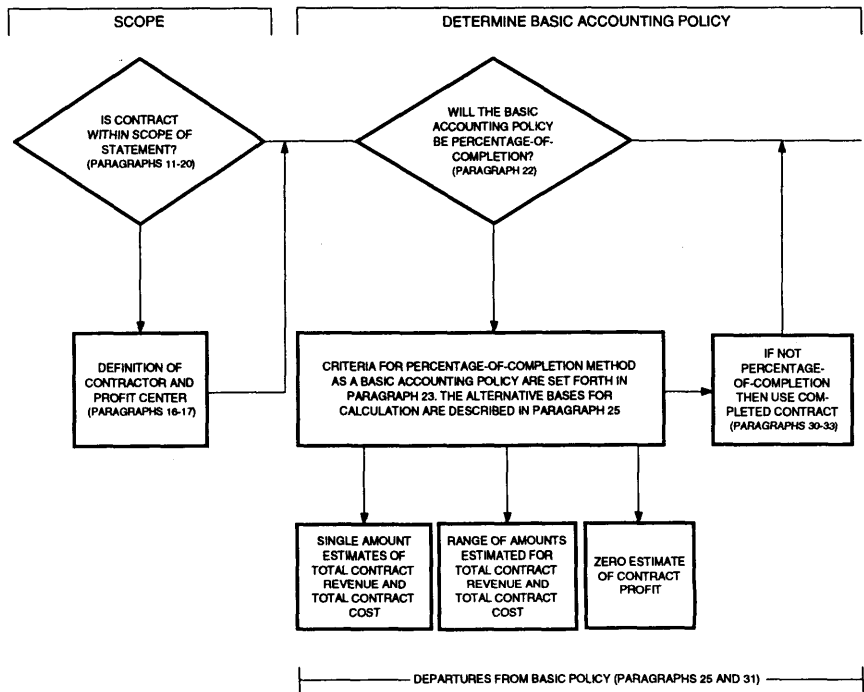
## Transition

**.90** An accounting change from the completed-contract method or from the percentage-of-completion method to conform to the recommendations of this statement of position should be made retroactively by restating the financial statements of prior periods. The restatement should be made on the basis of current information if historical information is not available. If the information for restatement of prior periods is not available on either a historical or current basis, financial statements and summaries should be restated for as many consecutive prior periods preceding the transition date of this statement as is practicable, and the cumulative effect on the retained earnings at the beginning of the earliest period restated (or at the beginning of the period in which the statement is first applied if it is not practicable to restate any prior periods) should be included in determining net income for that period (see paragraph 20 of APB Opinion No. 20, *Accounting Changes*).

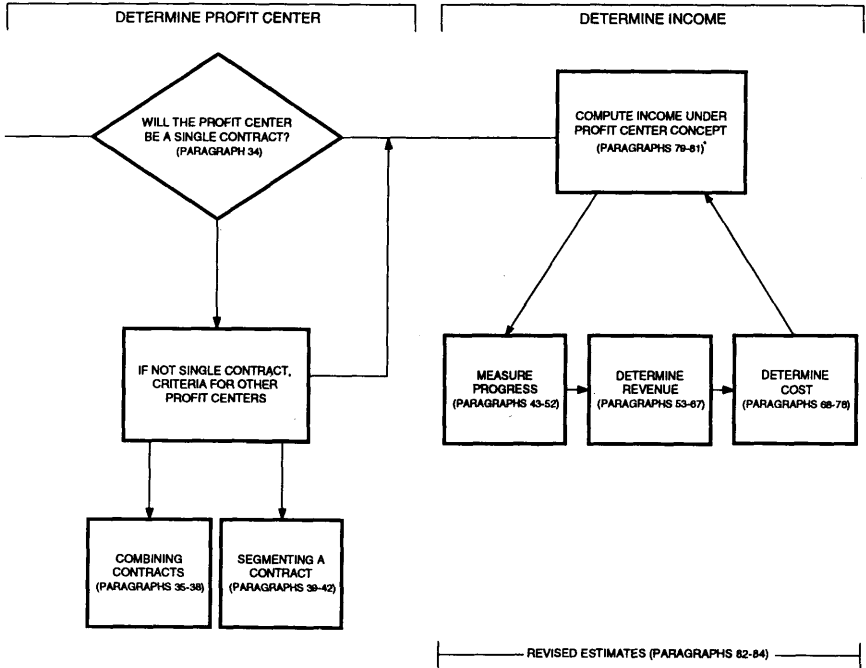
**.91** Accounting changes to conform to the recommendations of this statement of position, other than those stated in paragraph .90, should be made prospectively for contracting transactions, new contracts, and contract revisions entered into on or after the effective date of this statement. The division recommends the application of the provisions of this statement for fiscal years, and interim periods in such fiscal years, beginning after June 30, 1981. The division encourages earlier application of this statement, including retroactive application to all contracts regardless of when they were entered into. Disclosures should be made in the financial statements in the period of change in accordance with APB Opinion No. 20, paragraph 28.

Appendix A

Schematic Chart of SOP Organization



NOTE: ALL PARAGRAPH NUMBERS ABOVE REFER TO TEXT OF SOP.  
\* If computation results in a loss, see paragraphs 68-69



## Appendix B

### Types of Contracts

Four basic types of contracts are distinguished on the basis of their pricing arrangements in paragraph .15 of this statement: (a) fixed-price or lump-sum contracts, (b) time-and-material contracts, (c) cost-type (including cost-plus) contracts, and (d) unit-price contracts. This appendix describes the basic types of contracts in greater detail and briefly describes common variations of each basic type.

### Fixed-Price or Lump-Sum Contracts

A fixed-price or lump-sum contract is a contract in which the price is not usually subject to adjustment because of costs incurred by the contractor. Common variations of fixed-price contracts are:

1. *Firm fixed-price contract*—A contract in which the price is not subject to any adjustment by reason of the cost experience of the contractor or his performance under the contract.
2. *Fixed-price contract with economic price adjustment*—A contract which provides for upward or downward revision of contract price upon the occurrence of specifically defined contingencies, such as increases or decreases in material prices or labor wage rates.
3. *Fixed-price contract providing for prospective periodic redetermination of price*—A contract which provides a firm fixed-price for an initial number of unit deliveries or for an initial period of performance and for prospective price redeterminations either upward or downward at stated intervals during the remaining period of performance under the contract.
4. *Fixed-price contract providing for retroactive redetermination of price*—A contract which provides for a ceiling price and retroactive price redetermination (within the ceiling price) after the completion of the contract, based on costs incurred, with consideration being given to management ingenuity and effectiveness during performance.
5. *Fixed-price contract providing for firm target cost incentives*—A contract which provides at the outset for a firm target cost, a firm target profit, a price ceiling (but not a profit ceiling or floor), and a formula (based on the relationship which final negotiated total cost bears to total target cost) for establishing final profit and price.
6. *Fixed-price contract providing for successive target cost incentives*—A contract which provides at the outset for an initial target cost, an initial target profit, a price ceiling, a formula for subsequently fixing the firm target profit (within a ceiling and a floor established along with the formula, at the outset), and a production point at which the formula will be applied.
7. *Fixed-price contract providing for performance incentives*—A contract which incorporates an incentive to the contractor to surpass stated performance targets by providing for increases in the profit to the extent that such targets are surpassed and for decreases to the extent that such targets are not met.



8. *Fixed-price level-of-effort term contract*—A contract which usually calls for investigation or study in a specific research and development area. It obligates the contractor to devote a specified level of effort over a stated period of time for a fixed dollar amount.<sup>1</sup>

## Time-and-Material Contracts

Time-and-material contracts are contracts that generally provide for payments to the contractor on the basis of direct labor hours at fixed hourly rates (that cover the cost of direct labor and indirect expenses and profit) and cost of materials or other specified costs. Common variations of time and material contracts are:

1. Time at marked-up rate.
2. Time at marked-up rate, material at cost.
3. Time and material at marked-up rates.
4. Guaranteed maximum cost—labor only or labor and material.

## Cost-Type Contracts

Cost-type contracts provide for reimbursement of allowable or otherwise defined costs incurred plus a fee that represents profit. Cost-type contracts usually only require that the contractor use his best efforts to accomplish the scope of the work within some specified time and some stated dollar limitation. Common variations of cost-plus contracts are

1. *Cost-sharing contract*—A contract under which the contractor is reimbursed only for an agreed portion of costs and under which no provision is made for a fee.
2. *Cost-without-fee contract*—A contract under which the contractor is reimbursed for costs with no provision for a fee.
3. *Cost-plus-fixed-fee contract*—A contract under which the contractor is reimbursed for costs plus the provision for a fixed fee.
4. *Cost-plus-award-fee contract*—A contract under which the contractor is reimbursed for costs plus a fee consisting of two parts: (a) a fixed amount which does not vary with performance and (b) an award amount based on performance in areas such as quality, timeliness, ingenuity, and cost-effectiveness. The amount of award fee is based upon a subjective evaluation by the government of the contractor's performance judged in light of criteria set forth in the contract.
5. *Cost-plus-incentive-fee contract (Incentive based on cost)*—A contract under which the contractor is reimbursed for costs plus a fee which is adjusted by formula in accordance with the relationship which total allowable costs bear to target cost. At the outset there is negotiated a target cost, a target fee, a minimum and maximum fee, and the adjustment formula.
6. *Cost-plus-incentive-fee contract (Incentive based on performance)*—A contract under which a contractor is reimbursed for costs plus an in-

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<sup>1</sup> AICPA Audit and Accounting Guide *Audits of Federal Government Contractors*, paragraphs 1.27–1.35. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

centive to surpass stated performance targets by providing for increases in the fee to the extent that such targets are surpassed and for decreases to the extent that such targets are not met.<sup>2</sup>

### Unit-Price Contracts

Unit-price contracts are contracts under which the contractor is paid a specified amount for every unit of work performed. A unit-price contract is essentially a fixed-price contract with the only variable being units of work performed. Variations in unit-price contracts include the same type of variations as fixed-price contracts. A unit-price contract is normally awarded on the basis of a total price that is the sum of the product of the specified units and unit prices. The method of determining total contract price may give rise to unbalanced unit prices because units to be delivered early in the contract may be assigned higher unit prices than those to be delivered as the work under the contract progresses.

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<sup>2</sup> AICPA Audit and Accounting Guide *Audits of Federal Government Contractors*, paragraphs 1.41 and 1.42. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

## **Appendix C**

### **Summary of Disclosure Recommendations in Statement of Position**

<i>SOP Par.</i>	<i>Nature of Disclosure</i>
.21	Accounting policy—methods of reporting revenue
.45	Method or methods of measuring extent of progress toward completion
.52	Criteria for determining substantial completion
.65–.67	Information on revenue and costs arising from claims
.84	Effects of changes in estimates on contracts
.90–.91	Effects of accounting changes to conform to SOP

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[The next page is 18,931.]

## Section 10,350

# **Statement of Position 82-1 Accounting and Financial Reporting for Personal Financial Statements**

October 1, 1982

[Amendment to AICPA Industry Audit Guide *Audits of Personal Financial Statements*]

### **NOTE**

This statement of position significantly amends the recommendations on accounting principles in the AICPA Industry Audit Guide, *Audits of Personal Financial Statements* (1968), for personal financial statements dated June 30, 1983, or after.

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

## **Introduction**

.01 This statement of position deals with the preparation and presentation of personal financial statements, that is, financial statements of individuals or groups of related individuals (families). Personal financial statements are prepared for individuals either to formally organize and plan their financial affairs in general or for specific purposes, such as obtaining of credit, income tax planning, retirement planning, gift and estate planning, or public disclosure of their financial affairs. Users of personal financial statements rely on them in determining whether to grant credit, in assessing the financial activities of individuals, in assessing the financial affairs of public officials and candidates for public office, and for similar purposes.

.02 The 1968 AICPA Industry Audit Guide, *Audits of Personal Financial Statements*, supported historical cost as the primary basis of measurement for personal financial statements and recommended the presentation of estimated current values as additional information. The preface to that guide stated that "generally accepted accounting principles and auditing standards developed

for commercial enterprises are applicable in general to personal financial statements.” However, the increasing use of personal financial statements and experience with the use of the guide suggested the need to reassess those conclusions in light of the purposes for which personal financial statements are prepared, the users to whom they are directed, and the ways in which they are used. This statement of position is the result of that reassessment; it supersedes the accounting provisions of the 1968 AICPA Industry Audit Guide, *Audits of Personal Financial Statements*, in accordance with the transition and effective date set forth in paragraph .33 of this statement of position.

## Basis of Presentation of Personal Financial Statements

.03 The primary focus of personal financial statements is a person’s assets and liabilities, and the primary users of personal financial statements normally consider estimated current value information to be more relevant for their decisions than historical cost information. Lenders require estimated current value information to assess collateral, and most personal loan applications require estimated current value information. Estimated current values are required for estate, gift, and income tax planning, and estimated current value information about assets is often required in federal and state filings of candidates for public office.

.04 The accounting standards division therefore believes personal financial statements should present assets at their estimated current values and liabilities at their estimated current amounts at the date of the financial statements. Paragraph .12 of this statement of position defines estimated current values of assets. Paragraph .27 defines estimated current amounts of liabilities. This statement of position explains how the estimated current values of assets and the estimated current amounts of liabilities should be determined and applied in the preparation and presentation of personal financial statements.<sup>1</sup>

## Presentation of Personal Financial Statements

### The Reporting Entity

.05 Personal financial statements may be prepared for an individual, a husband and wife, or a family.

### The Form of the Statements

.06 Personal financial statements consist of—

- a. *A statement of financial condition.* This is the basic personal financial statement. It presents the estimated current values of assets, the estimated current amounts of liabilities, estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases, and net worth at a specified date. The term *net worth* should be used in the statement to designate the difference between total assets and total liabilities, after deducting estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases.

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<sup>1</sup> The division recognizes that users of personal financial statements may sometimes request certain historical cost information. This statement of position does not prohibit supplemental presentation of such information.

- b. *A statement of changes in net worth.* This statement presents the major sources of increases and decreases in net worth. It should present the major sources of increases in net worth: income, increases in the estimated current values of assets, decreases in the estimated current amounts of liabilities, and decreases in estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases. It should present the major sources of decreases in net worth: expenses, decreases in the estimated current values of assets, increases in the estimated current amounts of liabilities, and increases in estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases. One statement combining income and other changes is desirable because of the mix of business and personal items in personal financial statements. The presentation of a statement of changes in net worth is optional.
- c. *Comparative financial statements.* The presentation of comparative financial statements of the current period and one or more prior periods may sometimes be desirable. Such a presentation is more informative than the presentation of financial statements for only one period. The presentation of comparative financial statements is optional.

Illustrative financial statements are presented in appendix A [paragraph .34] to this statement of position.

## The Methods of Presentation

.07 Assets and liabilities and changes in them should be recognized on the accrual basis, not on the cash basis.

.08 The most useful and readily understood presentation of assets and liabilities in personal financial statements is by order of liquidity and maturity, without classification as current and noncurrent, since the concept of working capital applied to business enterprises is inappropriate for personal financial statements.

.09 If personal financial statements are prepared for one of a group of joint owners of assets, the statements should include only the person's interest as a beneficial owner, as determined under the property laws of the state having jurisdiction. If property is held in joint tenancy, as community property, or through a similar joint ownership arrangement, the legal status of the separate equities of the parties may not be evident. In that case, the person may require legal advice to determine whether an interest in the property should be included among the person's assets and, if so, the proper allocation of the equity in the property under the applicable state laws.

.10 Business interests that constitute a large part of a person's total assets should be shown separately from other investments. The estimated current value of an investment in a separate entity, such as a closely held corporation, a partnership, or a sole proprietorship, should be shown in one amount as an investment if the entity is marketable as a going concern. Assets and liabilities of the separate entity should not be combined with similar personal items.

.11 The estimated current values of assets and the estimated current amounts of liabilities of limited business activities not conducted in a separate

business entity, such as an investment in real estate and a related mortgage, should be presented as separate amounts, particularly if a large portion of the liabilities may be satisfied with funds from sources unrelated to the investment.

## **Guidelines for Determining the Estimated Current Values of Assets and the Estimated Current Amounts of Liabilities**

### **General**

.12 Personal financial statements should present assets at their estimated current values and liabilities at their estimated current amounts. The estimated current value of an asset in personal financial statements is the amount at which the item could be exchanged between a buyer and seller, each of whom is well informed and willing, and neither of whom is compelled to buy or sell. Costs of disposal, such as commissions, if material, should be considered in determining estimated current values.<sup>2</sup> The division recognizes that the estimated current values of some assets may be difficult to determine and the cost of obtaining estimated current values of some assets directly may exceed the benefits of doing so; therefore, the division recommends that judgment be exercised in determining estimated current values.

.13 Recent transactions involving similar assets and liabilities in similar circumstances ordinarily provide a satisfactory basis for determining the estimated current value of an asset and the estimated current amount of a liability. If recent sales information is unavailable, other methods that may be used include the capitalization of past or prospective earnings, the use of liquidation values, the adjustment of historical cost based on changes in a specific price index, the use of appraisals, or the use of the discounted amounts of projected cash receipts and payments.

.14 In determining the estimated current values of some assets (for example, works of art, jewelry, restricted securities, investments in closely held businesses, and real estate), the person may need to consult a specialist.

.15 The methods used to determine the estimated current values of assets and the estimated current amounts of liabilities should be followed consistently from period to period unless the facts and circumstances dictate a change to different methods.

### **Receivables**

.16 Personal financial statements should present receivables at the discounted amounts of cash the person estimates will be collected, using appropriate interest rates at the date of the financial statements.

### **Marketable Securities**

.17 Marketable securities include both debt and equity securities for which market quotations are available. The estimated current values of such securities are their quoted market prices. The estimated current values of securities traded on securities exchanges are the closing prices of the securities

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<sup>2</sup> Paragraph .27 defines the estimated current amount of a liability.



on the date of the financial statements (valuation date) if the securities were traded on that date. If the securities were not traded on that date but published bid and asked prices are available, the estimated current values of the securities should be within the range of those prices.

.18 For securities traded in the over-the-counter market, quotations of bid and asked prices are available from several sources, including the financial press, various quotation publications and financial reporting services, and individual broker-dealers. For those securities, the mean of the bid prices, of the bid and asked prices, or of the prices of a representative selection of broker-dealers quoting the securities may be used as the estimated current values.

.19 An investor may hold a large block of the equity securities of a company. A large block of stock might not be salable at the price at which a small number of shares were recently sold or quoted. Further, a large minority interest may be difficult to sell despite isolated sales of a small number of shares. However, a controlling interest may be proportionately more valuable than minority interests that were sold. Consideration of those factors may require adjustments to the price at which the security recently sold. Moreover, restrictions on the transfer of a security may also suggest the need to adjust the recent market price in determining the estimated current value.<sup>3</sup>

## Options

.20 If published prices of options are unavailable, their estimated current values should be determined on the basis of the values of the assets subject to option, considering such factors as the exercise prices and length of the option periods.

## Investment in Life Insurance

.21 The estimated current value of an investment in life insurance is the cash value of the policy less the amount of any loans against it. The face amount of life insurance the individuals own should be disclosed.

## Investments in Closely Held Businesses

.22 The division recognizes that the estimated current values of investments in closely held businesses usually are difficult to determine. The problems relate to investments in closely held businesses in any form, including sole proprietorships, general and limited partnerships, and corporations. As previously stated, only the net investment in a business enterprise (not its assets and liabilities) should be presented in the statement of financial condition. The net investment should be presented at its estimated current value at the date of the financial statement. Since there is usually no established ready market for such an investment, judgment should be exercised in determining the estimated current value of the investment.

.23 There is no one generally accepted procedure for determining the estimated current value of an investment in a closely held business. Several procedures or combinations of procedures may be used to determine the esti-

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<sup>3</sup> For further discussion on valuing marketable securities, see the AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraphs 2.27 through 2.34, "Basic Methods of Valuing Securities." [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

mated current value of a closely held business, including a multiple of earnings, liquidation value, reproduction value, appraisals, discounted amounts of projected cash receipts and payments, or adjustments of book value or cost of the person's share of the equity of the business.<sup>4</sup> The owner of an interest in a closely held business may have entered into a buy-sell agreement that specifies the amount (or the basis of determining the amount) to be received in the event of withdrawal, retirement, or sale. If such an agreement exists, it should be considered, but it does not necessarily determine estimated current value. Whatever procedure is used, the objective should be to approximate the amount at which the investment could be exchanged between a buyer and a seller, each of whom is well informed and willing, and neither of whom is compelled to buy or sell.

### **Real Estate (Including Leaseholds)**

.24 Investments in real estate (including leaseholds) should be presented in personal financial statements at their estimated current values. Information that may be used in determining their estimated current values includes—

- a. Sales of similar property in similar circumstances.
- b. The discounted amounts of projected cash receipts and payments relating to the property or the net realizable value of the property, based on planned courses of action, including leaseholds whose current rental value exceeds the rent in the lease.
- c. Appraisals based on estimates of selling prices and selling costs obtained from independent real estate agents or brokers familiar with similar properties in similar locations.
- d. Appraisals used to obtain financing.
- e. Assessed value for property taxes, including consideration of the basis for such assessments and their relationship to market values in the area.

### **Intangible Assets**

.25 Intangible assets should be presented at the discounted amounts of projected cash receipts and payments arising from the planned use or sale of the assets if both the amounts and timing can be reasonably estimated. For example, a record of receipts under a royalty agreement may provide sufficient information to determine its estimated current value. The cost of a purchased intangible should be used if no other information is available.

### **Future Interests and Similar Assets**

.26 Nonforfeitable rights to receive future sums that have all the following characteristics should be presented as assets at their discounted amounts:

- The rights are for fixed or determinable amounts.
- The rights are not contingent on the holder's life expectancy or the occurrence of a particular event, such as disability or death.
- The rights do not require future performance of service by the holder.

Nonforfeitable rights that may have those characteristics include—

- Guaranteed minimum portions of pensions.

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<sup>4</sup> The book value or cost of a person's share of the equity of a business adjusted for appraisals of specific assets, such as real estate or equipment, is sometimes used as the estimated current value.

- Vested interests in pension or profit sharing plans.
- Deferred compensation contracts.
- Beneficial interests in trusts.
- Remainder interests in property subject to life estates.
- Annuities.
- Fixed amounts of alimony for a definite future period.

## Payables and Other Liabilities

.27 Personal financial statements should present payables and other liabilities at the discounted amounts of cash to be paid. The discount rate should be the rate implicit in the transaction in which the debt was incurred. If, however, the debtor is able to discharge the debt currently at a lower amount, the debt should be presented at the lower amount.<sup>5</sup>

## Noncancellable Commitments

.28 Noncancellable commitments to pay future sums that have all the following characteristics should be presented as liabilities at their discounted amounts:

- The commitments are for fixed or determinable amounts.
- The commitments are not contingent on others' life expectancies or the occurrence of a particular event, such as disability or death.
- The commitments do not require future performance of service by others.

Noncancellable commitments that may have those characteristics include fixed amounts of alimony for a definite future period and charitable pledges.

## Income Taxes Payable

.29 The liability for income taxes payable should include unpaid income taxes for completed tax years and an estimated amount for income taxes accrued for the elapsed portion of the current tax year to the date of the financial statements. That estimate should be based on the relationship of taxable income earned to date to total estimated taxable income for the year, net of taxes withheld or paid with estimated income tax returns.

## Estimated Income Taxes on the Differences Between the Estimated Current Values of Assets and the Estimated Current Amounts of Liabilities and Their Tax Bases

.30 A provision should be made for estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases, including consideration of negative tax bases of tax shelters, if any. The provision should be computed as if the estimated current values of all assets had been realized and the estimated current amounts of all liabilities had been liquidated on the statement

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<sup>5</sup> For a further discussion of the setting of a discount rate for payables and other liabilities, see APB Opinion 21, *Interest on Receivables and Payables*, paragraph 13.

date, using applicable income tax laws and regulations, considering recapture provisions and available carryovers. The estimated income taxes should be presented between liabilities and net worth in the statement of financial condition. The methods and assumptions used to compute the estimated income taxes should be fully disclosed. Appendix B [paragraph .35] to this statement of position illustrates how to compute the provision.

## Financial Statement Disclosures

**.31** Personal financial statements should include sufficient disclosures to make the statements adequately informative. The disclosures may be made in the body of the financial statements or in the notes. The following enumeration is intended not to be all-inclusive but simply indicative of the nature and type of information that ordinarily should be disclosed:

- a.* A clear indication of the individuals covered by the financial statements
- b.* That assets are presented at their estimated current values and liabilities are presented at their estimated current amounts
- c.* The methods used in determining the estimated current values of major assets and the estimated current amounts of major liabilities or major categories of assets and liabilities, since several methods are available, and changes in methods from one period to the next
- d.* If assets held jointly by the person and by others are included in the statements, the nature of the joint ownership
- e.* If the person's investment portfolio is material in relation to his or her other assets and is concentrated in one or a few companies or industries, the names of the companies or industries and the estimated current values of the securities
- f.* If the person has a material investment in a closely held business, at least the following:
  - The name of the company and the person's percentage of ownership
  - The nature of the business
  - Summarized financial information about assets, liabilities, and results of operations for the most recent year based on the financial statements of the business, including information about the basis of presentation (for example, generally accepted accounting principles, income tax basis, or cash basis) and any significant loss contingencies
- g.* Descriptions of intangible assets and their estimated useful lives
- h.* The face amount of life insurance the individuals own
- i.* Nonforfeitable rights that do not have the characteristics discussed in paragraph .26, for example, pensions based on life expectancy
- j.* The following tax information:
  - The methods and assumptions used to compute the estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities

and their tax bases and a statement that the provision will probably differ from the amounts of income taxes that might eventually be paid because those amounts are determined by the timing and the method of disposal, realization, or liquidation and the tax laws and regulations in effect at the time of disposal, realization, or liquidation

- Unused operating loss and capital loss carryforwards
  - Other unused deductions and credits, with their expiration periods, if applicable
  - The differences between the estimated current values of major assets and the estimated current amounts of major liabilities or categories of assets and liabilities and their tax bases
- k. Maturities, interest rates, collateral, and other pertinent details relating to receivables and debt
- l. Noncancellable commitments that do not have the characteristics discussed in paragraph .28, for example, operating leases

.32 Generally accepted accounting principles other than those discussed in this statement of position may apply to personal financial statements. For example, FASB Statement No. 5, *Accounting for Contingencies*, and related amendments and interpretations, provide guidance on accounting for contingencies, and FASB Statement No. 57, *Related Party Disclosures*, provides guidance on related-party disclosures.

## Transition and Effective Date

.33 The accounting standards division recommends that the provisions of this statement of position should apply to personal financial statements dated June 30, 1983, or after. Comparative statements of prior periods should be restated to comply with the provisions of this statement of position.

Appendix A

Illustrative Financial Statements

James and Jane Person  
Statements of Financial Condition  
December 31, 19X3 and 19X2

	<i>December 31,</i>	
	<i>19X3</i>	<i>19X2</i>
Assets		
Cash	\$ 3,700	\$ 15,600
Bonus receivable	20,000	10,000
Investments		
Marketable securities (Note 2)	160,500	140,700
Stock options (Note 3)	28,000	24,000
Kenbruce Associates (Note 4)	48,000	42,000
Davekar Company, Inc. (Note 5)	550,000	475,000
Vested interest in deferred profit sharing plan	111,400	98,900
Remainder interest in testamentary trust (Note 6)	171,900	128,800
Cash value of life insurance (\$43,600 and \$42,900), less loans payable to insurance companies (\$38,100 and \$37,700) (Note 7)	5,500	5,200
Residence (Note 8)	190,000	180,000
Personal effects (excluding jewelry) (Note 9)	55,000	50,000
Jewelry (Note 9)	40,000	36,500
	<u>\$1,384,000</u>	<u>\$1,206,700</u>

	<i>December 31,</i>	
	<i>19X3</i>	<i>19X2</i>
Liabilities		
Income taxes—current year balance	\$ 8,800	\$ 400
Demand 10.5% note payable to bank	25,000	26,000
Mortgage payable (Note 10)	98,200	99,000
Contingent liabilities (Note 11)		
	<u>132,000</u>	<u>125,400</u>
Estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases (Note 12)	239,000	160,000
Net worth	<u>1,013,000</u>	<u>921,300</u>
	<u>\$1,384,000</u>	<u>\$1,206,700</u>

The accompanying notes are an integral part of these financial statements.

Statements of Position

James and Jane Person  
Statements of Changes in Net Worth  
For the Years Ended December 31, 19X3 and 19X2

	<i>Year ended December 31,</i>	
	<i>19X3</i>	<i>19X2</i>
Realized increases in net worth		
Salary and bonus	\$ 95,000	\$85,000
Dividends and interest income	2,300	1,800
Distribution from limited partnership	5,000	4,000
Gains on sales of marketable securities	1,000	500
	<u>103,300</u>	<u>91,300</u>
Realized decreases in net worth		
Income taxes	26,000	22,000
Interest expense	13,000	14,000
Real estate taxes	4,000	3,000
Personal expenditures	36,700	32,500
	<u>79,700</u>	<u>71,500</u>
Net realized increase in net worth	<u>23,600</u>	<u>19,800</u>



	<i>Year ended December 31,</i>	
	<i>19X3</i>	<i>19X2</i>
Unrealized increases in net worth		
Marketable securities (net of realized gains on securities sold)	\$ 3,000	\$ 500
Stock options	4,000	500
Davekar Company, Inc.	75,000	25,000
Kenbruce Associates	6,000	
Deferred profit sharing plan	12,500	9,500
Remainder interest in testamentary trust	43,100	25,000
Jewelry	3,500	
	<u>147,100</u>	<u>60,500</u>
Unrealized decrease in net worth		
Estimated income taxes in the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases	79,000	22,000
Net unrealized increase in net worth	<u>68,100</u>	<u>38,500</u>
Net increase in net worth	91,700	58,300
Net worth at the beginning of year	<u>921,300</u>	<u>863,000</u>
Net worth at the end of year	<u>\$1,013,000</u>	<u>\$921,300</u>

The accompanying notes are an integral part of these financial statements.

James and Jane Person

Notes to Financial Statements

**Note 1.** The accompanying financial statements include the assets and liabilities of James and Jane Person. Assets are stated at their estimated current values, and liabilities at their estimated current amounts.

**Note 2.** The estimated current values of marketable securities are either (a) their quoted closing prices or (b) for securities not traded on the financial statement date, amounts that fall within the range of quoted bid and asked prices.

Marketable securities consist of the following:

				<u>December 31, 19X3</u>		<u>December 31, 19X2</u>	
				<u>Number of</u>	<u>Estimated</u>	<u>Number of</u>	<u>Estimated</u>
				<u>shares or</u>	<u>current</u>	<u>shares or</u>	<u>current</u>
				<u>bonds</u>	<u>values</u>	<u>bonds</u>	<u>values</u>
<u>Stocks</u>							
Jaiven Jewels, Inc.	1,500	\$ 98,813					
McRae Motors, Inc.	800	11,000	600	\$ 4,750			
Parker Sisters, Inc.	400	13,875	200	5,200			
Rosenfield Rug Co.			1,200	96,000			
Rubin Paint Company	300	9,750	100	2,875			
Weiss Potato Chips, Inc.	200	20,337	300	25,075			
		<u>153,775</u>		<u>133,900</u>			
<u>Bonds</u>							
Jackson Van Lines, Ltd. (12% due 7/1/X9)	5	5,225	5	5,100			
United Garvey, Inc. (7% due 11/15/X6)	2	1,500	2	1,700			
		<u>6,725</u>		<u>6,800</u>			
		<u>\$160,500</u>		<u>\$140,700</u>			

**Note 3.** Jane Person owns options to acquire 4,000 shares of stock of Winner Corp. at an option price of \$5 per share. The option expires on June 30, 19X5. The estimated current value is its published selling price.

**Note 4.** The investment in Kenbruce Associates is an 8% interest in a real estate limited partnership. The estimated current value is determined by the projected annual cash receipts and payments capitalized at a 12% rate.

**Note 5.** James Person owns 50% of the common stock of Davekar Company, Inc., a retail mail order business. The estimated current value of the investment is determined by the provisions of a shareholders' agreement, which restricts the sale of the stock and, under certain conditions, requires the company to repurchase the stock based on a price equal to the book value of the net assets plus an agreed amount for goodwill. At December 31, 19X3, the agreed amount for goodwill was \$112,500, and at December 31, 19X2, it was \$ 100,000.

A condensed balance sheet of Davekar Company, Inc., prepared in conformity with generally accepted accounting principles, is summarized below:

	<i>December 31,</i>	
	<i>19X3</i>	<i>19X2</i>
Current assets	\$3,147,000	\$2,975,000
Plant, property, and equipment—net	165,000	145,000
Other assets	120,000	110,000
Total assets	<u>3,432,000</u>	<u>3,230,000</u>
Current liabilities	2,157,000	2,030,000
Long-term liabilities	400,000	450,000
Total liabilities	<u>2,557,000</u>	<u>2,480,000</u>
Equity	<u>\$ 875,000</u>	<u>\$ 750,000</u>

The sales and net income for 19X3 were \$ 10,500,000 and \$125,000 and for 19X2 were \$9,700,000 and \$80,000.

**Note 6.** Jane Person is the beneficiary of a remainder interest in a testamentary trust under the will of the late Joseph Jones. The amount included in the accompanying statements is her remainder interest in the estimated current value of the trust assets, discounted at 10%.

**Note 7.** At December 31, 19X3 and 19X2, James Person owned a \$300,000 whole life insurance policy.

**Note 8.** The estimated current value of the residence is its purchase price plus the cost of improvements. The residence was purchased in December 19X1, and improvements were made in 19X2 and 19X3.

**Note 9.** The estimated current values of personal effects and jewelry are the appraised values of those assets, determined by an independent appraiser for insurance purposes.

**Note 10.** The mortgage (collateralized by the residence) is payable in monthly installments of \$815 a month, including interest at 10% a year through 20Y8.

**Note 11.** James Person has guaranteed the payment of loans of Davekar Company, Inc., under a \$500,000 line of credit. The loan balance was \$300,000 at December 31, 19X3, and \$400,000 at December 31, 19X2.

**Note 12.** The estimated current amounts of liabilities at December 31, 19X3, and December 31, 19X2, equaled their tax bases. Estimated income taxes have been provided on the excess of the estimated current values of assets over their tax bases as if the estimated current values of the assets had been realized on the statement date, using applicable tax laws and regulations. The provision will probably differ from the amounts of income taxes that eventually might be paid because those amounts are determined by the timing and the method of disposal or realization and the tax laws and regulations in effect at the time of disposal or realization.

The estimated current values of assets exceeded their tax bases by \$850,000 at December 31, 19X3, and by \$770,300 at December 31, 19X2. The excess of estimated current values of major assets over their tax bases are—

	<i>December 31,</i>	
	<i>19X3</i>	<i>19X2</i>
Investment in Davekar Company, Inc.	\$430,500	\$355,500
Vested interest in deferred profit sharing plan	111,400	98,900
Investment in marketable securities	104,100	100,000
Remainder interest in testamentary trust	97,000	53,900

## Appendix B

### Computing the Excess of the Estimated Current Values of Assets Over Their Tax Bases and the Estimated Income Taxes on the Excess

This appendix relates to the preceding illustrative financial statements of James and Jane Person (Appendix A) and illustrates how to compute the excess of the estimated current values of assets over their tax bases and the provision for estimated income taxes on the excess.<sup>1</sup>

The excess or deficit of the estimated current values of major assets or categories of assets over their tax bases should be disclosed.<sup>2</sup> The provision for estimated income taxes should be presented in the statement of financial condition between liabilities and net worth.

The assumptions and the tax basis information used in computing the excess of the estimated current values of assets over their tax bases and the estimated income taxes on the excess depend on the facts, circumstances, tax laws and regulations, and assumptions that apply to the individual or individuals for whom the financial statements are prepared. The facts, circumstances, tax laws and regulations, and assumptions used in the following are illustrative only.

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<sup>1</sup> The provision for estimated income taxes should also reflect tax consequences that result from differences between the estimated current amounts of liabilities and their tax bases.

<sup>2</sup> Differences between the estimated current amounts of major liabilities or categories of liabilities and their tax bases should also be disclosed.

Statements of Position

Description	(A) Estimated current values	(B) Tax bases	Excess of (A) over (B)	Effective income tax rates	Amount of estimated income taxes	Assumptions used
Cash	\$ 3,700	\$ 3,700	—	—	—	No tax effect.
Bonus receivable	20,000	—	\$ 20,000	50%	\$ 10,000	Maximum tax rate.
Investments						
Marketable securities	160,500	56,400	104,100	36%	37,500	Weighted average of short-term and long-term capital gain rates based on composition of portfolio.
Stock options	28,000	20,000	8,000	50%	4,000	Short-term capital gain rate.
Kenbruce Associates	48,000	24,000	24,000	38%	9,100	Weighted average of short-term and long-term capital gain rates.
Davekar Company, Inc.						Long-term capital gain rate.
Vested interest in deferred profit sharing plan	550,000	119,500	430,500	20%	86,100	Maximum tax rate.
	111,400	—	111,400	50%	55,700	
Remainder interest in testamentary trust	171,900	74,900	97,000	26%	25,600	Weighted average of short-term and long-term capital gain rates.
Cash value of life insurance	5,500	5,500	—	—	—	No tax effect.
Residence	190,000	190,000	—	—	—	No tax effect.
Personal effects	55,000	30,000	25,000	20%	5,000	Long-term capital gain rate.
Jewelry	40,000	10,000	30,000	20%	6,000	Long-term capital gain rate.
	<u>\$1,384,000</u>	<u>\$534,000</u>	<u>\$850,000<sup>1</sup></u>		<u>\$239,000<sup>2</sup></u>	

<sup>1</sup> The excess or deficit of the estimated current values of major assets or categories of assets over their tax bases should be disclosed.

<sup>2</sup> This amount should be presented in the statement of financial condition between liabilities and net worth.

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[The next page is 19,061.]





## Section 10,390

# ***Statement of Position 85-3 Accounting by Agricultural Producers and Agricultural Cooperatives***

April 30, 1985

### **NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

## **Introduction**

.001 This statement discusses accounting by agricultural producers and agricultural cooperatives that intend to present financial statements in conformity with generally accepted accounting principles. The issues discussed are—

- Accounting for inventories by producers
- Accounting for development costs of land, trees and vines, intermediate-life plants, and animals
- Accounting by patrons for product deliveries to cooperatives
- Accounting by cooperatives for products received from patrons
- Accounting for investments in and income from cooperatives

This statement does not apply to personal financial statements of agricultural producers or statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, for example, the income tax or the cash basis of accounting. This statement also does not apply to growers of timber; growers of pineapple and sugarcane in tropical regions; raisers of animals for competitive sports; or merchants or noncooperative processors of agricultural products that purchase commodities from growers, contract harvesters, or others serving agricultural producers.

## Definitions

.002 For purposes of this statement, the following definitions apply.

*Advances.* Generally used in marketing and pooling cooperatives to denote amounts paid to patrons prior to final settlement; for example, amounts paid to patrons on delivery of crops.

*Agricultural cooperatives.* See paragraphs .006 through .022.

*Agricultural producers.* See paragraphs .003 through .005.

*Assigned amounts.* Amounts used to record products delivered by patrons of a marketing cooperative operating on a pooling basis, and the related liability to patrons if the ultimate amounts to be paid to patrons are determined when the pool is closed. These amounts may be established on the basis of current prices paid by other buyers (sometimes referred to as "field prices"), or they may be established by the cooperative's board of directors. The assigned amounts are sometimes referred to as "established values."

*Cash advance method.* A method of accounting for inventories of a marketing cooperative operating on a pooling basis. Under this method, inventories are accounted for at the amount of cash advances made to patrons. (This is sometimes referred to as the "cost advance method.")

*Commercial production.* The point at which production from an orchard, vineyard, or grove first reaches a level that makes operations economically feasible, based on prices normally expected to prevail.

*Crop development costs.* Costs incurred up to the time crops are produced in commercial quantities, including the costs of land preparation, plants, planting, fertilization, grafting, pruning, equipment use, and irrigation.

*Crops.* Grains, vegetables, fruits, berries, nuts, and fibers grown by agricultural producers.

*Exempt and nonexempt cooperatives.* Cooperatives classified according to their federal income tax status. Both types are permitted to deduct from taxable income patronage distributed or allocated on a qualified basis to patrons to the extent that the distributions represent earnings of the cooperative derived from business done with or for the patrons. In addition, cooperatives meeting the requirements of Internal Revenue Code section 521 (exempt cooperatives) are permitted to deduct (1) limited amounts paid as dividends on capital stock and (2) distributions to patrons of income from business done with the U.S. government or its agencies and income from nonpatronage sources.

*Farm price method.* A method of accounting for inventories at the sales prices in the nearest local market for the quantities that the producer normally sells less the estimated costs of disposition.

*Futures contract.* A standard and transferable form of contract that binds the seller to deliver to the bearer a standard amount and grade of a commodity to a specific location at a specified time. It usually includes a schedule of premiums and discounts for quality variation.

*Growing crop.* A field, row, tree, bush, or vine crop before harvest.

*Grove.* Fruit or nut trees planted in geometric patterns to economically facilitate care of the trees and harvest of the fruit or nuts.

*Harvested crop.* An agricultural product, gathered but unsold.

*Livestock.* Registered and commercial cattle, sheep, hogs, horses, poultry, and small animals bred and raised by agricultural producers.

*Market order prices.* Prices for raw products established by federal or state agencies.

*Marketing cooperative.* A cooperative that markets the products (crops, live-stock, and so on) produced by its patrons.

*Member and nonmember (of a cooperative).* A member is an owner-patron who is entitled to vote at corporate meetings of a cooperative. A nonmember patron is not entitled to voting privileges. A nonmember patron may or may not be entitled to share in patronage distributions, depending on the articles and bylaws of the cooperative or on other agreements.

*Net realizable value.* Valuation of inventories at estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation.

*Orchard.* Fruit trees planted in geometric patterns to economically facilitate care of the trees and harvest of the fruit.

*Patron.* Any individual, trust, estate, partnership, corporation, or cooperative with or for whom a cooperative does business on a cooperative basis, whether a member or nonmember of the cooperative association.

*Patronage.* The amount of business done with a cooperative by one of its patrons. Patronage is measured by either the quantity or value of commodities received from patrons by a marketing cooperative and the quantity or value of the goods and services sold to patrons by a supply cooperative.

*Patronage allocations.* Patronage earnings distributed, or allocated, to individual patrons on the basis of each patron's proportionate share of total patronage. Such allocations, which include notification to the patron, may be made on a qualified or nonqualified basis.

*Patronage earnings.* The excess of a cooperative's revenues over its costs arising from transactions done with or for its patrons. Generally a significant portion of those earnings is allocated to the cooperative's patrons in the form of cash, allocated equities, or both.

*Pools.* Accounting control centers used for determining earnings and patronage refunds due to particular patrons.

Open pools are accounting control centers that are not closed at the end of each accounting period. Open pools are sometimes used by marketing cooperatives for crops that may not be sold for two or more years after their receipt from patrons.

A single pool cooperative determines net proceeds or patronage refunds on the basis of overall operating results for all commodities marketed during an accounting period.

A multiple pool cooperative determines net proceeds or patronage refunds on the basis of separate commodities, departments, or accounting periods.

*Progeny.* Offspring of animals or plants.

*Raised animals.* Animals produced and raised from an owned herd, as opposed to purchased animals.

*Recurring land development costs.* Costs that do not result in permanent or long-term improvements to land, for example, maintenance costs that occur annually or periodically.

*Retains.* Amounts determined on a per-unit basis or as a percentage of patronage earnings that are withheld by cooperatives from distributions and allocated to patrons' capital accounts.

*Supply cooperative.* A cooperative that supplies to its patrons goods and services used by them in producing their products.

*Unit livestock method.* Accounting for livestock by using an arbitrary fixed periodic charge. For raised animals the amount is accumulated by periodic increments from birth to maturity or disposition. For purchased animals the arbitrary fixed periodic amount is added to the acquisition cost until maturity or disposition of the animal.

*Vineyards.* Grapevines planted in patterns for commercial cultivation and production.

*Written notice of allocation.* Any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice to the recipient that states the dollar amount allocated to the patron by the cooperative and the portion that constitutes a patronage dividend.

## Agricultural Producers

.003 In this statement, farmers and ranchers are referred to as “agricultural producers,” a term that includes, for example, those who raise crops from seeds or seedlings, breed livestock (whether registered or commercial), and feed livestock in preparation for slaughter. The term excludes, for example, merchants and processors of agricultural products who purchase commodities from growers, contract harvesters, or others serving agricultural producers, although they are covered by the term “agribusiness” as it is generally used. The term also excludes growers of timber and raisers of animals for competitive sports, although some of the accounting principles discussed in this statement may apply to such activities.

.004 Agricultural producers use every form of business organization, from sole proprietorship to a large publicly held corporation. They engage in numerous activities, for example:

- Growing wheat, milo, corn, and other grains
- Growing soybeans, vegetables, sugar beets, and sugarcane
- Growing citrus fruits, other fruits, grapes, berries, and nuts
- Growing cotton and other vegetable fibers
- Operating plant nurseries
- Breeding and feeding cattle, hogs, and sheep, including animals for wool production
- Operating dairies
- Operating poultry and egg production facilities
- Breeding horses
- Raising mink, chinchilla, and similar small animals

In addition, the operations of agricultural producers often involve various combinations of those activities. Agricultural practices and products may vary still further because of differences in temperature, soil, rainfall, and regional economics. Farm products may be used in related activities, such as the feeding of hay and grain to livestock, or they may be marketed directly by the producer. Producers often sell products in accordance with government programs or through agricultural cooperatives. Marketing strategies may include forward contracts or commodity futures contracts to reduce the risks of fluctuations in market prices.

.005 Agricultural producers often borrow to finance crop development costs and the costs of acquiring facilities and equipment.

## Agricultural Cooperatives

[.006-.008] [Deleted to remove outdated information.]

.009 Section 1141(j) of the Agricultural Marketing Act of 1929, as amended, contains the following definition of a cooperative association:

The term "cooperative association" means any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services. Provided, however, that such associations are operated for producers or purchasers and conform to one or both of the following requirements:

First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein; and

Second. That the association does not pay dividends on stock or membership capital in excess of 8 per centum per annum.

And in any case to the following:

Third. That the association shall not deal in farm products, farm supplies, and farm business services with or for nonmembers in an amount greater in value than the total amount of such business transacted by it with or for members. All business transacted by any cooperative association for or on behalf of the United States or any agency or instrumentality thereof shall be disregarded in determining the volume of member and nonmember business transacted by such association.

.010 A cooperative typically has the following characteristics:

- a. Assets are distributed periodically to patrons on a patronage basis. In certain situations, however, assets in the amount of net-of-tax earnings may be accumulated by the cooperative and may or may not be allocated to patrons' accounts.
- b. Members control the organization in their capacity as patrons and not as equity investors.
- c. Membership is limited to patrons.
- d. The return that can be paid on capital investment is limited.
- e. At least 50 percent of the cooperative's business is done on a patronage basis.

.011 Virtually all agricultural cooperatives meet the definition of cooperatives that is used to determine eligibility for borrowing from the banks for cooperatives and for exemption from the annual reporting requirements of the Securities and Exchange Act of 1934. Failure to meet the definition, however, does not necessarily prevent an entity from being considered as operating on a cooperative basis under subchapter T of the Internal Revenue Code.

.012 The main difference between cooperatives and other business enterprises is that cooperatives and their patrons operate as single economic units to accomplish specific business purposes, such as the marketing of farm products, the purchase of supplies, or the performance of services for the benefit of the patrons. The aim is to reduce costs, increase sales proceeds, and share risks through the increased bargaining power that results from the patrons' combined resources and buying power.

.013 The patron's role as an investor is secondary and incidental to his business relationship with the cooperative.

.014 If certain requirements are met, the Internal Revenue Code permits cooperatives tax deductions for earnings allocated to their patrons. Earnings not so allocated are taxed at corporate income tax rates. Cooperatives may use other terms for earnings, such as "margins," "net proceeds," or "savings."

.015 Another difference between cooperatives and other business corporations is that the cooperative's bylaws usually require it to distribute assets to patrons, or allocate to patrons' accounts amounts equal to its earnings, on the basis of their patronage. Distributions to patrons are different from dividend payments to stockholders in other corporations. The distribution of earnings on the basis of patronage has been termed the "price adjustment theory."

.016 Under the price adjustment theory, a cooperative agrees to do business at cost. In a purchasing cooperative, for example, a patron may be charged more than cost at the time of purchase; however, the cooperative normally must return to the patron all amounts received in excess of cost, including costs of operation and processing.

.017 Both exempt and nonexempt cooperatives are subject to federal income taxes on patronage earnings that are not distributed in cash or allocated on a qualified basis. Nonexempt cooperatives are subject to income taxes on earnings arising from sources other than patronage.

.018 Cooperatives generally try to buy or sell at the current market price. Periodically, they determine total costs and make distributions to patrons in the form of cash, certificates, or other notices of allocation based on the excess of revenues over costs.

.019 The two major types of cooperatives are supply cooperatives and marketing cooperatives. *Supply cooperatives* obtain or produce such items as building materials, equipment, feed, seeds, fertilizer, and petroleum products for their patrons. *Marketing cooperatives* provide means for agricultural producers to process and sell their products.

.020 Services related to those functions are provided by some supply and marketing cooperatives; they are also provided by separate associations known as *service cooperatives*, which provide such services as trucking, storage, accounting, and data processing. A special type of service cooperative is a *bargaining cooperative*, which serves its members by negotiating with processors on their behalf.

.021 Many marketing cooperatives commingle patrons' fungible products in pools. The excess of revenues over costs for each pool is allocated to patrons on the basis of their pro rata contributions to the pool, which may be determined by the number of units delivered, the volume of product delivered, or another equitable method.

.022 The members of *local cooperatives* are agricultural producers whose activities are generally centralized. The members of *federated cooperatives* are other cooperatives whose activities are regional. Some cooperatives have both individual producers and other cooperatives as members.

## Accounting for Inventories of Crops by Agricultural Producers

.023 Previously existing accounting literature does not specifically cover accounting by agricultural producers, and available material is predominantly

tax oriented. Accounting Research Bulletin (ARB) No. 43, chapter 4, provides the following information about accounting for inventories:

### STATEMENT 9

Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Where goods are stated above cost this fact should be fully disclosed.

#### *Discussion*

It is generally recognized that income accrues only at the time of sale, and that gains may not be anticipated by reflecting assets at their current sales prices. For certain articles, however, exceptions are permissible. Inventories of gold and silver, when there is an effective government-controlled market at a fixed monetary value, are ordinarily reflected at selling prices. A similar treatment is not uncommon for inventories representing agricultural, mineral, and other products, units of which are interchangeable and have an immediate marketability at quoted prices and for which appropriate costs may be difficult to obtain. Where such inventories are stated at sales prices, they should of course be reduced by expenditures to be incurred in disposal, and the use of such basis should be fully disclosed in the financial statements.

.024 Accounting Principles Board (APB) Statement No. 4, chapter 6, paragraph 16, states the following:

Revenue is sometimes recognized on bases other than the realization rule. For example, on long-term construction contracts revenue may be recognized as construction progresses. This exception to the realization principle is based on the availability of evidence of the ultimate proceeds and the consensus that a better measure of periodic income results. Sometimes revenue is recognized at the completion of production and before a sale is made. Examples include certain precious metals and farm products with assured sales prices. The assured price, the difficulty in some situations of determining costs of products on hand, and the characteristic of unit interchangeability are reasons given to support this exception.

Statement of Position 93-3, *Rescission of Accounting Principles Board Statements* [section 10,560], rescinds APB Statement No. 4. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, discusses matters similar to those in APB Statement No. 4. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.025 Accounting Research Study (ARS) 13, chapter 9, page 156, states—

#### *Market as the Accounting Basis of Inventories*

Exceptional cases exist in which it is not practicable to determine an appropriate cost basis for products. A market basis is acceptable if the products (1) have immediate marketability at quoted market prices that cannot be influenced by the producer, (2) have characteristics of unit interchangeability, and (3) have relatively insignificant costs of disposal. The accounting basis of those kinds of inventories should be their realizable value, calculated on the basis of quoted market prices less estimated direct costs of disposal. Examples are precious metals produced as joint products or by-products of extractive processes and fresh dressed meats produced in meat packing operations.

Paragraph 67 of FASB Concepts Statement No. 5 also discusses measurement of assets at current market value. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

## Diversity in Practice

.026 Published financial statements reveal several ways that agricultural producers account for growing crops:

- Charging costs to operations when they are incurred
- Including crop development costs in deferred charges and amortizing them
- Stating costs on the balance sheet at unchanging amounts substantially less than the costs incurred and charging all current costs to operations when they are incurred
- Deferring all costs and writing them off at harvest or, for perennial crops, over the estimated productive life of the planting

Agricultural producers report harvested crops using the farm price method, at cost (LIFO, FIFO, or average cost), and at the lower of cost or market.

Some producers use the farm price method (market) to account for inventories of harvested crops. Other agricultural producers, particularly those whose securities are publicly held, account for harvested crops at the lower of cost or market.

## Pros and Cons

.027 A study of accounting for producers' inventories involves an examination of chapter 4, statement 9, of ARB No. 43, which has been used as authority for accounting for producers' inventories at market.

.028 Some accountants believe that many producers cannot determine costs, and some believe that market is an appropriate valuation, whether or not cost data are available. Many accountants believe that users of producers' financial statements would find them less useful if inventories were valued at the lower of cost or market.

.029 Other reasons for the preference for market value are its long established use and the need to identify separately the gains and losses attributable to the production cycle and the marketing function, which is discussed in paragraph .035.

.030 For most business activities, the accounting literature requires an exchange of goods or services before income is recognized. That precludes accounting for inventories of unsold goods at market unless market value is less than cost. The principal exceptions to that rule are identified in chapter 9 of ARS 13 as "metals produced as joint products or by-products of extractive processes and fresh dressed meats produced in meat packing operations." Those products have unique cost identification problems. Chapter 9 of ARS 13 further states that carrying products at market is acceptable if those products "(1) have immediate marketability at quoted market prices that cannot be influenced by the producer, (2) have characteristics of unit interchangeability, and (3) have relatively insignificant costs of disposal."

.031 The first of the three conditions in ARB No. 43, statement 9, is the inability to determine costs. While many producers may not keep detailed cost records, costs usually either are available or can be determined with acceptable accuracy.



.032 Accountants who favor accounting for producers' inventories at market recognize that ARB No. 43 requires an *inability* to determine appropriate approximate costs. They point out, however, that the discussion interprets the statement to apply when "appropriate costs may be *difficult* to obtain" [emphasis added]. They also note that APB Statement No. 4,<sup>\*</sup> chapter 6, referred to the "difficulty in some situations of determining costs of products" as a partial justification for the use of market price. Thus, they interpret statement 9 as allowing the use of market if costs are difficult to determine, not only if they are impossible to determine.

.033 A major argument for accounting for inventories at market is the availability of established markets that provide quoted market prices for most agricultural commodities. However, because variations in grade and quantity, distance from central markets, shipping hazards, and other restrictions may affect the ultimate realization of quoted market prices for agricultural products, there are often serious difficulties in determining the market price for a given product in a given place. Also, many products have no central market with established prices, and determination of their market prices may be subjective and incapable of verification.

.034 While ARS 13 does not cover inventories of agricultural products, it questions the appropriateness of accounting for inventories at market even if an established market exists. The study notes that present principles appear to allow the use of market price in accounting for inventories of precious metals if there is a fixed selling price and insignificant marketing cost regardless of whether it is practicable to determine costs. The study states—

The apparent preferential treatment may have originally been considered appropriate because metals having fixed monetary values clearly demonstrated the "immediate marketability at quoted market prices and the characteristic of interchangeability" required in the cases in which it is impracticable to determine costs. Further question as to why preferential treatment was originally accorded to precious metals might now be considered academic. Silver no longer has a fixed monetary price, and gold has a fluctuating free market price for nonmonetary purposes. That raises questions as to whether the inventory basis for gold and silver should now be considered the same as for other metals produced as by-products or joint products.

.035 Some proponents of accounting for agricultural producers' inventories at market distinguish the production of a crop from its marketing; they believe that delays in the disposal of a harvested crop are due principally to the producer's desire to sell the commodities later at a higher price. They contend that, in order to separate the results of the two functions, the inventories should be accounted for at market prices after they are harvested. They point out that both functions are likely to cause significant gains and losses. Some opponents counter that the same argument can be made for many nonagricultural enterprises that are not permitted to recognize income at the end of production.

.036 The securities of most agricultural producers are not traded publicly, and their financial statements are prepared primarily for management and lenders. Advocates of the use of market prices contend that lenders are concerned with the market price of inventories to be used as collateral. Moreover,

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<sup>\*</sup> Statement of Position 93-3, *Rescission of Accounting Principles Board Statements* [section 10,560], rescinds APB Statement No. 4. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

most producers are not required to use cost information for income tax purposes. Thus, some accountants argue that determining cost for financial statements is an unproductive additional burden to the producer. Conversely, cost advocates point out that both public and nonpublic producers require long-term financing, and cost-basis financial statements may provide better information for those purposes.

.037 Some accountants believe that it is difficult to argue persuasively for charging the periodic costs of growing crops to expense as they are incurred since a valuable asset is being developed. Some contend that the use of a fixed amount less than cost violates existing principles of accounting for assets. Others believe it is acceptable and consistent with a market basis of accounting to account for growing crops at net realizable value or at no value.

### Division Conclusions

.038 All direct and indirect costs of growing crops should be accumulated and growing crops should be reported at the lower of cost or market.

.039 An agricultural producer should report inventories of harvested crops held for sale at (a) the lower of cost or market or (b) in accordance with established industry practice, at sales price less estimated costs of disposal, when all the following conditions exist:

- The product has a reliable, readily determinable and realizable market price.
- The product has relatively insignificant and predictable costs of disposal.
- The product is available for immediate delivery.

## Accounting for Development Costs of Land, Trees and Vines, Intermediate-Life Plants, and Animals

.040 Development costs of land, trees and vines, intermediate-life plants, and animals are different from costs incurred in raising crops for harvest, which were discussed in the previous section, "Accounting for Inventories of Crops by Agricultural Producers."

.041 Land development generally includes improvements to bring the land into a suitable condition for general agricultural use and to maintain its productive condition. Some improvements are permanent; some have a limited life. Permanent land developments include, for example, clearing, initial leveling, terracing, and construction of earthen dams; they involve changes to the grade and contour of the ground and generally have an indefinite life if they are properly maintained. Limited-life developments usually include such items as water distribution systems and fencing and may also include the costs of wells, levees, ponds, drain tile, and ditches, depending on the climate, topography, soil conditions, and farming practices in the area.

.042 Orchards, vineyards, and groves generally develop over several years before they reach commercial production. Production continues for varying numbers of years, depending on such influences as type of plant, soil, and climate. During development, the plants normally require grafting, pruning, spraying, cultivation, or other care.

.043 Intermediate-life plants have growth and production cycles of more than one year but less than those of trees and vines. They include, for example,

artichokes, various types of berries, asparagus, alfalfa, and grazing grasses. Development costs of intermediate-life plants include the cost of land preparation, plants, and cultural care until the plant, bush, or vine begins to produce in commercial quantities.

.044 The terms *livestock* and *animals* are used interchangeably and are meant to include cattle, sheep, hogs, horses, poultry, and other small animals. The development of animals requires care and maintenance of the breeding stock and their progeny until their transfer from the brood herd. Animals purchased before maturity also require care and maintenance to ready them for productive use or sale. The animals are ultimately identified for transfer to breeding herds, dairy herds, or other productive functions, are selected for sale, or are transferred to a feeding or other marketing operation.

### Diversity in Practice

.045 Development costs of land, trees and vines, intermediate-life plants, and animals are accounted for in the following ways:

- Charged to operations when they are incurred
- Included in deferred charges
- Included on the balance sheet at fixed amounts substantially less than the costs incurred, with all or a majority of the current costs charged to operations as they are incurred
- Capitalized and amortized over the estimated productive life of the animal, tree, vine, or plant
- Carried at market values

.046 In the case of annual field crops that are planted and harvested in the same accounting period, producers generally match costs with revenues. When the growing cycle continues beyond the accounting period, costs often are not matched with revenues.

.047 Few significant diversities of practice are apparent in the financial statements primarily because of lack of disclosure. However, some agricultural producers charge land development costs to expense based on provisions of the income tax laws.

.048 In accounting for development costs of trees and vines, some producers agree that the costs should be capitalized and depreciated over the expected productive life, but the costs to be capitalized and those to be charged to expense are not identified uniformly. Income tax concepts have had a strong influence on accounting practices for those development costs.

.049 Crops from intermediate-life plants have generally been accounted for in the same way as annual crops, with no distinctions for variations in the periods of development and productivity.

.050 Many livestock producers charge the costs of developing animals to expense without regard to their productive lives or future use or sales value. Animals are sometimes reported at cost and other times at market values. Some producers use the unit livestock method, and in many instances, the annual unit cost increments are below market and probably below cost.

### Pros and Cons

.051 Some accountants believe that large-scale improvements that transform the land to new and better uses are permanent land improvements to be

capitalized and that subsequent modifications and improvements are necessary and should be classified as period expenses.

.052 Others believe that it is difficult, or nearly impossible, to distinguish between permanent, limited-life, and recurring land development costs. Land improvements that an owner has made over many years tend to lose their original characteristics. Such improvements are usually accompanied by increasingly intensive land use over relatively long periods. Prior improvements are modified, improved on, or eliminated, and the resulting land configuration and use are noticeably changed. The characteristics of continuing land improvements accomplished over long periods are given as justification for classifying those costs as recurring.

.053 Many accountants believe that all direct and related indirect costs of land development, such as leveling, clearing of brush, terracing, and installation of drain tile, should be capitalized. They further believe that land development costs that waste away or diminish in efficiency through use, such as drainage tile, should be depreciated or amortized over the number of seasons that the land can reasonably be expected to produce without renovation or renewal of the particular development.

.054 It is generally agreed that development costs of orchards, vineyards, and groves should be capitalized, but there is no agreement on the specific costs that should be capitalized. Many believe it necessary to capitalize only those costs that the income tax laws require to be capitalized.

.055 Some accountants believe that all direct and indirect costs for orchards, vineyards, and groves incurred during the development period should be capitalized until commercial production is achieved. Others believe all such costs, except annual maintenance costs, should be capitalized. All agree that capitalized costs should be depreciated or amortized over the useful life of the plantings.

.056 Accounting practices for development costs of intermediate-life plants are inconsistent. Producers who deduct expenses before revenues are realized for intermediate-life plants and orchardists and vineyardists who do not want to capitalize development costs and depreciate them over the estimated productive life of the developed asset are motivated by the same reasons. The question of capitalization and depreciation is similar for producers of intermediate-life plants and for producers of trees and vines. The principal distinctions are in development period and productive life. For example, orchard trees may require four to seven years before nominal production, while limited production may occur during the first year of such crops as alfalfa, some berries, and asparagus.

.057 Some accountants have resisted accumulating development costs for growing animals, based on the difficulty and expense of accumulating such information and, in some instances, the problem of identifying individual animals or groups and categories of animals. Instead of cost, the unit livestock method or a market value has been used for assigning amounts to the animals at each level of maturity in the belief that such accounting methods, if consistently applied, would not adversely affect income recognition.

.058 Others believe that all direct and indirect development costs of raising livestock should be accumulated and capitalized until the livestock have reached maturity and have been selected for breeding or other productive purposes. Many believe that income-producing livestock should be depreciated on the basis of their expected productive lives.

## Division Conclusions

**.059** Permanent land development costs should be capitalized and should not be depreciated or amortized, since they have, by definition, an indefinite useful life.

**.060** Limited-life land development costs and direct and indirect development costs of orchards, groves, vineyards, and intermediate-life plants should be capitalized during the development period and depreciated over the estimated useful life of the land development or that of the tree, vine or plant.

**.061** All direct and indirect costs of developing animals should be accumulated until the animals reach maturity and are transferred to a productive function. At that point the accumulated development costs, less any estimated salvage value, should be depreciated over the animals' estimated productive lives.

**.062** All direct and indirect development costs of animals raised for sale should be accumulated, and the animals should be accounted for at the lower of cost or market until they are available for sale. Agricultural producers should report animals available and held for sale (a) at the lower of cost or market or (b) in accordance with established industry practice at sales price, less estimated costs of disposal, when all of the following conditions exist:

- There are reliable, readily determinable and realizable market prices for the animals.
- The costs of disposal are relatively insignificant and predictable.
- The animals are available for immediate delivery.

## Accounting for Patrons' Product Deliveries to Marketing Cooperatives Operating on a Pooling Basis

**.063** Agricultural marketing cooperatives process and market their patrons' products. There are frequently good bases for recording transfers of products between cooperatives and their patrons. For example, dairy cooperatives record transfers of products on the basis of market order prices, and grain cooperatives record transfers of products on the basis of readily determined cash prices. Many cooperatives, therefore, transfer patrons' products at market prices, and the transactions are treated as purchases by the cooperatives and as sales by the patrons.

**.064** However, cooperatives operating on a pooling basis may receive products from their patrons without paying a fixed price to the patrons. A cooperative may assign amounts to products based on current prices paid by other buyers or on amounts established by the cooperative's board of directors, or it may assign no amount. The cooperative estimates a liability to patrons equal to the assigned amount for the delivered product, and it usually pays this liability on a short-term basis. The excess of revenues over the assigned amounts and operating costs at the end of a pool period, which may be a week, a month, a year, or longer, is paid or allocated to patrons. Assets equal to that excess may be distributed to the patrons or retained by the cooperative.

**.065** The different accounting methods used by pooling cooperatives have been developed to satisfy provisions of their bylaws and contractual arrange-

ments with patrons and to provide equitable methods of settlement from pool period to pool period, as well as among the various classes of patrons. For pooling cooperatives, accounting methods have been developed to allow the use of the single-pool or multiple-pool methods of accounting.

## Diversity in Practice

.066 Significant information about the accounting practices of patrons in recording the delivery of raw products to marketing cooperatives is scarce. Among the practices used are recognition (1) at the estimated net return, presumably at the time of delivery, and (2) at the time of sale by the cooperative to an outside party. Those two examples provide the extremes, one recognizing the delivery to the cooperative as a sale and the other continuing to carry the product as inventory of the producer until it is sold by the cooperative. Transfer prices for products delivered to cooperatives are established in diverse ways:

- At market order price or governmental support price
- At market price
- At an assigned amount determined by the cooperative's board of directors to approximate market price
- At the amount of advances
- At cost to the producer
- At no amount until the cooperative advises the producer of the expected proceeds from the ultimate disposition of the product

.067 Cooperatives that receive products from patrons and pay their patrons a firm market price, at or shortly after delivery, treat the payments as purchases. In those situations the prices are paid regardless of the amount of the cooperatives' earnings. Those cooperatives normally report inventories at the lower of cost or market. However, pooling cooperatives estimate amounts due to patrons at the time of delivery, and those amounts are later adjusted on the basis of the pool's earnings. This presents a significant accounting problem. The following paragraphs discuss only the accounting issues that result from deliveries of products by patrons to cooperatives operating on a pooling basis.

.068 In cooperatives operating on a pooling basis, products delivered by patrons are commingled with other patrons' products, processed, and marketed. Earnings from the sale of finished products are returned to patrons, either in cash or in some form of equity, whether or not those earnings were determined on the basis of current market prices at the time of delivery. Many cooperatives value patrons' products at assigned amounts (usually current market prices) set by the board of directors at delivery. A corresponding estimated liability is accrued for amounts due to patrons. At the end of the pool period, the pool's net earnings are credited to amounts due patrons on a patronage basis.

.069 Some cooperatives cannot determine the market prices of patrons' products when they receive them because of limited cash purchases by other processors. They are usually cooperatives that process and market a high percentage of limited specialty crops. Many of those cooperatives account for inventories of goods in process and finished goods at net realizable value, determined by deducting estimated completion and disposition costs from the

estimated sales value of the processed inventory, because a reliable price for the unprocessed product is not available to account for inventories at the lower of cost or market. Furthermore, many cooperatives must determine net realizable value to comply with bylaw provisions and contractual obligations and to facilitate equitable pool settlements from pool period to pool period and among various classes of patrons.

.070 A 1973 survey by the National Council of Farmer Cooperatives indicated that many marketing cooperatives use net realizable value to account for inventories. An excerpt from an article on this subject prepared for the council's legal, tax, and accounting committee appears below.

The National Council of Farmer Cooperatives made a survey of the inventory valuation methods used by its marketing cooperatives. The results of this survey confirm what has been the private belief of most cooperative accountants, that the net realizable market value method is perhaps the most widely used and accepted method of inventory valuation by marketing cooperatives. This survey reflects the responses of 49 cooperatives and, in summary, indicates that the following inventory methods are in use.

<u>Method</u>	<u>Cooper- atives</u>	<u>Sales (In Thousands)</u>	<u>% of Total Sales</u>
Net realizable market value	24	\$2,310,938	48%
Lower of cost or market, using field price as the established value of raw product	8	630,898	13
Net realizable market value and lower of cost or market, using field price as the established value of raw product	5	802,867	17
Cost	2	53,400	1
Rev. Rul. 69-67*	7	367,469	8
Other	3	621,925	13
	<u>49</u>	<u>\$4,787,497</u>	<u>100%</u>

\* Note: Rev. Rul. 69-67 refers to the cash advance method.

.071 The net realizable value method of accounting for inventories permits the recognition of the pool's estimated net earnings at the end of the fiscal period in which the patrons supply their crops to the cooperative or when pools are closed. Inventories are stated at net realizable value, and the amounts due to patrons are credited with the earnings. The net realizable value method of accounting for inventories permits the closing of the pools and provides equitable treatment to patrons if the cooperative transfers the inventories forward to the next period's pool at estimated market value.

.072 Some marketing cooperatives receive products from patrons without assigning amounts to them. During the year, cash is advanced to patrons on the basis of anticipated earnings. Inventories are recorded at amounts advanced plus costs of processing, and patrons' products are valued at the amount of advances made to the date of the financial statements. This is commonly called the "cash advance method."

## Authoritative Literature

.073 The primary source of authoritative guidance for accounting for inventories that result from deliveries of products by patrons to cooperatives has been ARB No. 43.

## Pros and Cons

.074 A transaction is usually completed when a patron delivers his product to a cooperative. The patron's product is commingled with that of other patrons, and title and individual risk of loss have passed. Some accountants believe that no accounting is necessary at the time of delivery because the transfer price is frequently not known until some later date. Nevertheless, accrual basis accounting calls for reporting the transaction according to the best information available at the time. While greater accuracy may be achieved by waiting for the cooperative to advise the patron of the net proceeds, the handicap of not having current financial information could outweigh the benefit of greater accuracy, and the lack of consistency in reporting could be confusing to the users of the financial statements.

.075 Some accountants argue that pooling cooperatives should not use an assigned amount for products received from patrons for financial accounting and reporting purposes because the amounts may not be reliable and the patrons may be paid more or less than that amount at the end of the pool period. Others argue that the use of an assigned amount permits the establishment of a tentative liability due patrons and allows inventories to be stated at the lower of cost or market. The method also facilitates allocation of pool proceeds to patrons.

.076 Some accountants believe that the net realizable value method of accounting for inventories is unacceptable because it anticipates cooperative earnings. Further, they believe that future selling prices and disposition costs are too uncertain to base accounting on them. Alternatively, those who favor the use of the net realizable value method believe that the problems of determining net realizable value do not differ from those of determining market under the lower of cost or market method. They also consider the method to be acceptable in accounting for pools because it enables the cooperative to settle pools annually and to comply with bylaw provisions and contractual obligations. In essence, they claim, the inventory is transferred to the next period's pool on an equitable basis.

.077 Some accountants believe that cooperatives may record products received from patrons at assigned amounts and then account for the inventories at net realizable value. That method permits the closing of pools at least annually on an equitable basis. Others believe that, if assigned amounts are used on receipt of the product, the inventories should be accounted for at the lower of cost or market.

.078 Some accountants favor the cash advance method of accounting for inventories. They believe that the only product cost that should be accounted for is the total of cash advanced to patrons to the date of the financial statements, because the cooperative has no liability to pay more unless more is earned. Others favor the cash advance method because the Internal Revenue Service has held in several rulings that pooling cooperatives should use that method in tax computations. Others reject the cash advance method because advances to patrons are primarily determined on availability of cash, the per-



centage of the pool production sold to the date of the financial statements, and short-term inventory loan restrictions rather than on the value of products received. Further, they reject the method because the amount and timing of advances are generally subject to the board of directors' action and may vary from period to period.

## **Division Conclusions**

### ***Accounting by Patrons for Products Delivered to Pooling Cooperatives***

.079 If control over the future economic benefits relating to the product has passed, which ordinarily is evidenced by the transfer of title, and if a price is available by reference to contemporaneous transactions in the market, or if the cooperative establishes an assigned amount, a delivery to the cooperative should be recorded as a sale by the patron at that amount on the date of delivery. If there is a reasonable indication that the proceeds from the cooperative will be less than the market price or the assigned amount, the lower amount should be used.

.080 If control over the future economic benefits relating to the product has passed, which ordinarily is evidenced by the transfer of title, and there are neither prices determined by other market buyers nor amounts assigned by the cooperative, or if such amounts are erratic, unstable, or volatile, the patron should record the delivery to the cooperative as a sale at the recorded amount of the inventory and should record an unbilled receivable. If there is a reasonable indication that the proceeds from the cooperative will be less than the receivable, the lower amount should be used.

.081 If title has not passed, the identity of the individual patron's product is maintained by the cooperative, and the price to the patron is to be based on the identified product's sale, the transaction is not complete, and the product should be included in the patron's inventory until it is sold by the cooperative, at which time the patron should record the sale.

.082 Advances are financing devices and should be treated as reductions in the unbilled receivable and should not be used as amounts for recording sales.

### ***Accounting by Pooling Cooperatives for Products Received From Patrons***

.083 If the boards of directors of agricultural marketing cooperatives operating on a pooling basis with no obligation to pay patrons fixed prices (pooling cooperatives) assign amounts that approximate estimated market to unprocessed products received from patrons, the assigned amounts are cost and should be charged to cost of goods sold and credited to amounts due patrons. The inventories should be accounted for at the lower of cost or market or, as described more fully in paragraph .084, at net realizable value. When assigned amounts are used, they should approximate estimated market of unprocessed products delivered by patrons (an example of inventories at lower of cost or market is provided in the appendix [paragraph .107], column A). The method used and the dollar amounts assigned to members' products should be disclosed.

.084 If the boards of directors of pooling cooperatives assign amounts to products received from patrons, the cooperatives should use those assigned amounts in determining the estimated amounts due patrons. Such cooperatives

may use net realizable value for determining pool proceeds, transferring inventory amounts to subsequent pools, or for other purposes (an example is provided in the appendix [paragraph .107], column B). The method used and the dollar amounts assigned to members' products should be disclosed.

**.085** If the boards of directors of pooling cooperatives do not assign amounts that approximate market to unprocessed products received from patrons, the cooperatives should account for inventories at net realizable value (an example is provided in the appendix [paragraph .107], column C). Because amounts that approximate estimated market are not assigned to products received from patrons, cost of goods sold will not include a charge for unprocessed products under this method.

**.086** Pooling cooperatives should not use the cash advance method to account for inventories.

## Accounting for Investments in and Income From Cooperatives

**.087** Member patrons of cooperatives can be producers or other cooperatives. Member patrons provide most of the capital required by cooperatives. The capital usually represents long-term investments acquired through initial cash investments, retains, or noncash patronage allocations. Voting rights for those investments are usually based on one-member-one-vote or limited weighted voting rather than on the number or amount of securities or other evidence of equity ownership held. The investments are made primarily to obtain an economical source of supply or marketing services and not on the expectation of a return on investment. The sale of such investments, other than back to the issuing cooperative, is usually restricted or prohibited.

### Diversity in Practice

**.088** Investments in cooperatives are generally carried by producers at cost, at cost plus declared retains, at cost plus estimated retains, or at an amount less than cost.

**.089** Most cooperatives carry their investments in other cooperatives at cost if they are purchased or at face amount if they are received in other than purchase transactions (retains or noncash patronage allocations). However, they usually write the investments down to estimated net realizable value if evidence indicates they will be unable to recover the full carrying amount of the investments. That practice has been endorsed in Accounting Research Bulletin 2, issued by the National Society of Accountants for Cooperatives, which states—

Investments in cooperatives made by user patrons for the purpose of providing capital for operations of the investee cooperative should be carried at cost, if purchased, or at face value if received in transactions other than purchases such as non-cash patronage dividends. Such investments should be written down to an appropriate amount if reliable evidence indicates that their value has been permanently impaired.

It should be noted that in most instances accounting for investments in other cooperatives (including banks for cooperatives and other cooperative financing organizations, such as the National Rural Utilities Cooperative Finance Corporation) on the basis outlined above results in investment carrying values equal to the equity values of the investing cooperative's interest in the investee

cooperatives; therefore, it would appear that the basis outlined complies with APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, to the extent that the intent of the opinion is applicable to investments of cooperatives. In the infrequent instances where the investor's share of unallocated retained earnings of an investee cooperative is material to the investor, the principles set forth in APB Opinion No. 18 should be applied.

.090 Cooperatives that invest in other cooperatives usually recognize allocated equities in the cooperative investor's fiscal year within which written notice of allocation is received, and the investment is carried at cost plus allocated equities. That method of revenue recognition conforms with federal income tax requirements. It is the most practical method of reporting because many investee cooperatives issue financial statements and determine patronage allocations only at the close of their accounting years. Many cooperatives do that because they find determination of patronage allocations to be complex and time consuming, since their operations may include both marketing and supply functions, as well as several departments under each function.

.091 Diversity in practice has developed in accounting for unallocated equities. Some patrons who hold at least a 20 percent ownership interest recognize their interest in unallocated equities in accordance with APB Opinion No. 18. Others do not recognize unallocated equities, primarily because the equity ownership percentage changes according to patronage and because voting is usually based on the one-member-one-vote principle, which does not necessarily provide significant influence. Interpretation and application of APB Opinion No. 18 may become more significant in financial reporting for cooperatives because 1978 changes in the Internal Revenue Code, relating to the investment tax credit, may encourage cooperatives to reduce distributions of assets to patrons and increase unallocated net after-tax earnings for the purchase of assets.

.092 Most patrons recognize their patronage allocations when they are notified, which conforms with federal income tax reporting requirements. Other patrons accrue patronage allocations on the basis of the cooperatives' interim financial statements.

.093 Presentation of patronage allocations in patrons' financial statements is also diverse. Some patrons recognize patronage allocations as reductions of purchase or interest costs on purchases from supply or financing cooperatives or as increases in sales for deliveries to marketing cooperatives. Other patrons recognize all patronage allocations as nonoperating income.

## Authoritative Literature

.094 Authoritative literature on marketable investments—Statement of Financial Accounting Standards No. 12,\* *Accounting for Certain Marketable Securities*, and FASB Interpretation No. 16, *Clarification of Definitions and Accounting for Marketable Equity Securities That Become Nonmarketable*—has little applicability to investments in cooperatives. Investments in cooperatives are not equity securities and usually are not readily marketable, and transfer or sale, other than back to the issuing cooperative, is usually restricted

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\* FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, supersedes FASB Statement No. 12. [Added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

or prohibited. Current accounting literature supports the carrying of long-term investments, such as nonmarketable investments in agricultural cooperatives, at cost if the value of the investments is not impaired. Carrying amounts are reduced when the investor becomes unable to recover the full carrying amounts. APB Opinion No. 18 requires the equity method of accounting for investments in which the investor has significant influence over an investee's operating and financial policies.

.095 The significance of investments by patrons results primarily from the purchasing or marketing rights and participation in the operating earnings. As such, the operations of cooperatives have many of the attributes of corporate joint ventures or partnerships.

## Pros and Cons

.096 Some accountants argue that the investment in a cooperative is in substance a long-term investment and, as such, should be carried at cost or at cost plus allocated equities. Others believe that the investments should be discounted to their present value. The carrying amounts would be adjusted downward as required by generally accepted accounting principles when the patron becomes unable to recover the full carrying amounts.

.097 Those that support discounting of investments in cooperatives to present value believe that it results in satisfactory presentation in the financial statements because allocated equities are usually not redeemed or are redeemed over a long period. However, others believe that patrons contribute amounts to cooperatives not as investments but to obtain supply or marketing sources, and the allocated equities represent a proportionate share of the cooperative's earnings for the period of patronage. That is similar to accounting for equities in partnerships or corporate joint ventures, in which undistributed earnings are recognized for accounting purposes on the same basis as for federal income tax reporting. Proponents of the stated amount method also believe that it produces symmetry, since the investee records the issuance of securities or book credits at par or face amounts rather than on the basis of discounted values. They argue further that the method conforms with the underlying price-adjustment theory of cooperatives, which holds that such allocated equities are merely reductions of the cost of supply purchases or increases in the proceeds of products marketed through the cooperative and that they should therefore be reflected in the patrons' results of operations.

.098 Accountants who believe that a cooperative's unallocated losses should not be recognized by the patrons base their contention on the premise that operating losses may indicate temporary rather than permanent declines in value because they may result from identifiable, isolated, or nonrecurring events. Accordingly, they should not be recognized. Furthermore, because many investor cooperatives determine patronage allocations on the basis of financial statement reporting rather than federal income tax reporting, some accountants argue that financial statement recognition by investor cooperatives of unallocated losses will cause the payment of federal income taxes by the investor cooperative that would not otherwise be payable and such taxes will not be recoverable if the losses are later allocated. That adverse effect is the result of federal income tax regulations that limit the patronage refund deduction to the lesser of the patronage refund "paid" and the patronage refund "allowable," as determined in accordance with federal income tax rules and regulations.

.099 Those who believe that unallocated losses should be recognized argue that patrons must recognize allocated losses for consistent reporting, much as if the investment were in a corporate joint venture or partnership rather than a cooperative. They further contend that failure to recognize unallocated losses permits manipulation of earnings because patrons often serve on the cooperative's board of directors or can influence the board of directors, which has the authority to determine the portions, if any, of the losses that will be allocated to patrons.

.100 Accountants who believe that unallocated equities should not be recognized by the patrons generally contend that APB Opinion No. 18 does not apply because equity ownership generally does not convey voting control and because ownership interests in unallocated equities may be temporary, being subject to changes in patronage participation and the redemption of equities. However, others argue that APB Opinion No. 18 should apply to all investments in cooperatives in which the patrons hold at least 20 percent of the equity securities, regardless of the one-member-one-vote requirement and the fact that ownership interests may change. They believe that the patron frequently has significant influence due to patronage volume, assured representation on the board of directors, or other means.

.101 Some accountants believe that patronage allocations should be recognized in the accounting period in which the supply is purchased or the product is marketed, since those transactions are the source of the patronage allocations and are adjustments of the price at which the supply is purchased or the product marketed. Others believe that the accrual of estimated patronage allocations is impractical because many cooperatives do not determine patronage allocations during interim periods and the amount of the allocations usually cannot be determined from the cooperatives' interim financial statements. Further, existing federal income tax rules and regulations, as well as the bylaws of most investee cooperatives, require the investee's patronage allocations to be included in taxable income in the period the investor is notified of the patronage allocation. This requirement may cause adverse tax effects for investors.

.102 Some accountants argue that allocated and unallocated equities should be reflected in the statement of operations as reductions of costs or increases in proceeds because such amounts result from the transactions by which supplies are purchased, interest is paid, or products are sold. Accordingly, the proponents believe that the equities should be reported in the same manner as the original transactions to report sales, cost of sales, and operating expenses. Other accountants believe that the allocations should be reported as other income rather than as increases or decreases in sales, cost of sales, or operating expenses; they argue that including the allocations in sales, cost of sales, or operating expenses could misstate gross profit or expenses.

## **Division Conclusions**

.103 Investments in cooperatives should be accounted for at cost, including allocated equities and retains. The carrying amount of an investment in a cooperative should be reduced if the patron is unable to recover the full carrying value of the investment. Losses unallocated by the investee may indicate such an inability, and, at a minimum, the excess of unallocated losses over unallocated equities should be recognized by the patron based on the patron's proportionate share of the total equity of the investee cooperative, or any other appropriate method, unless the patron demonstrates that it is probable that the carrying amount of the investment in the cooperative can be fully recovered.

**.104** Patrons should recognize patronage refunds either—

- a.* When the related patronage occurs if it is then probable that (1) a patronage refund applicable to the period will be declared, (2) one or more future events confirming the receipt of a patronage refund are expected to occur, (3) the amount of the refund can be reasonably estimated, and (4) the accrual can be consistently made from year to year or
- b.* On notification by the distributing cooperative.

The accrual should be based on the latest available reliable information and should be adjusted on notification of allocation.

**.105** Either (1) the classification of the allocations in the financial statements should follow the recording of the costs or proceeds or (2) the allocations should be presented separately.

## Effective Date and Transition

**.106** The Accounting Standards Division recommends application of this statement to financial statements prepared for fiscal years, and interim periods in such fiscal years, beginning after June 15, 1985. Accounting changes to conform to the recommendations of this statement should be made prospectively for transactions or activities occurring on or after the effective date of this statement. Application for earlier years, including retroactive application, is encouraged for all transactions or activities regardless of when they occurred. Disclosures should be made in the financial statements in the period of change in accordance with APB Opinion No. 20, *Accounting Changes*.

## Appendix

### Accounting by Pooling Cooperatives for Products Received From Patrons

The following illustrates the statement of net earnings prepared under each of two possible methods of accounting for inventories (columns A and B), the statement of net proceeds prepared under the net realizable value method (column C), and the respective statements of amounts due patrons, if such latter statement is included in the financial statements. (See paragraphs .083, .084, and .085.) Column A demonstrates the lower of cost or market method with patrons' raw product being charged to cost of production at assigned amounts. Column B demonstrates the net realizable value method with patrons' raw product being charged to cost of production at assigned amounts. Column C demonstrates the net realizable value method when no amounts are assigned to patrons' raw product; therefore, there is no charge to cost of production for patrons' raw product. The assumed facts are as follows:

Sales	\$129,630
Beginning inventory	
Net realizable value	31,128
Lower of cost or market	28,380
Assigned value of patrons' raw product received	56,500
Ending inventory	
Net realizable value	35,596
Lower of cost or market	32,360
Income taxes	1,250
Other costs and expenses	56,580
Amounts paid to patrons, retains, and non-patronage earnings	74,430
Amounts due patrons at beginning of year	
Lower of cost or market method	8,910
Net realizable value method	11,748

Statements of Net Earnings (columns A and B)

Statement of Net Proceeds (column C)

	Inventories Valued At		
	Lower of Cost or Market—A	Net Realizable Value—B	Net Realizable Value—C
Sales	\$129,630	\$129,630	\$129,630
Costs and expenses (I)	109,100	108,702	52,202
Earnings before income taxes	20,530	20,928	—
Proceeds before income taxes	—	—	77,428
Income taxes	1,250	1,250	1,250
Net earnings	<u>\$ 19,280</u>	<u>\$ 19,678</u>	
Net proceeds			<u>\$ 76,178</u>
I. Beginning inventory	\$ 28,380	\$31,218	\$31,218
Assigned value of patrons' raw product received	56,500	56,500	—
Ending inventory	(32,360)	(35,596)	(35,596)
Other costs and expenses	56,580	56,580	56,580
	<u>\$109,100</u>	<u>\$108,702</u>	<u>\$ 52,202</u>



## Statements of Amounts Due Patrons

	Inventories Valued At		
	Lower of Cost or Market—A	Net Realizable Value—B	Net Realizable Value—C
Amounts due patrons at beginning of year	\$ 8,910	\$11,748	\$11,748
Net earnings	19,280	19,678	—
Net proceeds	—	—	76,178
Assigned value of patrons' raw product received	56,500	56,500	—
	84,690	87,926	87,926
Less amounts paid to patrons, retains, and non-patronage earnings	74,430	74,430	74,430
Amounts due patrons at end of year	<u>\$10,260</u>	<u>\$13,496</u>	<u>\$13,496</u>

Under the two inventory methods presented, the difference in amounts due patrons at the end of the year results from the difference in the ending inventory valuations, illustrated as follows:

Inventories of finished goods and goods in process at:	
Net realizable value	\$35,596
Lower of cost or market	<u>(32,360)</u>
	3,236
Amounts due patrons at end of year on lower of cost or market basis	<u>10,260</u>
Amounts due patrons at end of year on net realizable value basis	<u>\$13,496</u>

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## Section 10,430

# **Statement of Position 88-1 Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications**

September 30, 1988

### **NOTE**

This statement of position amends chapter 3 of the AICPA Industry Audit Guide, *Audits of Airlines*.

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

## **Industry Developments**

### **Deregulation**

.01 In 1981, when the AICPA Industry Audit Guide, *Audits of Airlines*, was issued, airlines were regulated by the Civil Aeronautics Board (CAB). However, the Airline Deregulation Act of 1978 (ADA) terminated the CAB's authority over rates and route access on January 1, 1983, and its responsibility for evaluating the fitness of new entrants on January 1, 1985.

.02 In addition to liberalizing the general provisions for awarding certificates to new airlines, the ADA established new provisions for automatic market entry and issuance of experimental certificates on a temporary basis. Other provisions eased restrictions on suspension and reduction of service and expedited market entry and exit. As a result, the ADA has enabled many new entrants to gain access to domestic markets and has allowed trunk, local service, and commuter carriers to expand and otherwise alter their service patterns. Airlines are now classified as certificated scheduled (route) airlines, certificated nonscheduled (charter) airlines, air-cargo airlines, and intrastate airlines. Within the route airline classification, airlines are now identified as major, national, regional, and air-taxi operators.

.03 In addition, the ADA transferred responsibility for overseeing airline operations to the Department of Transportation (DOT). The DOT has assumed responsibility for both monitoring the air safety and fitness characteristics of the various airlines and approving merger proposals and sales of airline routes. In this new competitive environment, marketing strategies, pricing of tickets, and costs of service have become important business issues for the airlines.

## **International Air Transportation**

.04 Airline operations between countries continue to be governed by specific bilateral agreements between the countries. The access of U.S. airlines to routes between the United States and other countries requires the approval of the respective countries for both landing rights at specified airports and frequency of flights.

.05 The International Air Transport Association (IATA), a voluntary organization of international airlines, was established in 1946 to negotiate international air fares, cargo rates, conditions of service, and ancillary matters. The Federal Aviation Act required U.S. airlines participating in such an organization to obtain approval from the CAB. In 1946, the CAB granted U.S. airlines immunity from antitrust laws, permitting them to participate in IATA conferences for the purpose of establishing fares and rates. Agreements reached by the airlines at those meetings are subject to the approval of the respective governments.

.06 In anticipation of deregulation in the United States, IATA established two types of airline participation: one deals with facilitation matters and is mandatory for all members; the other sets fares and rates for air transportation. Participation in the latter is optional, but a member choosing to participate in fare and rate conferences must do so for all areas served.

## **Air Transport Association of America (ATA)**

.07 Founded in 1936, the Air Transport Association of America is a trade and service organization representing member U.S.-scheduled airlines. The joint interests of the airlines as an industry are expressed through a system of councils and related committees on which airline and ATA representatives work together.

.08 Because travel agent sales constitute a significant portion of the airline business, the ATA designed the Area Settlement Plan (ASP), which is operated by the Airlines Reporting Corporation. The plan enables each travel agent to submit one sales report to an area processing center that then distributes the agent's sales and receivable transactions to the respective airlines. Because the dollar volumes involved and competitive needs for sales information are substantial, the ASP program requires continuous monitoring and updating. This service is provided to the airlines and travel agents by the ATA.

.09 Other plans, called bank settlement plans (BSPs), have been established recently in Japan, the United Kingdom, the Federal Republic of Germany, and other countries. The BSPs, although not identical to the ASP, contain many of the same features.

## **Regional Airline Association**

.10 The Regional Airline Association, formerly the Commuter Airline Association, is the national association of member airlines engaged in scheduled air transportation of passengers and cargo in local, feeder, and short-haul

markets throughout the United States and its territories. In addition, the association's finance and accounting committee has developed a uniform system of accounts for regional airline use.

## Regulations and Reporting

.11 Although the CAB is no longer in existence, airline accounting information continues to be reported to the DOT in conformity with the Uniform System of Accounts and Reports (USAR) previously issued by the CAB. The USAR consists of a list of titles and account numbers and instructions for their use. DOT—and, previously, CAB—policy has been to conform its accounting requirements to generally accepted accounting principles.

.12 Financial data and reports based on the USAR must be filed with the DOT on Form 41 quarterly and annually. Securities and Exchange Commission filings and annual financial reports frequently follow the wording and captions of the USAR accounts.

## Computerized Reservation Systems (CRSs)

.13 Computerized reservation systems (CRSs) developed by several airlines (CRS vendors) have significantly affected the industry. The systems are marketed to travel agents as an efficient method of accessing airline schedules and information regarding hotels, car rentals, and so forth. The CRSs permit the agency user to, among other things, check seat availability, make reservations, and print tickets for flights on participating domestic and international airlines. In 1984, the CAB ordered the elimination of display preference in the systems for all participating airlines (those paying a fee to participate) and required CRS vendors to charge uniform booking fees for airline users of CRSs, based on the level of service received. Nonparticipating airline schedules are also included in the CRSs for informational purposes.

.14 The CRS vendors receive booking fees per segment from participating airlines on which flights are booked and user fees from the travel agencies. Some airlines have contracted with CRS vendors to process all of their reservations through the CRS vendors' reservation systems, thereby eliminating the need for the airlines' in-house reservation systems.

.15 The CRSs increase the amount of information that may be captured online at the time the reservation is booked. This information normally includes passenger name, ticket number, the travel agent selling the ticket, itinerary, class of service, and price.

## Marketing Arrangements

.16 One of the developments in the deregulated environment is the *hub and spoke strategy* that has been adopted by many airlines. Under this concept, the airline identifies certain cities as hub cities to serve both long-haul flights and connecting short-haul flights. This strategy has led carriers operating from a hub city to enter into agreements with other carriers to coordinate flight schedules at the hub city to facilitate the interchange of passengers. The advantage to both airlines is that each feeds passengers to the other. The agreements may include joint promotion and advertising efforts, use of the major carrier's reservation system, and dual designation of flights in a CRS or other reservation systems and the official airline guide. The dual designation

of flights (that is, a national or regional flight arriving at or departing the hub city using the same flight number as the major carrier) is the subject of controversy within the industry.

### Commissions

.17 Before deregulation, commissions to travel agents were limited to amounts authorized by the CAB or foreign governments. Since deregulation, a myriad of commission arrangements has evolved both domestically and internationally. In addition to basic commissions, travel agents may be entitled to incentive commissions for certain routes, travel periods, and defined volumes. The independent accountant should consider the increasingly significant cost of travel agents' commissions when designing compliance and substantive tests of commissions expense.

### Accounting Issues

.18 The guidance presented in this statement modifies certain aspects of the guide and addresses issues that have developed as a result of deregulation.

### Developmental and Preoperating Costs

.19 Developmental and preoperating costs are as follows:

*Developmental costs* include those types of costs directly related to the development of new routes (or extension of existing routes), such as advertising and promotion expenses, related travel and incidental expenses, and expenses of regulatory proceedings.

*Preoperating costs* include flight crew training, maintenance training, prerenue flight expenses, insurance, and depreciation. Like developmental costs, preoperating costs relate directly to specific preoperating projects, such as preparation for operation of new routes . . . or integration of new types of aircraft . . .

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.20 Before deregulation, costs meeting the foregoing criteria for developmental and preoperating costs were normally deferred and amortized over the expected period of benefit, generally two-to-five years. In that regulated environment, the expected future benefit and recoverability of such costs was generally not in doubt.

.21 Under the ADA, new domestic routes can be obtained more readily without regulatory delay, and there is presently little domestic protection against new entrants. The designation of additional U.S. cities as gateway cities with direct service to various international cities, as well as the increased competition over traditional international routes, has altered the historical competitive relationship and earnings potential that previously existed on given routes. Therefore, the future benefits to be derived from new routes may be uncertain in the present operating environment.

### Division's Conclusions

.22 Because of the current deregulated environment and the uncertainty regarding the recoverability of route developmental costs, the majority of the Accounting Standards Executive Committee (AcSEC) believes that developmental costs, other than advertising costs, related to preparation of operations of new routes should not be capitalized, as previously permitted under the guide. (Advertising costs should be accounted for in conformity with the gui-

dance in SOP 93-7, *Reporting on Advertising Costs* [section 10,590].) Route expansion or alteration has become a recurring activity among the airlines, and any related cost is considered a normal and recurring cost of conducting business. [As amended, effective for financial statements for years beginning after June 15, 1994, by Statement of Position 93-7.] (See section 10,590.)

.23 Preoperating costs related to the integration of new types of aircraft would continue to be eligible to be capitalized, as permitted in the guide.\*

.24 A minority of AcSEC believes that the current accounting model permits the capitalization of developmental costs. They believe that the airline industry should not be precluded from capitalizing those costs.

.25 After the decision has been made to defer certain preoperating costs, questions arise about the appropriate cost-accumulation periods (in other words, the end-of-the-deferral period) and the date on which amortization of deferred costs should begin. Generally, current practice is to terminate the cost-deferral period and, consequently, begin the cost-amortization period on the date scheduled air service commences. AcSEC believes that it is inappropriate to defer preoperating costs after the new aircraft type is ready to be placed in service and that the amortization period for such costs should begin when the new aircraft is ready to be placed in service.\*

## Take-Off and Landing Slots

.26 New entrants to a market and airlines expanding in markets need gates, and take-off and landing slots available to them at the airports in those markets. At certain airports, the frequency of take-offs and landings at all times is generally at capacity. At other airports, the slots during popular travel times are at capacity.

.27 Because an airline cannot enter a market where no slots are available, the DOT has adopted a rule under which airlines may sell or trade slots. These transactions frequently include the sale of or access to gates for the acquiring airlines. Although slots, particularly those in high-demand time periods, have always had intrinsic value, the DOT policy of transferability through sale or exchange has made the slot a salable right.

## Division's Conclusions

.28 When airlines buy slots, the recorded asset is an identifiable intangible asset that should be accounted for in conformity with Accounting Principles Board Opinion No. 17, *Intangible Assets*. When establishing a policy for amortization of the cost of such intangible assets, the following factors should be considered:

- The accelerated pace of change in the airline industry and the effects of competition among airports
- The uncertainty of the continuation of the current governmental policy regarding sale of and access to landing slots

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\* SOP 98-5, *Reporting on the Costs of Start-Up Activities*, amends this SOP (a) to require that preoperating costs be expensed as incurred rather than capitalized, and (b) to delete paragraph 25. SOP 98-5 is effective for financial statements for fiscal years beginning after December 15, 1998. This SOP will be updated to reflect the provisions of SOP 98-5 nearer to the pronouncement's effective date. See section 10,750.

- The terms of existing facility leases at airports
- Probability of new airport construction to serve the same metropolitan area
- Traffic patterns and trends and local operating restrictions

.29 When an airline exchanges slots with another airline, the slots acquired in the exchange are nonmonetary assets that should be recorded in conformity with APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, and amortized in accordance with APB Opinion No. 17.

### **Airframe Modifications**

.30 Historically, airlines have undertaken major programs to modify interior configurations of certain aircraft types—including the reconfiguration and replacement of seats, galley equipment, and storage space—in response to market forces and passenger demands. Since deregulation, such changes have been more frequent.

### **Division's Conclusions**

.31 If the modifications enhance the usefulness of the aircraft, the costs associated with the changes should be capitalized and depreciated over the estimated useful life of the aircraft or the modifications, whichever is less. The cost of the replaced asset net of accumulated depreciation and anticipated recovery value should be charged to income in the current period. However, detailed records may often be inadequate to permit identification of the cost of the replaced asset; therefore, estimates may be required.

### **Effective Date**

.32 The conclusions in this statement of position should be applied to transactions initiated after September 30, 1988, although earlier application is encouraged. Restatement of previously issued financial statements is not permitted.



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## Section 10,450

### ***Statement of Position 90-3 Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position***

February 13, 1990

#### **NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

### **Scope**

.01 This Statement of Position provides guidance for determining whether two debt instruments are *substantially the same*. The recommendations herein are limited to transactions involving a sale and purchase or exchange of debt instruments between entities who hold the debt instruments as an asset. The term *debt instruments* is used in this statement of position to include instruments usually considered to be securities such as notes, bonds, and debentures, as well as other evidence of indebtedness such as money market instruments, certificates of deposit, mortgage loans, commercial loans, and commercial paper, that often are not referred to as securities. Debt instruments also include evidence of indebtedness that represents aggregations of debt instruments, such as mortgage-backed certificates.

.02 The conclusions in this statement of position are not intended to modify, in any way, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*. Paragraph 42 of SFAS No. 15 discusses certain situations in which troubled debt restructurings may involve substituting debt of other business enterprises, individuals, or governmental units for that of the troubled debtors. The accounting principles in paragraph 42 of SFAS No. 15 are not affected by this statement of position. Also, this

statement of position is not intended to apply to situations in which financial institutions originate or buy whole loan mortgages and exchange those loans for a participation certificate issued by government-sponsored enterprises or agencies (FHLMC, FNMA, or GNMA) representing direct ownership of the same mortgages. However, the statement of position does apply to exchanges of participation certificates.

.03 The recommendations in this statement of position amend AICPA Industry Audit Guide *Audits of Banks* (Bank Audit Guide)<sup>1</sup> and Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* (Broker-Dealer Guide).

## Background

.04 The preface of the Bank Audit Guide (May 1994) stated that certain issues affecting the banking industry were not included in the guide or were under study by the AICPA or the FASB. One of those issues related to the definition of the term *substantially the same* as used in the guide.<sup>2</sup>

.05 In paragraphs 5.19 and 5.20 of the Bank Audit Guide (May 1994), the term *substantially the same* was used in describing wash sales as follows:<sup>3</sup>

Bank supervisory agencies currently prescribe that investment security gains and losses be recognized according to the completed transaction method. In practice, serious questions develop about the proper definition of "completed transactions" when securities are sold with the intent to reacquire the same or *substantially the same* securities, most often to obtain income tax or other benefits. In such transactions, known as "wash sales," the period of time between sale and reacquisition varies. It is often very short, especially when readily marketable securities are involved. In some cases, the security or evidence of ownership of the security remains in the possession of the seller or his agent; only brokers' advices provide evidence of the sale and reacquisition.

In a sale, the risks and opportunities of ownership are transferred for a reasonable period of time; such a transfer is necessary to constitute realization and permit recognition of revenue. Therefore, when a bank sells a security and concurrently reinvests the proceeds from the sale in the same or *substantially the same* security, no sale should be recognized, since the effect of the sale and repurchase transaction leaves the bank in essentially the same position as before, notwithstanding the fact that the bank has incurred brokerage fees and taxes. When the proceeds are not reinvested immediately, but soon thereafter, the test is whether the bank was at risk for a reasonable period of time to warrant recognition of a sale. The period of time cannot be defined exactly; rather, the type of securities involved and the circumstances of the particular transaction should enter into the determination of what constitutes a reasonable period of time. For example, a day may be appropriate for a quoted stock or bond that has a history of significant market price fluctuations over short periods of time. Similarly, a bank's liquidity requirements may require that a

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<sup>1</sup> The AICPA Audit and Accounting Guide *Banks and Savings Institutions*, incorporated and superseded Statement of Position (SOP) 90-3 to the extent SOP 90-3 amended previous editions of the Bank Audit Guide and the AICPA Audit and Accounting Guide *Audits of Savings Institutions*. [Footnote added, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

<sup>2</sup> See footnote 1. [Footnote added, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

<sup>3</sup> See footnote 1. [Footnote added, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

long-term bond be replaced by a short-term money market instrument; but, a week later, the bank's liquidity requirements may change, and reacquisition of the bond previously sold may be a reasonable business decision, wholly independent of the previous decision to sell the bond. [*Emphasis added.*]

.06 The terms *substantially the same*, *substantially similar*, and *substantially identical* are also used to describe a factor that is considered in determining whether a sale of a debt instrument under an agreement to repurchase should be accounted for as a sale and a purchase or as a financing transaction. Dollar repurchase—dollar reverse repurchase agreements involve similar but not identical securities. The terms of the agreements often provide data to determine whether the securities are similar enough to make the transaction in substance a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities.

.07 A dollar repurchase—dollar reverse repurchase agreement is an agreement (contract) to sell and repurchase or to purchase and sell back securities of the same issuer but not the original securities. Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with securities having the same stated interest rate as the interest rate stated on the securities sold. In a yield maintenance agreement, the parties agree that delivery will be made with securities that will provide the seller a yield that is specified in the agreement.

[.08] [Paragraph deleted, August 1991, by the Audit and Accounting Guide *Audits of Savings Institutions*.]

.09 The term *substantially identical* is also used by brokers and dealers in discussing repurchase transactions. The AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities* states the following in paragraph 1.40:

A repurchase transaction, commonly known as a repo transaction, is a sale of security coupled with an agreement by the seller to repurchase the same or *substantially identical* security at a stated price . . . .

A reverse repurchase agreement, known as a reverse repo, is the purchase of a security at a specified price with an agreement to resell the same or *substantially identical* security at a definite price at a specific future date. [*Emphasis added.*]

The Broker/Dealer Guide does not provide any guidance for determining whether the securities are *substantially identical*.

.10 Because of the lack of an authoritative definition of *substantially the same*, alternative accounting practices have developed or may develop for the exchange of *substantially the same* assets.

## Current Accounting Practices

.11 The issue of whether two debt instruments are *substantially the same* is generally encountered in connection with determining whether a transaction involving debt instruments results in a sale or a financing, for example, the sale of a debt instrument under an agreement to repurchase another debt instrument. If the debt instrument to be repurchased is *substantially the same* as a debt instrument sold, it may be viewed as a financing transaction. However, if the debt instrument to be repurchased is viewed as not being *substantially the same*, that transaction is generally recorded as a sale with a commitment to buy another debt instrument.

.12 Two debt instruments can differ in a variety of ways, such as the obligor, maturity, interest rate, and yield. If two debt instruments are exchanged and many of the characteristics of the instruments differ, for example, exchange of a U.S. Treasury bill for a mortgage-backed security, virtually all would agree that a transaction has taken place that requires accounting recognition as a sale, not a financing. In contrast, if two debt instruments are exchanged and most of the characteristics of the instruments are the same, many would view the exchange as involving *substantially the same* securities prohibiting accounting recognition, for example, the exchange of two GNMA securities bearing the identical contractual interest rate that are collateralized by similar pools of mortgages resulting in approximately the same yield. Thus, the issue to resolve is how similar the characteristics of two debt instruments have to be viewed as *substantially the same*.

## Conclusions

.13 To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of *substantially the same* should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be *substantially the same*, all the following criteria must be met:<sup>4</sup>

- a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same.<sup>5</sup>
- b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.<sup>6</sup>
- c. The debt instruments must bear the identical contractual interest rate.
- d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.<sup>7</sup>

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<sup>4</sup> See footnote 1. [Footnote added, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

<sup>5</sup> The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered *substantially the same*. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1996.]

<sup>6</sup> For example, the following exchanges would not meet this criterion: GNMA I securities for GNMA II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary "in form and type"); commercial paper for redeemable preferred stock. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1996.]

<sup>7</sup> For example, the exchange of a "fast-pay" GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a "slow-pay" GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1996.]

- e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
- f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard for the type of mortgage-backed security involved.<sup>8</sup>

## Effective Date and Transition

.14 The conclusions of this statement of position should be applied prospectively to transactions entered into after March 31, 1990. Earlier application to transactions occurring in periods for which financial statements have not been issued is encouraged. However, previously issued annual or interim financial statements should not be restated.

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<sup>8</sup> Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities*, which is published by PSA. [Footnote renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1996.]

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## Section 10,460

# **Statement of Position 90-7 Financial Reporting by Entities in Reorganization Under the Bankruptcy Code**

November 19, 1990

### NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

## Introduction

.01 This statement of position (SOP) was prepared by the Task Force on Financial Reporting by Entities in Reorganization Under the *Bankruptcy Code* to provide guidance on financial reporting by entities that have filed petitions with the *Bankruptcy Court* and expect to reorganize as going concerns under *Chapter 11* of title 11 of the United States Code ("Chapter 11").<sup>1</sup>

## Petition, Proceeding, and Plan

.02 An entity enters reorganization under Chapter 11 by filing a petition with the Bankruptcy Court, an adjunct of the United States District Courts. The filing of the *petition* starts the *reorganization proceeding*. The goal of the proceeding is to maximize recovery by creditors and shareholders by preserving it as a viable entity with a going concern value. For that purpose, the entity prepares a *plan of reorganization* intended to be confirmed by the court. The plan provides for treatment of all the assets and liabilities of the debtor, which might result in forgiveness of indebtedness. For the plan to be confirmed and the reorganization proceedings thereby concluded, the consideration to be received by parties in interest under the plan must exceed the consideration they would otherwise receive on liquidation of the entity under *Chapter 7* of the

<sup>1</sup> A glossary of defined terms, which are in *italics* when they first appear in the text, is in paragraph .69.

Bankruptcy Code. The court may confirm a plan even if some classes of creditors or some of the stockholders have not accepted it, provided that it meets standards of fairness required by Chapter 11 to the dissenting class of creditors or the dissenting stockholders.

.03 The plan is the heart of every Chapter 11 reorganization. The provisions of the plan specify the treatment of all creditors and equity holders upon its approval by the Bankruptcy Court. Moreover, the plan shapes the financial structure of the entity that emerges.

.04 Chapter 11 provides that, unless a *trustee* is appointed, the debtor has the exclusive right to file a plan for the first 120 days of the case, or such longer or shorter time as the Bankruptcy Court decrees, for cause. If a plan is filed within the exclusive period, additional time is provided to allow the debtor to obtain plan acceptance. The appointment of the trustee immediately terminates the debtor's exclusive right to file a plan, and any party in interest may then do so.

.05 Except to the extent that specific debts are determined by the Bankruptcy Court not to be discharged by the plan, the provisions of a *confirmed plan* bind the debtor, any entity issuing securities under the plan, any entity acquiring assets under the plan, and any creditor, equity security holder, or general partner in the debtor, regardless of whether the *claim* is impaired under the plan and whether such creditor, equity security holder, or general partner has accepted the plan. A claim is impaired if, subject to certain rights to cure defaults, its legal rights are affected adversely by the plan.

.06 In general, except as provided in the plan or in the order confirming the plan, confirmation of the plan discharges the debtor from all preconfirmation claims and terminates all rights and interest of equity security holders or general partners as provided for in the plan.

.07 The Bankruptcy Court confirms a plan if it finds all of the following:

- The plan and the plan proponent have complied with various technical requirements of the Bankruptcy Code.
- Disclosures made in soliciting acceptance of the plan have been adequate.
- Dissenting members of *consenting classes of impaired claims* would receive under the plan at least the amount they would have received under a Chapter 7 proceeding.
- Claims entitled to priority under the Bankruptcy Code will be paid in cash.
- Confirmation of the plan is not likely to be followed by liquidation or further reorganization.
- At least one class of impaired claims, apart from insiders, has accepted the plan.
- The plan proponent has obtained the consent of all impaired classes of claims or equity securities, or the plan proponent can comply with the *cram-down provisions* of the Bankruptcy Code. (Under the cram-down provisions, the court may confirm a plan even if one or more classes of holders of impaired claims or equity securities do not accept it, as long as the court finds the plan does not discriminate unfairly and is fair and equitable to each *nonconsenting class* impaired by the plan.)

.08 In general, a *secured claim* is deemed to be treated fairly and equitably if it remains adequately collateralized and will receive a stream of payments whose discounted value equals the amount of the secured claim on the effective date of the plan. In general, an *unsecured claim* is deemed to be treated fairly and equitably if it receives assets whose discounted value equals the allowed amount of the claim, or if the holder of any claim or equity security interest that is junior to the dissenting class will not receive or retain any assets under the plan. Similarly, an equity security interest is deemed fairly and equitably treated if that interest receives assets whose discounted value equals the greatest of any fixed liquidation preference, any fixed redemption price, or the value of such interest, or if no junior equity security interest will receive any assets under the plan.

## Reorganization Value

.09 An important part of the process of developing a plan is the determination of the *reorganization value* of the entity that emerges from bankruptcy. Reorganization value generally approximates fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after the restructuring. The reorganization value of an entity is the amount of resources available and to become available for the satisfaction of postpetition liabilities and *allowed claims* and interest, as negotiated or litigated between the *debtor-in-possession* or trustee, the creditors, and the holders of equity interests. Reorganization value includes the sum of the value attributed to the reconstituted entity and other assets of the debtor that will not be included in the reconstituted entity. Reorganization value and the terms of the plan are determined only after extensive arms-length negotiations or litigation between the interested parties. Before the negotiations, the debtor-in-possession, creditors, and equity holders develop their own ideas on the reorganization value of the entity that will emerge from Chapter 11. Several methods are used to determine the reorganization value; however, generally it is determined by discounting future cash flows for the reconstituted business that will emerge from Chapter 11 and from expected proceeds or collections from assets not required in the reconstituted business, at rates reflecting the business and financial risks involved.

## The Disclosure Statement

.10 A *disclosure statement* approved by the court is transmitted to all parties entitled to vote on the plan at or before the time their acceptance of the plan is solicited. The disclosure statement provides information that enables them to make informed judgments about the plan.

.11 No postpetition solicitation of acceptance of a plan may be made unless by the time of the solicitation a disclosure statement previously approved by the Bankruptcy Court has been sent to those whose acceptance is required. The disclosure statement must contain adequate information, which is defined in the Bankruptcy Code as information that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan, as far as it is reasonably practicable to provide in light of the nature and history of the *emerging entity* and the condition of the emerging entity's records. Examples of the kinds of items that may be included in disclosure statements to provide such information include a summary of the reorganization plan, historical and

prospective financial information, and a pro forma balance sheet reporting the reorganization value and the capital structure of the emerging entity.

.12 What constitutes adequate information depends on the circumstances of the entity in Chapter 11, the nature of the plan, and the sophistication of the various classes whose acceptance is required. Although a valuation is not required for a Bankruptcy Court's approval of a disclosure statement, the instances in which valuations are not made are generally restricted to those in which the reorganization value of the emerging entity is greater than the liabilities or in which holders of existing voting shares retain more than 50 percent of the emerging entity's voting shares when the entity emerges from reorganization.

.13 After reorganization proceedings have started, acceptances of a plan may not be solicited by any person without a disclosure statement approved by the court, but acceptances obtained before the proceedings started may be counted if (a) they were solicited in compliance with applicable nonbankruptcy law governing the adequacy of disclosure or (b) there is not any applicable nonbankruptcy law but there was in fact adequate information provided at the time of the prebankruptcy solicitation of acceptances of the plan.

## Current Literature and Reporting Practices

.14 The current financial reporting literature provides no specific guidance for financial reporting by entities in reorganization proceedings. Entities generally continue to apply the financial reporting principles they applied before filing petitions; these principles usually do not adequately reflect all changes in the entity's financial condition caused by the proceeding. The financial statements prepared while entities are in Chapter 11 reorganization are therefore not as useful to users of financial statements as they should be. For example, the Bankruptcy Code allows the debtor to reject executory contracts such as leases and take-or-pay contracts. Some entities report the resulting claims at the estimated amounts of the allowed claims, while others report them at the estimated amounts at which they will be settled.

.15 Another area in which reporting is diverse during the Chapter 11 reorganization is the classification of liabilities. Some entities report all *prepetition liabilities* as current, whereas others report them as long-term debt or as a separate item between current and long-term liabilities. Financial Accounting Standards Board (FASB) Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced*, states that all short-term obligations resulting from transactions in the normal course of business that are due in customary terms, such as trade payables, advance collections, and accrued expenses, are to be classified as current liabilities. However, FASB Statement No. 6 does not address reporting by entities in Chapter 11 reorganization whose unsecured debt may not be paid without approval of the Bankruptcy Court and therefore may neither be paid within one year, or the operating cycle, if longer, nor satisfied with current assets.

.16 Further, the financial reporting literature provides no specific guidance for financial reporting by entities emerging from Chapter 11 reorganization under confirmed plans. As a result, practice is diverse. For example, FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, in footnote 4, and FASB Technical Bulletin No. 81-6, *Applicability of Statement 15 to Debtors in Bankruptcy Situations*, indicate that State-

ment No. 15 does not apply to troubled debt restructurings in which debtors restate their liabilities generally under the purview of the Bankruptcy Court. A majority of reorganizations of businesses result in general restructuring of liabilities, and considerable confusion exists on how to report the restructured liabilities. FASB Interpretation No. 2, *Imputing Interest on Debt Arrangements Made under the Federal Bankruptcy Act*, states that Accounting Principles Board (APB) Opinion 21, *Interest on Receivables and Payables*, should apply to cases under the Bankruptcy Code. However, that interpretation was superseded by FASB Statement No. 15. An analysis of reporting by entities emerging from bankruptcy indicates that some report their debt at discounted amounts and others follow the guidelines in FASB Statement No. 15.

.17 There is no specific guidance on whether an emerging entity should restate assets. For example, some restate their assets—though there generally is no net write-up—through quasi-reorganizations, and others do not. An analysis of reporting by emerging entities indicates that some eliminate deficits in their retained earnings by reducing additional paid-in capital while others retain such deficits.

## Scope

.18 This statement of position applies to financial reporting both by entities that have filed petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11 and by entities that have emerged from Chapter 11 (emerging entities) under confirmed plans.

.19 It does not apply to entities that restructure their debt outside Chapter 11, to governmental organizations, or to entities that liquidate or adopt plans of liquidation under the Bankruptcy Code.

## Conclusions

.20 The following is a summary of the conclusions reached by the Accounting Standards Division. They should be read in conjunction with the discussion of conclusions, which follows this summary and explains the basis for the conclusions.

## Financial Reporting During Reorganization Proceedings

.21 Entering a reorganization proceeding, although a significant event, does not ordinarily affect or change the application of generally accepted accounting principles followed by the entity in the preparation of its financial statements. However, the needs of financial statement users change, and thus changes in the reporting practices previously followed by the entity are necessary.

.22 An objective of financial statements issued by an entity in Chapter 11 should be to reflect its financial evolution during the proceeding. For that purpose, the financial statements for periods including and subsequent to filing the Chapter 11 petition should distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business.

## Balance Sheet

.23 The balance sheet of an entity in Chapter 11 should distinguish prepetition liabilities subject to compromise from those that are not (such as

fully secured liabilities that are expected not to be compromised) and *postpetition liabilities*. Liabilities that may be affected by the plan should be reported at the amounts expected to be allowed, even if they may be settled for lesser amounts. If there is uncertainty about whether a secured claim is *undersecured*, or will be impaired under the Plan, the entire amount of the claim should be included with prepetition claims subject to compromise; such a claim should not be reclassified unless it is subsequently determined that the claim is not subject to compromise.

**.24** Prepetition liabilities, including claims that become known after a petition is filed, should be reported on the basis of the expected amount of the allowed claims in accordance with FASB Statement No. 5, *Accounting for Contingencies*, as opposed to the amounts for which those allowed claims may be settled. Claims not subject to reasonable estimation should be disclosed in the notes to the financial statements based on the provisions of FASB Statement No. 5. Once these claims satisfy the accrual provisions of FASB Statement No. 5, they should be recorded in the accounts in accordance with the first sentence of this paragraph.

**.25** Debt discounts or premiums as well as debt issue costs should be viewed as valuations of the related debt. When the debt has become an allowed claim and the allowed claim differs from the net carrying amount of the debt, the recorded amount should be adjusted to the amount of the allowed claim (thereby adjusting existing discounts or premiums, and deferred issue costs to the extent necessary to report the debt at this allowed amount). The gain or loss resulting from the entries to record the adjustment should be classified as *reorganization items*, as discussed in paragraph .27. Premiums and discounts as well as debt issuance cost on debts that are not subject to compromise, such as fully secured claims, should not be adjusted.

**.26** Liabilities subject to compromise should be segregated from those that are not subject to compromise on the balance sheet. The principal categories of the claims subject to compromise should be disclosed in the notes to the financial statements. Circumstances arising during reorganization proceedings may require a change in the classification of liabilities between those subject to compromise and those not subject to compromise. Liabilities not subject to compromise should be further segregated into current and noncurrent classifications if the entity presents a classified balance sheet.

## Statement of Operations

**.27** The statement of operations should portray the results of operations of the reporting entity while it is in Chapter 11. Revenues, expenses (including professional fees), realized gains and losses, and provisions for losses resulting from the reorganization and restructuring of the business should be reported separately as reorganization items, except for those required to be reported as discontinued operations and extraordinary items in conformity with APB Opinion 30, *Reporting the Results of Operations*.

**.28** Some entities defer professional fees and similar types of expenditures until the plan is confirmed and then reduce gain from debt discharge to the extent of the previously deferred expenses. Others accrue professional fees and similar types of expenditures upon the filing of the Chapter 11 petition. Still others expense professional fees and similar types of expenditures as incurred. The task force concluded that professional fees and similar types of expenditures directly relating to the Chapter 11 proceeding do not result in as-



sets or liabilities and thus should be expensed as incurred and reported as reorganization items.

.29 Interest expense should be reported only to the extent that it will be paid during the proceeding or that it is probable that it will be an allowed priority, secured, or unsecured claim. Interest expense is not a reorganization item. The extent to which reported interest expense differs from stated contractual interest should be disclosed. The task force understands that the staff of the Securities and Exchange Commission (SEC) prefers that SEC registrants disclose this parenthetically on the face of the statement of operations.

.30 Interest income earned by an entity in Chapter 11 that it would not have earned but for the proceeding (normally all interest income) should be reported as a reorganization item.

## Statement of Cash Flows

.31 Reorganization items should be disclosed separately within the operating, investing, and financing categories of the statement of cash flows. This presentation can be better accomplished by the use of the direct method of presenting the statement. If the indirect method is used, details of operating cash receipts and payments resulting from the reorganization should be disclosed in a supplementary schedule or in the notes to the financial statements.

## Condensed Combined Financial Statements

.32 Consolidated financial statements that include one or more entities in reorganization proceedings and one or more entities not in reorganization proceedings should include condensed combined financial statements of the entities in reorganization proceedings. The combined financial statements should be prepared on the same basis as the consolidated financial statements.

.33 Intercompany receivables and payables of entities in reorganization proceedings should be disclosed in the condensed combined financial statements. In addition, the propriety of the carrying amounts of intercompany receivables from entities in Chapter 11 should be evaluated.

## Earnings Per Share

.34 Earnings per share should be reported, when required, in conformity with APB Opinion 15, *Earnings Per Share*. If it is probable that the plan will require the issuance of common stock or common stock equivalents, thereby diluting current equity interests, that fact should be disclosed.

## Financial Reporting When Entities Emerge From Chapter 11 Reorganization

.35 Entities whose plans have been confirmed by the court and have thereby emerged from Chapter 11 should apply the reporting principles in the following paragraphs as of the confirmation date or as of a later date when all material conditions precedent to the plan's becoming binding are resolved.

## Fresh-Start Reporting

.36 If the reorganization value of the assets of the emerging entity immediately before the date of confirmation is less than the total of all postpetition liabilities and allowed claims, and if holders of existing voting shares immediately before confirmation receive less than 50 percent of the voting shares of

the emerging entity, the entity should adopt fresh-start reporting upon its emergence from Chapter 11. The loss of control contemplated by the plan must be substantive and not temporary. That is, the new controlling interest must not revert to the shareholders existing immediately before the plan was filed or confirmed.

.37 While the court determines the adequacy of the disclosure statement, entities that expect to adopt fresh-start reporting should report information about the reorganization value in the disclosure statement, so that creditors and stockholders can make an informed judgment about the plan. The most likely place to report the reorganization value is in the pro forma balance sheet that is commonly part of the disclosure statement. Because reorganization value may not have been allocated to individual assets concurrently with the preparation of the pro forma balance sheet included in the disclosure statement in some cases, it may be necessary to include in the pro forma balance sheet a separate line item to reflect the difference of the total reorganization value of the emerging entity over recorded amounts. When possible, reorganization value should be segregated into major categories.

.38 Entities that adopt fresh-start reporting in conformity with paragraph .36 should apply the following principles:

- The reorganization value of the entity should be allocated to the entity's assets in conformity with the procedures specified by APB Opinion 16, *Business Combinations*, for transactions reported on the basis of the purchase method. If any portion of the reorganization value cannot be attributed to specific tangible or identified intangible assets of the emerging entity, such amounts should be reported as the intangible asset identified as "reorganization value in excess of amounts allocable to identifiable assets." This excess should be amortized in conformity with APB Opinion 17, *Intangible Assets*. There usually are overriding pertinent factors that should be considered in determining the proper amortization period of this asset that would generally result in a useful life of substantially less than forty years. At a minimum, the same considerations used in determining the reorganization value should be applied in determining the period of amortization.
- Each liability existing at the plan confirmation date, other than deferred taxes, should be stated at present values of amounts to be paid determined at appropriate current interest rates.
- Deferred taxes should be reported in conformity with generally accepted accounting principles. Benefits realized from preconfirmation net operating loss carryforwards should first reduce reorganization value in excess of amounts allocable to identifiable assets and other intangibles until exhausted and thereafter be reported as a direct addition to paid-in capital.
- Changes in accounting principles that will be required in the financial statements of the emerging entity within the twelve months following the adoption of fresh-start reporting should be adopted at the time fresh-start reporting is adopted.

.39 The financial statements of the entity as of and for the period immediately preceding the date determined in conformity with the guidance in paragraph .35 should reflect all activity through that date in conformity with the guidance in paragraphs .21 through .34. Additionally, the effects of the ad-

justments on the reported amounts of individual assets and liabilities resulting from the adoption of fresh-start reporting and the effects of the forgiveness of debt should be reflected in the predecessor entity's final statement of operations. Forgiveness of debt, if any, should be reported as an extraordinary item. Adopting fresh-start reporting results in a new reporting entity with no beginning retained earnings or deficit. When fresh-start reporting is adopted, the notes to the initial financial statements should disclose the following:

- Adjustments to the historical amounts of individual assets and liabilities.
- The amount of debt forgiveness.
- The amount of prior retained earnings or deficit eliminated.
- Significant matters relating to the determination of reorganization value, such as—
  - The method or methods used to determine reorganization value and factors such as discount rates, tax rates, the number of years for which cash flows are projected, and the method of determining *terminal value*.
  - Sensitive assumptions—that is, assumptions about which there is a reasonable possibility of the occurrence of a variation that would have significantly affected measurement of reorganization value.
  - Assumptions about anticipated conditions that are expected to be different from current conditions, unless otherwise apparent.

## Comparative Financial Statements

.40 Chapter 2A of Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*, state the following in paragraph 1:

The presentation of comparative financial statements in annual and other reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the enterprise.

Paragraph 3 of that chapter requires comparative financial statements that are presented to be comparable from year to year, with any exceptions to comparability being clearly disclosed. Fresh-start financial statements prepared by entities emerging from Chapter 11 will not be comparable with those prepared before their plans were confirmed because they are, in effect, those of a new entity. Thus, comparative financial statements that straddle a confirmation date should not be presented.<sup>2</sup>

## Reporting by Entities Not Qualifying for Fresh Start

.41 Entities emerging from Chapter 11 that do not meet the criteria in paragraph .36 do not qualify for a fresh start. Liabilities compromised by confirmed plans should be stated at present values of amounts to be paid, determined at appropriate current interest rates. Forgiveness of debt, if any, should be reported as an extraordinary item.

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<sup>2</sup> The SEC and other regulatory agencies may require the presentation of predecessor financial statements. However, such presentations should not be viewed as a continuum because the financial statements are those of a different reporting entity and are prepared using a different basis of accounting, and, therefore, are not comparable. Attempts to disclose and explain exceptions that affect comparability would likely result in reporting that is so unwieldy it would not be useful.

.42 Because this statement of position applies to financial reporting for entities that enter and intend to emerge from Chapter 11 reorganization, quasi-reorganization accounting should not be used at the time of the reorganization.

## Discussion of Conclusions

### Reporting Prepetition Liabilities

.43 The task force believes that entities in Chapter 11 reorganization should segregate liabilities subject to compromise from those that are not subject to compromise. Therefore, prepetition liabilities that may be impaired by a plan and that are eligible for compromise because they are either unsecured or undersecured should be separately classified and designated in the balance sheet as prepetition liabilities subject to compromise, because that provides the most meaningful presentation while in Chapter 11 reorganization.

.44 The financial reporting literature does not specifically address the balance sheet classification issues that result from filing a petition. Guidance for classifying liabilities as current in a classified balance sheet is provided in paragraph 7 of ARB No. 43, chapter 3A, which states the following:

The term *current liabilities* is used to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classified as current assets, or the creation of other current liabilities . . . .

Trade payables that are incurred in the normal course of business are usually classified as current in classified balance sheets because they meet the ARB No. 43 criteria cited above. However, filing a petition generally causes the payment of unsecured or undersecured prepetition liabilities to be prohibited before the plan is confirmed. The Chapter 11 reorganization ending in confirmation of a plan typically takes more than one year or one operating cycle, if longer.

.45 It might be argued that prepetition liabilities classified as current in a classified balance sheet, such as trade payables, should retain that classification under the provisions of FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced*. That Statement requires all short-term liabilities incurred in the normal course of business and due in customary terms to be classified as current. Other short-term liabilities are excluded from the current liability classification under FASB Statement No. 6 if the entity intends to refinance the obligations on a long-term basis and such intent is supported by the facts. However, FASB Statement No. 6 does not address what occurs when a petition is filed.

.46 FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor*, amended paragraph 7 of ARB No. 43, chapter 3A, by requiring current liabilities classification in a classified balance sheet for long-term liabilities that, by their terms, are due on demand or will be due on demand within one year, or the operating cycle, if longer. This definition also includes long-term liabilities that are or will be callable by the creditor because of a violation of a provision of the debt agreement. The *automatic stay provisions* of Chapter 11 make it unnecessary to reclassify prepetition long-term liabilities even though prepetition creditors might demand payment or there is a violation of a covenant in the debt agreement.

.47 Prepetition liabilities should be reported at the amounts of allowed claims—that is, at the amount allowed by the court, even though such liabilities may not be paid in full.

.48 When prepetition claims become known after a petition is filed (for example, a claim resulting from the rejection of an operating lease), they should be reported at the estimated amounts of the allowed claims. Some believe that such prepetition claims should be reported at estimates of the settlement amounts. However, these prepetition claims should be reported at an amount allowed by the court because that is the amount of the liability until it is settled and the use of allowed amounts is consistent with the amounts at which other prepetition liabilities are stated and thereby provides comparability among the various kinds of claims.

## Statement of Operations

.49 Losses as a result of restructuring or disposal of assets directly related to reorganization proceedings are best included as reorganization items to the extent that they are not otherwise reported as part of the results of discontinued operations in conformity with APB Opinion 30, *Reporting the Results of Operations*. That does not result in reclassification of revenues and expenses from operations sold or abandoned, except those that meet the criteria in APB Opinion 30. Rather, gains or losses classified as reorganization items might include a gain or loss on disposal of assets plus related employee costs and charges or other costs directly related to the assets disposed of or the operations restructured. Also, income, expenses, realized gains, and losses that can be directly associated with the proceeding are best segregated and presented as reorganization items in the statement of operations. Examples include interest income (as indicated in paragraph .30), professional fees, and losses on executory contracts.<sup>3</sup>

.50 The task force believes that segregation of reorganization items provides meaningful disclosure and is consistent with APB Opinion 30, paragraph 26, which states the following:

A material event or transaction that is unusual in nature or occurs infrequently but not both, and therefore does not meet both criteria for classification as an extraordinary item, should be reported as a separate component of continuing operations.

## Interest Expense

.51 Certain provisions of the Bankruptcy Code may relieve the entity from its obligation to pay interest. Generally, interest on secured claims accrues only to the extent that the value of underlying collateral exceeds the principal amount of the secured claim. In addition, interest on unsecured claims does not accrue during the proceeding if the entity is insolvent; therefore, disclosure of contractual interest is considered useful because it may differ from interest actually being reported.

## Interest Income

.52 An entity in reorganization typically accumulates cash during the proceeding because it is not paying its obligations currently. The cash ultimately is distributed to creditors or others in conformity with the plan. The

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<sup>3</sup> Appendix A [paragraph .67] illustrates a statement of operations that includes reorganization items.

amount of cash accumulated does not reflect the entity's prepetition activities, and it is not expected that such an accumulation would recur in the reorganized entity. The interest income earned during the proceeding on cash accumulated during the proceeding, therefore, is a reorganization item. To the extent that management can reasonably estimate that portion of interest income applicable to normal invested working capital, it should be reported as an operating item in the ordinary manner.

## Statement of Cash Flows

.53 FASB Statement No. 95, *Statement of Cash Flows*, requires information on the cash activity of reporting entities. The task force believes that such information is the most beneficial information that can be provided in the financial statements of an entity in Chapter 11. It also believes the direct method is the better method to provide such information by such entities.

.54 Paragraph 27 of FASB Statement No. 95 lists the operating items that should be reported separately when the direct method is used. That paragraph encourages further breakdown of those operating items if the entity considers such a breakdown meaningful and it is feasible to do so. Further identification of cash flows from reorganization items should be provided to the extent feasible. For example, interest received might be segregated between estimated normal recurring interest received and interest received on cash accumulated because of the reorganization. Appendix A [paragraph .67] illustrates a statement of cash flows for an entity operating under Chapter 11.

## Fresh-Start Reporting

.55 The effects of a plan should be included in the entity's financial statements as of the date the plan is confirmed. However, inclusion should be delayed to a date not later than the effective date if there is a material unsatisfied condition precedent to the plan's becoming binding on all the parties in interest or if there is a stay pending appeal. That might occur, for example, if obtaining financing for the plan or for the transfer of material assets to the debtor by a third party is a condition to the plan's becoming effective.

.56 Financial statements prepared as of the date after the parties in interest have approved a plan through the voting process, and issued after the plan has been confirmed by the court, should report the effects of the plan if there are no material unsatisfied conditions.

.57 An essential element in negotiating a plan with the various classes of creditors and equity interests is the determination of reorganization value by the parties in interest. The plan provides for allocating the reorganization value among the parties in interest in accordance with their legal priorities: first to secured claims to the extent of the value of the collateral securing the claims, then to claims entitled to priority under the Bankruptcy Code, and then to the various classes of unsecured debt and equity interests in accordance with their legal priorities or as the parties may otherwise agree. In the event that the parties in interest cannot agree on the reorganization value and presumably the plan of reorganization, the court may be called upon to determine the reorganization value of the entity before a plan of reorganization can be confirmed.

.58 The task force concluded that reorganization value can be a more objective measure of fair value than a purchase price in a business combina-

tion. This view is based on two factors. First, a purchase price in a nonbankruptcy business combination may exceed the fair value of the acquired entity, because such determinations may be influenced by a variety of factors unrelated to that entity. Second, in the reorganization process, extensive information available to the parties in interest, the adversarial negotiation process, the involvement of the Bankruptcy Court, the use of specialists by one or more of the parties in interest, and the fact that all elements of the determination are focused solely on the economic viability of the emerging entity result in an objective and reliable determination of reorganization value.

.59 If, based on reorganization value, the parties in interest allow the entity to survive as a going concern and emerge from Chapter 11, the financial reporting should reflect that fact. The ability to reflect reorganization value would enhance the representational faithfulness of the emerging entity's financial statements.

.60 Under the *absolute priority doctrine* of the Bankruptcy Code, if the amount of postpetition liabilities and allowed claims exceeds the reorganization value of the emerging entity, existing shareholders lose their legal right to any economic interest without the consent of creditors. Therefore, any equity interest in the emerging entity ultimately held by existing shareholders is given to them by the creditors. Among the reasons the creditors might give such shareholders equity interests in the emerging entity are to avoid the expensive and time-consuming legal proceedings necessary to implement the cram-down provisions of the Bankruptcy Code or to preserve continuity of management.

.61 Based on the factors described in paragraphs .57, .58, and .60, some would conclude that the combination of change in majority ownership and voting control—that is, loss of control by the existing shareholders, a court-approved reorganization, and a reliable measure of the entity's fair value—results in a fresh start, creating, in substance, a new reporting entity. Others believe that a change in control and the exchange of debt and equity based on reorganization value is in substance an acquisition at fair value by new shareholders in exchange for extinguishing their debt. Although the former shareholders can receive a portion of the new equity, they have lost their rights to any equity interest in the reorganized entity and receive such interest only with the consent of the real stakeholders, the creditors who will become the new shareholders. The task force concluded that under each view a new reporting entity is created and assets and liabilities should be recorded at their fair values. That is, assets should be recorded on the basis of reorganization value and liabilities should be recorded at fair value.

.62 Some believe that the recognition of reorganization value in the balance sheet of an emerging entity that meets the criteria for fresh-start reporting should be limited to no net write-up of assets, similar to the SEC staff's interpretation of FRR Section 210 (ASR 25). That view is a combination of the notion that assets and liabilities should be reported at fair value in a fresh start and the belief that assets cannot be written up in a historical cost transaction-based accounting model. The task force did not accept that view for the reasons stated in paragraph .61.

## Fair Value of Liabilities

.63 In a typical Chapter 11 reorganization, there is a general restructuring of liabilities. FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, does not apply in a general restructuring of liabilities.

.64 A general restructuring of liabilities involves negotiation between the parties in interest. The negotiation and distribution under the confirmed plan constitutes an exchange of resources and obligations. By analogy, the guidance provided by APB Opinion 16 for recording liabilities assumed in a business combination accounted for as a purchase should be applied in reporting liabilities by an entity emerging from Chapter 11.

### Analogous Literature

.65 The task force believes that the principles of quasi-reorganization accounting are not applicable to Chapter 11 reorganizations. Some argue that such a requirement would conflict with ARB No. 43 because it would prohibit adopting an accounting procedure that is now generally accepted. The task force does not believe that is the case. ARB No. 43 relates to a procedure called a quasi-reorganization. Webster's dictionary defines *quasi* as "having some resemblance." The task force interprets ARB No. 43 to apply to situations that resemble but are not reorganizations under Chapter 11. There is no specific guidance for a legal reorganization, so practice has sometimes looked to ARB No. 43 when reporting a legal reorganization. The task force believes that is the case with many emerging entities. This statement of position provides specific guidance for all reorganizations under Chapter 11, and an analogy to ARB No. 43 is not appropriate.

### Effective Date and Transition

.66 This entire statement of position shall become effective for financial statements of enterprises that have filed petitions under the Bankruptcy Code after December 31, 1990. Additionally, for enterprises that file petitions prior to January 1, 1991, and that have plans of reorganization confirmed after June 30, 1991, paragraphs .35 through .42 of this SOP shall be applied to their financial statements. Earlier application by entities in reorganization is encouraged.



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## Appendix A

### Illustrative Financial Statements and Notes to Financial Statements for an Entity Operating Under Chapter 11

A-1. XYZ Company is a manufacturing concern headquartered in Tennessee, with a fiscal year ending on December 31. On January 10, 19X1, XYZ filed a petition for relief under Chapter 11 of the federal bankruptcy laws. The following financial statements (balance sheet and statements of operations and cash flows) are presented as of and for the year ended December 31.

**XYZ Company  
(Debtor-in-Possession)  
Balance Sheet  
December 31, 19X1**

<u>Assets</u>	<u>(000s)</u>
Current Assets	
Cash	\$ 110
Accounts receivable, net	300
Inventory	250
Other current assets	<u>30</u>
Total current assets	690
Property, plant and equipment, net	430
Goodwill	<u>210</u>
Total Assets	<u><u>\$1,330</u></u>

<u>Liabilities and Shareholders' Deficit</u>	<u>(000s)</u>
Liabilities Not Subject to Compromise	
Current Liabilities:	
Short-term borrowings	\$ 25
Accounts payable—trade	200
Other liabilities	50
Total current liabilities	275
Liabilities Subject to Compromise	1,100 (a)
Total liabilities	1,375
Shareholders' (deficit):	
Preferred stock	325
Common stock	75
Retained earnings (deficit)	(445)
	(45)
Total Liabilities & Shareholders' (Deficit)	\$ 1,330

(a) Liabilities subject to compromise consist of the following:

Secured debt, 14%, secured by first mortgage on building	\$ 300,000 (b)
Priority tax claims	50,000
Senior subordinated secured notes, 15%	275,000
Trade and other miscellaneous claims	225,000
Subordinated debentures, 17%	250,000
	<u>\$1,100,000</u>

(b) The secured debt in this case should be considered, due to various factors, subject to compromise.

The accompanying notes are an integral part of the financial statements.

**XYZ Company**  
**(Debtor-in-Possession)**  
**Statement of Operations**  
**For the Year Ended December 31, 19X1**  
*(000s)*

	<u>19X1</u>
Revenues:	
Sales	\$2,400
Cost and expenses:	
Cost of goods sold	1,800
Selling, operating and administrative	550
Interest (contractual interest \$5)	<u>3</u>
	<u>2,353</u>
Earnings before reorganization items and income tax benefit	<u>47</u>
Reorganization items:	
Loss on disposal of facility	(60)
Professional fees	(50)
Provision for rejected executory contracts	(10)
Interest earned on accumulated cash resulting from Chapter 11 proceeding	<u>1</u>
	<u>(119)</u>
Loss before income tax benefit and discontinued operations	(72)
Income tax benefit	<u>10</u>
Loss before discontinued operations	(62)
Discontinued operations:	
Loss from operations of discontinued products segment	<u>(56)</u>
Net loss	<u>\$ (118)</u>
Loss per common share:	
Loss before discontinued operations	\$ (.62)
Discontinued operations	<u>\$ (.56)</u>
Net loss	<u><u>\$ (1.18)</u></u>

The accompanying notes are an integral part of the financial statements.

**XYZ Company**  
**(Debtor-in-Possession)**  
**Statement of Cash Flows**  
**For the Year Ended December 31, 19X1**  
**Increase in Cash and Cash Equivalents**  
*(000s)*

	<u>19X1</u>
Cash flows from operating activities:	
Cash received from customers	\$ 2,220
Cash paid to suppliers and employees	(2,070)
Interest paid	<u>(3)</u>
Net cash provided by operating activities before reorganization items	<u>147</u>
Operating cash flows from reorganization items:	
Interest received on cash accumulated because of the Chapter 11 proceeding	1
Professional fees paid for services rendered in connection with the Chapter 11 proceeding	<u>(50)</u>
Net cash used by reorganization items	<u>(49)</u>
Net cash provided by operating activities	<u>98</u>
Cash flows from investing activities:	
Capital expenditures	(5)
Proceeds from sale of facility due to Chapter 11 proceeding	<u>40</u>
Net cash provided by investing activities	<u>35</u>
Cash flows used by financing activities:	
Net borrowings under short-term credit facility (post petition)	25
Repayment of cash overdraft	(45)
Principal payments on prepetition debt authorized by court	<u>(3)</u>
Net cash provided by financing activities	<u>(23)</u>
Net increase in cash and cash equivalents	110
Cash and cash equivalents at beginning of year	<u>—</u>
Cash and cash equivalents at end of year	<u><u>\$ 110</u></u>
Reconciliation of net loss to net cash provided by operating activities	
Net loss	\$ (118)
Adjustments to reconcile net loss to net cash provided by operating activities	
Depreciation	20
Loss on disposal of facility	60
Provision for rejected executory contracts	10
Loss on discontinued operations	56
Increase in postpetition payables and other liabilities	250
Increase in accounts receivable	<u>(180)</u>
Net cash provided by operating activities	<u><u>\$ 98</u></u>

The accompanying notes are an integral part of the financial statements.

**XYZ Company**  
**Notes to Financial Statements**  
**December 31, 19X1**

**Note X—Petition for Relief Under Chapter 11**

On January 10, 19X1, XYZ Company (the “Debtor”) filed petitions for relief under Chapter 11 of the federal bankruptcy laws in the United States Bankruptcy Court for the Western District of Tennessee. Under Chapter 11, certain claims against the Debtor in existence prior to the filing of the petitions for relief under the federal bankruptcy laws are stayed while the Debtor continues business operations as Debtor-in-possession. These claims are reflected in the December 31, 19X1, balance sheet as “liabilities subject to compromise.” Additional claims (liabilities subject to compromise) may arise subsequent to the filing date resulting from rejection of executory contracts, including leases, and from the determination by the court (or agreed to by parties in interest) of allowed claims for contingencies and other disputed amounts. Claims secured against the Debtor’s assets (“secured claims”) also are stayed, although the holders of such claims have the right to move the court for relief from the stay. Secured claims are secured primarily by liens on the Debtor’s property, plant, and equipment.

The Debtor received approval from the Bankruptcy Court to pay or otherwise honor certain of its prepetition obligations, including employee wages and product warranties. The Debtor has determined that there is insufficient collateral to cover the interest portion of scheduled payments on its prepetition debt obligations. Contractual interest on those obligations amounts to \$5,000, which is \$2,000 in excess of reported interest expense; therefore, the debtor has discontinued accruing interest on these obligations. Refer to note XX [see *Appendix B (paragraph .68), note X*] for a discussion of the credit arrangements entered into subsequent to the Chapter 11 filings.

## Appendix B

### Fresh-Start Accounting and Illustrative Notes to Financial Statements

**B-1.** The Bankruptcy Court confirmed XYZ's plan of reorganization as of June 30, 19X2. It was determined that XYZ's reorganization value computed immediately before June 30, 19X2, the date of plan confirmation, was \$1,300,000, which consisted of the following:

Cash in excess of normal operating requirements generated by operations	\$ 150,000
Net realizable value of asset dispositions	75,000
Present value of discounted cash flows of the emerging entity	<u>1,075,000</u>
Reorganization value	<u><u>\$1,300,000</u></u>

XYZ Company adopted fresh-start reporting because holders of existing voting shares immediately before filing and confirmation of the plan received less than 50% of the voting shares of the emerging entity and its reorganization value is less than its postpetition liabilities and allowed claims, as shown below:

Postpetition current liabilities	\$ 300,000
Liabilities deferred pursuant to Chapter 11 proceeding	<u>1,100,000</u>
Total postpetition liabilities and allowed claims	1,400,000
Reorganization value	<u>(1,300,000)</u>
Excess of liabilities over reorganization value	<u><u>\$ 100,000</u></u>

**B-2.** The reorganization value of the XYZ Company was determined in consideration of several factors and by reliance on various valuation methods, including discounting cash flow and price/earnings and other applicable ratios. The factors considered by XYZ Company included the following:

- Forecasted operating and cash flow results which gave effect to the estimated impact of
  - Corporate restructuring and other operating program changes
  - Limitations on the use of available net operating loss carryovers and other tax attributes resulting from the plan of reorganization and other events
- The discounted residual value at the end of the forecast period based on the capitalized cash flows for the last year of that period
- Market share and position
- Competition and general economic considerations
- Projected sales growth
- Potential profitability

- Seasonality and working capital requirements

**B-3.** After consideration of XYZ Company's debt capacity and other capital structure considerations, such as industry norms, projected earnings to fixed charges, earnings before interest and taxes to interest, free cash flow to interest, and free cash flow to debt service and other applicable ratios, and after extensive negotiations among parties in interest, it was agreed that XYZ's reorganization capital structure should be as follows:

Postpetition current liabilities	\$ 300,000
IRS note	50,000
Senior debt	275,000 (1)
Subordinated debt	175,000
Common stock	350,000
	<u>\$1,150,000 (2)</u>

(1) Due \$50,000 per year for each of the next four years, at 12% interest, with \$75,000 due in the fifth year.

(2) See paragraph B-5 for the balance sheet adjustments required to reflect XYZ Company's reorganization value as of the date of plan confirmation.

**B-4.** The following entries record the provisions of the plan and the adoption of fresh-start reporting:

Entries to record debt discharge:

Liabilities subject to compromise	1,100,000	
Senior debt—current		50,000
Senior debt—long-term		225,000
IRS note		50,000
Cash		150,000
Subordinated debt		175,000
Common stock (new)		86,000
Additional paid-in capital		215,000
Gain on debt discharge		149,000

Entries to record exchange of stock for stock:

Preferred stock	325,000	
Common stock (old)	75,000	
Common stock (new)		14,000
Additional paid-in capital		386,000

Entries to record the adoption of fresh-start reporting and to eliminate the deficit:

Inventory	50,000	
Property, plant, and equipment	175,000	
Reorganization value in excess of amounts allocable to identifiable assets	175,000	
Gain on debt discharge	149,000	
Additional paid-in capital	351,000	
Goodwill		200,000
Deficit		700,000

B-5. The effect of the plan of reorganization on XYZ Company's balance sheet, as of June 30, 19X2, is as follows:

	Adjustments to Record Confirmation of Plan			XYZ Company's Reorganized Balance Sheet
	Precon- firmation	Debt discharge	Exchange of stock	Fresh Start
<b>Assets:</b>				
<b>Current Assets</b>				
Cash	\$ 200,000	\$ (150,000)		\$ 50,000
Receivables	250,000			250,000
Inventory	175,000			225,000
Assets to be disposed of valued at market, which is lower than cost	25,000			25,000
Other current assets	25,000			25,000
	675,000	(150,000)		575,000
Property, plant, and equipment	175,000			350,000
Assets to be disposed of valued at market, which is lower than cost	50,000			50,000
Goodwill	200,000			(200,000)
Reorganization value in excess of amounts alloc- able to identifiable assets				175,000
	<u>\$1,100,000</u>	<u>\$ (150,000)</u>		<u>\$ 200,000</u>
				<u>\$1,150,000</u>
<b>Liabilities and Shareholders'</b>				
<b>Deficit:</b>				
<b>Liabilities Not Subject to Compromise Current liabilities</b>				
Short-term borrowings	\$ 25,000			\$ 25,000
Current maturities of senior debt		\$ 50,000		50,000
Accounts payable trade	175,000			175,000
Other liabilities	100,000			100,000
	300,000	50,000		350,000
<b>Liabilities Subject to Compromise</b>				
Prepetition liabilities	1,100,000	(1,100,000)		
IRS note		50,000		50,000
Senior debt, less current maturities		225,000		225,000
Subordinated debt		175,000		175,000
<b>Shareholders' deficit:</b>				
Preferred stock	325,000		\$(325,000)	
Additional paid-in capital		215,000	386,000	250,000
Common stock-old	75,000		(75,000)	
Common stock-new		86,000	14,000	100,000
Retained earnings (deficit)	(700,000)	149,000		700,000
				(149,000)
	<u>(300,000)</u>	<u>450,000</u>	<u>0</u>	<u>200,000</u>
	<u>\$1,100,000</u>	<u>\$ (150,000)</u>	<u>\$ 0</u>	<u>\$ 200,000</u>
				<u>\$1,150,000</u>

B-6. The following illustrative footnote disclosure discusses the details of XYZ Company's confirmed plan of reorganization. In this illustration a tabular presentation entitled "Plan of Reorganization Recovery Analysis" is incorporated in the footnote. The plan of reorganization recovery analysis may alternatively be presented as supplementary information to the financial statements.



## Note X—Plan of Reorganization

On June 30, 19X2, the Bankruptcy Court confirmed the Company's plan of reorganization. The confirmed plan provided for the following:

**Secured Debt**—The Company's \$300,000 of secured debt (secured by a first mortgage lien on a building located in Nashville, Tennessee) was exchanged for \$150,000 in cash and a \$150,000 secured note, payable in annual installments of \$27,300 commencing on June 1, 19X3, through June 1, 19X6, with interest at 12% per annum, with the balance due on June 1, 19X7.

**Priority Tax Claims**—Payroll and withholding taxes of \$50,000 are payable in equal annual installments commencing on July 1, 19X3, through July 1, 19X8, with interest at 11% per annum.

**Senior Debt**—The holders of approximately \$275,000 of senior subordinated secured notes received the following instruments in exchange for their notes: (a) \$87,000 in new senior secured debt, payable in annual installments of \$15,800 commencing March 1, 19X3, through March 1, 19X6, with interest at 12% per annum, secured by first liens on certain property, plants, and equipment, with the balance due on March 1, 19X7; (b) \$123,000 of subordinated debt with interest at 14% per annum due in equal annual installments commencing on October 1, 19X3, through October 1, 19X9, secured by second liens on certain property, plant, and equipment; and (c) 11.4% of the new issue of outstanding voting common stock of the Company.

**Trade and Other Miscellaneous Claims**—The holders of approximately \$225,000 of trade and other miscellaneous claims received the following for their claims: (a) \$38,000 in senior secured debt, payable in annual installments of \$6,900 commencing March 1, 19X3, through March 1, 19X6, with interest at 12% per annum, secured by first liens on certain property, plants, and equipment, with the balance due on March 1, 19X7; (b) \$52,000 of subordinated debt, payable in equal annual installments commencing October 1, 19X3, through October 1, 19X8, with interest at 14% per annum; and (c) 25.7% of the new issue of outstanding voting common stock of the Company.

**Subordinated Debentures**—The holders of approximately \$250,000 of subordinated unsecured debt received, in exchange for the debentures, 48.9% of the new issue outstanding voting common stock of the Company.

**Preferred Stock**—The holders of 3,250 shares of preferred stock received 12% of the outstanding voting common stock of the new issue of the Company in exchange for their preferred stock.

**Common Stock**—The holders of approximately 75,000 outstanding shares of the Company's existing common stock received, in exchange for their shares, 2% of the new outstanding voting common stock of the Company.

The Company accounted for the reorganization using fresh-start reporting. Accordingly, all assets and liabilities are restated to reflect their reorganization value, which approximates fair value at the date of reorganization. The following table ("Plan of Reorganization Recovery Analysis") summarizes the adjustments required to record the reorganization and the issuance of the various securities in connection with the implementation of the plan.

XYZ Company  
Plan of Reorganization  
Recovery Analysis

	Elimination of Debt and Equity	Recovery						Total Recovery	
		Surviving Debt	Cash	IRS Note	Senior Debt	Subordinated Debt	Common Stock %	Value	\$
									%
Postpetition liabilities	\$ 300,000	\$300,000							\$ 300,000 100%
Claim/Interest									
Secured debt	300,000		\$150,000	\$50,000	\$150,000				300,000 100
Priority tax claim	50,000								50,000 100
Senior debt	275,000	\$(25,000)			87,000	\$123,000	11.4%	\$ 40,000	250,000 91
Trade and other miscellaneous claims	225,000	(45,000)							
Subordinated debentures	250,000	(79,000)			38,000	52,000	25.7	90,000	180,000 80
	1,100,000						48.9	171,000	171,000 68
Preferred stockholders	325,000	(283,000)						42,000	42,000
Common stockholders	75,000	(68,000)						7,000	7,000
Deficit	(700,000)	700,000							
Total	\$1,100,000	\$200,000	\$150,000	\$50,000	\$275,000	\$175,000	100.0%	\$350,000	\$1,300,000

\* The aggregate par value of the common stock issued under the plan is \$100,000.

## Glossary

**Absolute priority doctrine.** A doctrine that provides that if an impaired class does not vote in favor of a plan, the court may nevertheless confirm the plan under the cram-down provisions of the Bankruptcy Code. The absolute priority doctrine is triggered when the cram-down provisions apply. The doctrine states that all members of the senior class of creditors and equity interests must be satisfied in full before the members of the second senior class of creditors can receive anything, and the full satisfaction of that class must occur before the third senior class of creditors may be satisfied, and so on.

**Administrative expenses (claims).** Claims that receive priority over all other unsecured claims in a bankruptcy case. Administrative claims (expenses) include the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case. Fees paid to professionals for services rendered after the petition is filed are considered administrative expenses.

**Allowed claim(s).** The amount allowed by the Court as a claim against the Estate. This amount may differ from the actual settlement amount.

**Automatic stay provisions.** Provisions causing the filing of a petition under the Bankruptcy Code to automatically stay virtually all actions of creditors to collect prepetition debts. As a result of the stay, no party, with minor exceptions, having a security or adverse interest in the debtor's property can take any action that will interfere with the debtor or the debtor's property, regardless of where the property is located or who has possession, until the stay is modified or removed.

**Bankruptcy Code.** A federal statute, enacted October 1, 1979, as title 11 of the United States Code by the Bankruptcy Reform Act of 1978, that applies to all cases filed on or after its enactment and that provides the basis for the current federal bankruptcy system.

**Bankruptcy Court.** The United States Bankruptcy Court is an adjunct of the United States District Courts. Under the jurisdiction of the District Court, the Bankruptcy Court is generally responsible for cases filed under Chapters 7, 11, 12, and 13 of the Bankruptcy Code.

**Chapter 7.** A liquidation, voluntarily or involuntarily initiated under the provisions of the Bankruptcy Code, that provides for liquidation of the business or the debtor's estate.

**Chapter 11.** A reorganization action, either voluntarily or involuntarily initiated under the provisions of the Bankruptcy Code, that provides for a reorganization of the debt and equity structure of the business and allows the business to continue operations. A debtor may also file a plan of liquidation under Chapter 11.

**Claim.** As defined by Section 101(4) of the Bankruptcy Code, (a) a right to payment, regardless of whether the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, secured, or unsecured, or (b) a right to an equitable remedy for breach of performance if such breach results in a right to payment, regardless of whether the right is reduced to a fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured right.

**Confirmed plan.** An official approval by the court of a plan of reorganization under a Chapter 11 proceeding that makes the plan binding on the debtors and creditors. Before a plan is confirmed, it must satisfy eleven requirements in section 1129(a) of the Bankruptcy Code.

**Consenting classes.** Classes of creditors or stockholders that approve the proposed plan.

**Cram-down provisions.** Provisions requiring that for a plan to be confirmed, a class of claims or interests must either accept the plan or not be impaired. However, the Bankruptcy Code allows the Court under certain conditions to confirm a plan even though an impaired class has not accepted the plan. To do so, the plan must not discriminate unfairly and must be fair and equitable to each class of claims or interests impaired under the plan that have not accepted it. The Code states examples of conditions for secured claims, unsecured claims, and stockholder interests in the fair and equitable requirement.

**Debtor-in-possession.** Existing management continuing to operate an entity that has filed a petition under Chapter 11. The debtor-in-possession is allowed to operate the business in all Chapter 11 cases unless the court, for cause, authorizes the appointment of a trustee.

**Disclosure statement.** A written statement containing information approved as adequate by the court. It is required to be presented by a party before soliciting the acceptance or rejection of a plan of reorganization from creditors and stockholders affected by the plan. Adequate information means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan.

**Emerging entity (reorganized entity).** An entity that has had its plan confirmed and begins to operate as a new entity.

**Impaired claims.** In determining which class of creditors' claims or stockholders' interests must approve the plan, it is first necessary to determine if the class is impaired. A class of creditors' claims or stockholders' interests under a plan is not impaired if the plan (a) leaves unaltered the legal, equitable, and contractual right of a class, (b) cures defaults that lead to acceleration of debt or equity interest, or (c) pays in cash the full amount of the claim, or for equity interests, the greater of the fixed liquidation preference or redemption price.

**Nonconsenting class.** A class of creditors or stockholders that does not approve the proposed plan.

**Obligations subject to compromise.** Includes all prepetition liabilities (claims) except those that will not be impaired under the plan, such as claims where the value of the security interest is greater than the claim.

**Petition.** A document filed in a court of bankruptcy, initiating proceedings under the Bankruptcy Code.

**Plan (plan of reorganization).** An agreement formulated in Chapter 11 proceedings under the supervision of the Bankruptcy Court that enables the debtor to continue in business. The plan, once confirmed, may affect the rights of undersecured creditors, secured creditors, and stockholders as

well as those of unsecured creditors. Before a plan is confirmed by the Court, it must comply with general provisions of the Code. Those provisions mandate, for example, that (a) the plan is feasible, (b) the plan is in the best interest of the creditors, and, (c) if an impaired class does not accept the plan, the plan must be determined to be fair and equitable before it can be confirmed.

**Postpetition liabilities.** Liabilities incurred subsequent to the filing of a petition that are not associated with prebankruptcy events. Thus, these liabilities are not considered prepetition liabilities.

**Prepetition liabilities.** Liabilities that were incurred by an entity prior to its filing of a petition for protection under the Code, including those considered by the Bankruptcy Court to be prepetition claims, such as a rejection of a lease for real property.

**Reorganization items.** Items of income, expense, gain, or loss that are realized or incurred by an entity because it is in reorganization.

**Reorganization proceeding.** A Chapter 11 case from the time at which the petition is filed until the plan is confirmed.

**Reorganization value.** The value attributed to the reconstituted entity, as well as the expected net realizable value of those assets that will be disposed before reconstitution occurs. Therefore, this value is viewed as the fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after the restructuring.

**Secured claim.** A liability that is secured by collateral. A fully secured claim is one where the value of the collateral is greater than the amount of the claim.

**Terminal value.** Reorganization value calculated based on the discounting of cash flows normally consists of three parts: (a) the discounted cash flows determined for the forecast period, (b) residual value or terminal value, and (c) the current value of any excess working capital or other assets that are not needed in reorganization. Terminal or residual value represents the present value of the business attributable to the period beyond the forecast period.

**Trustee.** A person appointed by the Bankruptcy Court in certain situations based on the facts of the case, not related to the size of the company or the amount of unsecured debt outstanding, at the request of a party in interest after a notice and hearing.

**Undersecured claim (liability).** A secured claim whose collateral is worth less than the amount of the claim.

**Unsecured claim (liability).** A liability that is not secured by collateral. In the case of an undersecured creditor, the excess of the secured claim over the value of the collateral is an unsecured claim, unless the debtor elects in a Chapter 11 proceeding to have the entire claim considered secured. The term is generally used in bankruptcy to refer to unsecured claims that do not receive priority under the Bankruptcy Code.

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[The next page is 19,451.]

## Section 10,500

# **Statement of Position 92-1 Accounting for Real Estate Syndication Income**

February 6, 1992

### **NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## **Introduction**

.01 This statement of position (SOP) provides guidance for the recognition of income from real estate syndication activities. Syndication activities are efforts to directly or indirectly sponsor the formation of entities that acquire interests in real estate by raising funds from investors. As consideration for their investments, the investors receive ownership of or other financial interests in the sponsored entities.

.02 The sponsored entities are generally organized as limited partnerships, trusts, or joint ventures, but they may also be organized in other forms. For convenience, the term *partnership* is used in this SOP to refer to such entities regardless of their form.

## **Scope**

.03 This SOP applies to the recognition of income from real estate syndication activities and to all entities that perform those activities. For purposes of applying the guidance in this SOP, entities that perform real estate syndication activities are syndicators regardless of whether their primary business is related to real estate syndication. Entities that may function as syndicators include real estate companies, brokers and dealers in securities, banks, savings and loan associations, insurance companies, finance companies, and entities organized solely to syndicate real estate.

.04 This SOP applies to the combined activities of entities in the consolidated or combined financial statements of syndicators, including those entities in which the syndicators have investments accounted for under the equity

method, as set forth in Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. However, it does not apply to the separate financial statements of subsidiaries or affiliates of syndicators, unless such entities are also considered to be syndicators on the basis of the separate activities included in their consolidated or combined financial statements. For example, this SOP does not apply to the separate financial statements issued by a broker-dealer subsidiary of a syndicator if the role of the subsidiary and its subsidiaries, if any, in the transaction is limited to the sale of partnership interests.

.05 This SOP does not address accounting by the partnerships in which the interests are syndicated, and it does not apply to syndications of assets other than real estate.

## Definitions

.06 Significant terms used in this SOP are defined as follows:

*Blind pool or partially blind pool partnerships.* Partnerships in which investment units are sold before some or all of the properties to be acquired are identified.

*Flip transactions.* Transactions in which syndicators acquire ownership interests and resell them to the partnerships shortly thereafter.

*Investor notes.* Promissory notes, generally with full recourse, that are payable by investors to partnerships in connection with purchases of partnership interests.

*Ownership interests.* Title to real estate or other interests in real estate, such as partnership interests or shares in joint ventures; also, options or contracts to acquire specified real estate or real estate interests.

*Partnership notes.* Notes payable to syndicators by partnerships in connection with acquisitions of property or in payment of fees. Partnership notes may be collateralized by investor notes, mortgages, or other liens against partnership assets.

*Syndication activities.* Efforts to directly or indirectly sponsor the formation of entities that acquire interests in real estate by raising funds from investors. As consideration for their investments, the investors receive ownership or other financial interests in the sponsored entities. For purposes of applying the guidance in this SOP, all general partners in syndicated partnerships are deemed to perform syndication activities.

*Syndication (or securities-placement) fees.* Compensation, including commissions and reimbursement of expenses, for selling debt or equity interests in partnerships. Such fees are generally paid in cash, notes, or partnership interests.

## Background

.07 In order to earn commissions and fees, syndicators perform a variety of services and activities. For example, they organize partnerships, sell (syndicate) debt or equity interests in the partnerships to third parties, sell real estate to the partnerships, arrange for the partnerships to purchase real estate directly from (or sell it directly to) third parties, develop partnership properties, supervise construction of partnership properties, raise or provide funds for use by the partnerships, provide income or cash-flow guarantees to the



partnerships, and provide initial and long-term property management services to the partnerships. They also earn income from a variety of other sources, such as incentive arrangements and participations in profits on future sales of real estate by the partnerships.

**.08** Syndicators may receive cash, notes or other receivables, partnership interests, or rights to share in the proceeds of the sale or refinancing of the properties. At the time of syndication, partnerships generally pay cash to the syndicators for portions of their fees. The sources of the cash are generally initial payments by the investors to the partnerships or proceeds of borrowings secured by investor notes. Subsequent payments are expected to be made to the syndicators based on the availability of cash from installments on investor notes, partnership operations, mortgage refinancing, or sales of properties.

**.09** Syndicators may arrange for partnerships to acquire properties in the following ways:

- By acquiring ownership interests and reselling them to the partnerships in flip transactions
- By selling to the partnerships properties that the syndicators already own, or by transferring options or contracts to buy properties
- By arranging for the partnerships to acquire the properties directly from third parties

Selling prices may be greater than the syndicators' acquisition costs, or the syndicators may receive compensation for arranging the acquisitions.

**.10** In some syndication transactions, the syndicators have substantial risks of ownership in properties they sell to the partnerships or arrange for the partnerships to acquire, as indicated by some or all of the following characteristics:

- The partnerships make only nominal down payments.
- The syndicators receive partnership notes that are subject to future subordination by the partnerships to the claims of other creditors.
- The syndicators, or affiliates of the syndicators, are general partners in the partnerships.
- The syndicators are obligated to or intend to continue supporting the properties after syndication.

**.11** In some syndication transactions, the syndicators market no-load investment units.<sup>1</sup> Some syndicators that sponsor such transactions initially own the entire partnership and, after completing the syndication, generally retain an ownership interest in the partnership. Other syndicators that do not initially have an ownership interest in the partnership generally receive an ownership interest in lieu of selling commissions. In addition, syndicators that market no-load investment units pay expenses related to organization and syndication activities in excess of contractual reimbursement allowances, such as charges for lawyers and broker-dealers. Such syndicators generally expect

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<sup>1</sup> The North American Securities Administrators' Association, Inc. (NASAA) defines a carried interest in the "Real Estate Programs" section of its *Statements of Policy* as an equity interest (other than a "promotional interest") that participates in all allocations and distributions and for which full consideration is neither paid nor to be paid. A syndication in which the syndicator receives a carried interest is known in the industry as a "no load" offering.

to recover their costs by charging fees for various other services, such as property acquisition and asset management.

.12 Investors in partnerships expect to realize appreciation, earn operating income, receive distributions of cash, obtain tax benefits, or obtain some or all of those benefits. The interests in real estate may be represented by direct ownership, mortgages, master leases, sale-leasebacks, or options to acquire real estate. Some partnership agreements require investors to pay their total capital contributions to the partnerships immediately; others require the investors to pay some cash immediately and permit them to issue investor notes to the partnerships for the balance.

## Current Practice

.13 Syndicators use various methods of accounting for income from syndications. Some recognize profit on the sales of real estate in conformity with Financial Accounting Standards Board (FASB) Statement No. 66, *Accounting for Sales of Real Estate*, and recognize additional fee income either as part of the real estate sales transactions or separately. Others believe that FASB Statement No. 66 does not apply to syndication transactions, and they either recognize all syndication profits immediately upon entering into the syndication transaction or follow methods based on discounting cash flows.

.14 Some syndicators that apply FASB Statement No. 66 to syndication transactions in which they sell real estate to the partnerships do not apply it to syndication transactions in which they do not have ownership interests in the real estate acquired by the partnerships.

.15 Some syndicators do not apply FASB Statement No. 66 to flip transactions because they believe the brief ownership period involved in a flip transaction is not substantive.

.16 Syndicators that use discounted cash-flow methods include in reported revenue the discounted amounts of expected cash flows from partnerships. The discount rates are determined by reference to the estimated market rate of interest, using APB Opinion No. 21, *Interest on Receivables and Payables*, as guidance. Discounts or premiums on notes are determined to the extent that the stated or implicit interest rates of the notes differ from the market rates of interest. Some syndicators use the stated payment periods of principal and interest in determining the timing of the expected cash flows from the notes, whereas others use anticipated payment dates corresponding to the dates on which the syndicators expect the properties to be sold.

.17 Some syndicators determine the projected depreciated cost of the properties and subtract the estimated balances of senior mortgage debt at the properties' anticipated dates of disposal (before the maturity of partnership notes). The difference is discounted to determine the amounts at which the partnership notes should be carried.

.18 Syndicators that use discounted cash-flow methods recognize the discounted amounts of notes received from partnerships as income at the time capital is raised from investors in the partnerships. In subsequent periods, discounts or premiums on the notes, if any, are recognized in income ratably using the interest method.

.19 Some syndicators recognize all revenue as of the date of syndication. Others use the guidance in FASB Statement No. 66 and, because of continuing involvement, defer recognizing some portion of the revenue.

.20 Some syndicators use the criteria in FASB Statement No. 66 to account for fee revenue from real estate syndication transactions because they believe the transactions are, in substance, sales of real estate.

.21 Some syndicators that account for fees by applying the revenue-recognition criteria in FASB Statement No. 66 exclude from the sales value of the properties, as the term *sales value* is defined in paragraph 7 of that Statement, some or all of the fees charged to the partnerships. Accordingly, they do not include the related payments of such fees in determining whether the buyers' initial and continuing investments in the properties are adequate for the seller to recognize profit in full on the sales. Other syndicators include all fees and related payments in determining sales value and in assessing whether the buyers' initial and continuing investment criteria have been met.

.22 Syndicators of blind pool or partially blind pool transactions are often entitled to nonrefundable syndication fees at the time of syndication, which would generally be before some or all of the properties are acquired by the partnerships. The general practice is to recognize nonrefundable syndication fees or partnership interests in income when received if there will be adequate fees to compensate the syndicators for whatever future services they may have to perform for the partnerships.

.23 Syndicators may receive or retain partnership interests as compensation for services. Some syndicators do not record their partnership interests, and others record them based principally on the following amounts:

- Estimated fair values
- The proportionate shares of (a) the amounts at which the syndicators carried the properties, if the syndicators had ownership interests in the properties, or (b) the partnerships' acquisition costs, if the syndicators never had ownership interests in the properties
- The costs incurred by the syndicators in excess of amounts charged to the partnerships
- Nominal amounts

## Conclusions

.24 The following conclusions should be read in conjunction with the "Discussion of Conclusions and Implementation Guidance," beginning with paragraph .40 of this SOP, which explains the bases for the conclusions and provides guidance for implementing them.

## Applicability of FASB Statement No. 66 to Syndication Activities

.25 FASB Statement No. 66 applies to the recognition of profit on the sale of real estate by syndicators to partnerships. This SOP concludes that the guidance in FASB Statement No. 66 should also be applied to the recognition of profit on real estate syndication transactions even if the syndicators never had ownership interests in the properties acquired by the real estate partnerships. For purposes of applying the profit recognition criteria of FASB Statement No. 66 to transactions in which syndicators never had such ownership interests, the syndicators should recognize profit on the transactions in the same way that they would have recognized such profit had they acquired the real estate and sold it to the partnerships.

## Determining the Sales Value of Property and Fee Income

.26 All fees charged by syndicators should be included in the determination of sales value in applying FASB Statement No. 66, except (a) fees for which future services must be performed and (b) syndication fees. FASB Statement No. 66 does not apply to the recognition of fees excluded from sales value.

.27 *Fees for Future Services.* Syndicators should recognize fees for future services when they render the services. If fees designated for future services are excessive or inadequate, they should be adjusted for accounting purposes and the adjustments should be allocated to or from the real estate sales portion of the transaction. However, the buyer's initial and continuing investment should not include cash payments on amounts reallocated from fees for future services until the services have been performed.

.28 *Syndication Fees.* Syndicators should not recognize syndication fees until the earnings process is complete and collectibility is reasonably assured. Further, if a syndicator receives or retains a partnership interest as compensation for a portion of the syndication fee, the profit recognized on that portion of the fee should not exceed the amount that would be recognized by applying partial sale accounting to the underlying partnership interest, as set forth in paragraph .38 of this SOP.

.29 If stated syndication fees are not reasonable, they should be adjusted for accounting purposes to amounts that are reasonable, and the adjustments should be allocated to or from the real estate sales portion of the transaction. Guidance on accounting for nonrefundable fees received from blind pools before property acquisition is provided in paragraph .32 of this SOP.

.30 The syndication fee for a transaction, which consists of cash and the value of any notes or partnership interests designated as consideration for the syndication fee, is reasonable if it falls within the range of syndication fees charged by independent brokers in similar transactions and is at least adequate to reimburse the syndicator for amounts paid to independent brokers or other third parties associated with the transaction. The range of reasonable fees can generally be determined by reference to various sources, including independent brokers, publicly offered transactions, and industry-monitoring reports.

.31 If, in addition to cash or notes, a syndicator receives a partnership interest as compensation for the syndication fee, the syndicator should include the value of the partnership interest in determining the reasonableness of the syndication fee. If the amount of the syndication fee is determined not to be reasonable, the fee should be adjusted for accounting purposes, as described in paragraph .29 of this SOP. However, the adjustment should not reduce the syndication fee by more than the sum of the cash and notes received for the syndication fee. Further, the syndication fee should not be adjusted if all, or substantially all, of the compensation to the syndicator consists of partnership interests received or retained, as in the no-load transactions discussed in paragraph .11 of this SOP.

## Accounting for Nonrefundable Fees Received From Blind Pools Before Property Acquisition

.32 Syndication fees received from blind pool transactions should be recognized in income ratably as the syndication partnership invests in prop-

erty acquisitions, but only to the extent that the syndication fees are nonrefundable and meet all conditions for recognition in income, as set forth in paragraphs .28 to .31 of this SOP.

### **Exposure to Losses or Costs From Syndicator Involvement and Collectibility Risk**

.33 If syndicators are exposed to future losses or costs from (a) material involvement with the properties, partnerships, or partners or (b) uncertainties regarding the collectibility of partnership notes, they should defer income recognition on syndication fees and fees for future services until the losses or costs can be reasonably estimated. Syndicators should reduce income recognized by the estimated losses or costs. The guidance in paragraphs 29 and 30 of FASB Statement No. 66 should be used in estimating potential losses or costs of support obligations. If such losses or costs cannot be estimated, the income recognized should be reduced by the maximum exposure. Paragraphs .61 to .63 of this SOP provide examples of syndicator involvement and uncertainties surrounding the collectibility of partnership notes that should be considered in recognizing real estate syndication income.

### **Allocating Cash Payments**

.34 For the purpose of determining whether buyers' initial and continuing investments satisfy the requirements for recognizing profit in full in conformity with FASB Statement No. 66, cash received by syndicators should be allocated to unpaid syndication fees before being allocated to the initial and continuing investment. After the syndication fee has been fully paid, additional cash received should be allocated to unpaid fees for future services, to the extent that those services have been performed by the time the cash is received, before being allocated to the initial and continuing investment.

.35 If, at or near the time of syndication, syndicators pay cash or unconditionally commit to pay cash to the partners or partnerships or to third parties on behalf of the partners or partnerships, the syndicators should account for those amounts as reductions of cash received from the partnerships, rather than as separate cash outlays.

### **Recognition of Partnership Interests Received or Retained**

.36 This SOP amends paragraph 32 of SOP 78-9, *Accounting for Investments in Real Estate Ventures* [section 10,240.32], which requires the investor's costs of services or intangibles contributed to a partnership or joint venture to be allocated to the cost of the investment. The following footnote is appended to paragraph 32 of that SOP immediately following the paragraph heading "Contribution of Services or Intangibles":

The provisions of this paragraph do not apply to real estate syndication activities in which the syndicators receive or retain partnership interests. Such activities are discussed in SOP 92-1, *Accounting for Real Estate Syndication Income*.

.37 *Participation in Future Profits Without Risk of Loss.* If syndicators receive or retain limited partnership interests that are subordinate for any distributions to the majority class of ownership interests, they should generally account for the interests as participations in future profits without risk of loss. Profits should be recognized when they are realized, in conformity with paragraph 43 of FASB Statement No. 66.

**.38 *Partial Sale.*** If the partnership interests received by the syndicators have the same pro rata rights as the majority class of ownership interests for all distributions, the syndicators should account for their partnership interests as retained interests from partial sales of real estate, in conformity with FASB Statement No. 66, regardless of whether the syndicators ever held title to the underlying properties. Syndication fees should be accounted for as set forth in paragraphs .28 to .31 of this SOP.

## Effective Date and Transition

**.39** The recommendations in this SOP should be applied to transactions for which the initial closing with investors occurs after March 15, 1992. Earlier application is encouraged for financial statements that have not been previously issued.

## Discussion of Conclusions and Implementation Guidance

**.40** The following discussion explains the bases for the conclusions reached in this SOP and provides implementation guidance.

### Applicability of FASB Statement No. 66 to Syndication Activities

**.41** In some syndication transactions, the syndicator acquires the properties, or options to acquire the properties, and sells them to the partnership. Paragraph 1 of FASB Statement No. 66 indicates that such real estate sales transactions are within the scope of that Statement, as follows: "This Statement establishes standards for recognition of profit on all real estate sales transactions without regard to the nature of the seller's business." Ownership interests provide evidence that syndicators are sellers of real estate, and FASB Statement No. 66 therefore applies to real estate syndication transactions in which ownership interests in properties pass from the syndicators to the partnerships. FASB Statement No. 66 does not specify the duration of ownership, so it applies as much to a brief ownership as to a lengthy one.

**.42** In other transactions, the syndicator arranges for the partnership to acquire the property from a third party without ever having acquired the property or an option to acquire the property. Although the form of such transactions differs from those described previously, the substance is the same: The syndicator is primarily compensated for arranging the acquisition of property by the partnership and for arranging the sale of partnership shares to investors. Accordingly, this SOP takes the position that the guidance in FASB Statement No. 66 should be applied to the recognition of profit on real estate syndication transactions even if the syndicators never had ownership interests in the properties acquired by the real estate partnerships.

**.43** The following describes how a syndicator should apply the profit-recognition criteria in FASB Statement No. 66 to a real estate syndication transaction in which a partnership acquires real estate from a third party rather than from the syndicator:

- The syndicator should impute a purchase of the real estate from the third party at the amount paid by the partnership to the third party. The syndicator should also impute a corresponding sale of the real estate to the partnership at the same price.

- Except for fees for which future services must be performed and syndication fees, all fees charged by the syndicator to the partnership as part of the syndication transaction should be added to the sales price in the imputed sales transaction to arrive at the deemed sales value of the real estate syndication transaction.
- The syndicator should recognize profit on the real estate syndication transaction to the extent that profit could be recognized in conformity with FASB Statement No. 66 on an otherwise identical transaction with the deemed sales value described in the preceding bullet. In determining whether the partnership would meet the initial and continuing investment criteria for recognition of profit in full on the imputed sales transaction, as described in paragraphs 11 and 12 of FASB Statement No. 66, the syndicator should include amounts paid by the partnership to the third party on the real estate sale.

Example 1b of appendix B of this SOP [paragraph .73] illustrates the accounting methods described previously.

### Determining the Sales Value of Property and Fee Income

.44 Paragraph 7 of FASB Statement No. 66 states that sales value is determined by—

- a. Adding to the stated sales price the proceeds from the issuance of a real estate option that is exercised and other payments that are *in substance additional sales proceeds*. These nominally may be management fees, points, or prepaid interest or fees that are required to be maintained in an advance status and applied against the amounts due to the seller at a later date. [*Emphasis added.*]
- b. Subtracting from the sale price a discount to reduce the receivable to its present value and by the net present value of services that the seller commits to perform without compensation or by the net present value of the services in excess of the compensation that will be received.

.45 In reviewing fees charged in connection with syndication transactions, the Real Estate Committee found that syndication fees and fees for future services are the only fees that are consistently separable from the corresponding real estate sales transaction. This SOP therefore concludes that all other fees should be included in the calculation of sales value, as described in part *a* of the foregoing quotation. This SOP also concludes that fees for future services associated with syndication transactions should be accounted for in the same manner as similar fees associated with real estate sales transactions, as described in part *b* of the foregoing quotation. Guidance on accounting for syndication fees is provided in paragraphs .28 to .31 of this SOP.

.46 *Fees for Future Services.* Fees for future services excluded from sales value include fees for managing properties and brokerage commissions on sales of properties by partnerships but do not include fees directly related to the acquisition or initial financing of syndication properties, such as cash flow guarantee fees, initial loan fees, and rent-up guarantee fees.

.47 Fees for future services that are deemed to be excessive or inadequate should be adjusted for accounting purposes. If the fees for future services are deemed to be excessive, the adjustments reduce amounts accounted for as fees for future services, and the sales value of the real estate is adjusted upward. However, until the services are performed, the syndicator remains contractu-

ally obligated to the partnership for the stated amount of the fees for future services regardless of whether they have been reallocated to sales value for reporting purposes. Payments made in consideration of such services are thus not included in the determination of the buyer's initial and continuing investment until the services are performed.

.48 Conversely, if the fees are deemed to be inadequate, the adjustments increase amounts accounted for as fees for future services. The sales value of the real estate is adjusted downward, because the real estate sales price is assumed to be overstated by the amount by which the fees for future services are understated. Furthermore, the payments made on the portion of sales value reallocated to fees for future services are not considered in evaluating whether the buyer has demonstrated a commitment to pay for the real estate, as described in paragraph 8 of FASB Statement No. 66. Profit is recognized on the amounts reallocated to the fees as the services are performed.

.49 *Syndication Fees.* This SOP recommends excluding syndication fees from sales value because they relate to the raising of equity rather than to the acquisition or operation of property. Recognition of syndication fees in income on completion of the earnings process is consistent with paragraph 11 of FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, which states that the "enterprise managing a loan syndication (the syndicator) shall recognize loan syndication fees when the syndication is complete."

.50 Syndication fees are usually paid in cash at the time of syndication, and thus, their inclusion in sales value would unsoundly accelerate recognition of income on the real estate transaction, because the cash received would be included in calculating the down payment on the transaction, as provided in paragraph 8 of FASB Statement No. 66.

.51 This SOP recommends adjusting unreasonable stated syndication fees for accounting purposes to amounts that are reasonable, and allocating the adjustments to the real estate sales portion of the transaction. Such adjustments are necessary to account for the substance of the transaction.

.52 Syndication fees are generally based on a percentage of funds raised from investors. The variety of real estate syndication transactions precludes the applicability of a particular rate of syndication fee in all circumstances. For example, the rate may be affected by—

- The size of the offering.
- The effort expected to be required to market the offering.
- The tax consequences to the partnership and to the investors.
- The stated syndication fees in similar syndication transactions.
- Regulatory constraints.
- Any payments to independent brokers or other independent third parties associated with the transaction.
- Any costs incurred in connection with the syndication, such as the preparation of offering circulars or prospectuses.
- The choice of a public or private offering.
- The existence of competitors.

.53 If the adjustments increase amounts accounted for as syndication fees, the sales value of the real estate is adjusted downward because the real



estate sales price is considered to be overstated by the amount by which the syndication fees are understated. The adjustments reduce the sales value of the real estate, and the payments made on the portion of sales value reallocated to syndication fees are not considered in evaluating whether the partnership has demonstrated a commitment to pay for the real estate, as described in paragraph 8 of FASB Statement No. 66, because such payments do not give the partnership an increased stake in the property.

.54 Conversely, if adjustments reduce amounts accounted for as syndication fees, the sales value of the real estate is adjusted upward, and the payments made on the portion of sales value reallocated from syndication fees are accounted for as part of the partnership's initial or continuing investment in the property, because such payments create an increased stake in the property from the partnership's perspective.

.55 Example 2 in appendix B of this SOP [paragraph .73] illustrates transactions in which syndication fees are adjusted.

.56 Syndication fees should not be adjusted in transactions in which partnership interests are received or retained by the syndicators in lieu of cash syndication fees, as in the no-load transactions discussed in paragraph .11 of this SOP, because the partnership interests represent the total compensation to which the syndicator is entitled, unless additional future services are performed. To be consistent with that guidance, this SOP prohibits adjustment of the syndication fee by more than the sum of the cash and notes received for the syndication fee.

.57 *All Other Fees.* All fees charged by syndicators, other than syndication fees and fees for which future services must be performed, are included in the determination of sales value, in conformity with FASB Statement No. 66, because they cannot be consistently distinguished from the corresponding real estate transaction as discussed in paragraph .44 of this SOP.

## **Accounting for Nonrefundable Fees Received From Blind Pools Before Property Acquisition**

.58 In blind pool and partially blind pool syndications, partnerships generally pay syndication fees to syndicators, or promise to pay them, before the syndicators acquire properties for the partnerships. Such fees are usually stated separately from the property acquisition fees.

.59 Although the syndication fees may be contractually nonrefundable even if the syndicators do not ultimately locate properties to acquire, a syndicator that could not successfully complete that phase of the transaction would soon be out of business. As a result, the earnings process is incomplete until both the partnership shares are sold and the corresponding properties are acquired.

.60 If the syndicator arranges for the partnership to acquire a property in which the syndicator has or expects to have significant involvement, or if the syndicator has a history of such transactions, revenue recognition should be deferred for all fees related to all properties, in conformity with the guidance in the following section.

## **Exposure to Losses or Costs From Syndicator Involvement and Collectibility Risk**

.61 If syndicators are exposed to future losses or costs from (a) material involvement with the properties, partnerships, or partners or (b) uncertainties

regarding the collectibility of partnership notes, they should defer income recognition on syndication fees and fees for future services until the losses or costs can be reasonably estimated. This SOP recommends that the syndicators reduce income recognized by the estimated losses or costs. The guidance in paragraphs 29 and 30 of FASB Statement No. 66 is used in estimating potential losses or costs of support obligations. If such losses or costs cannot be estimated, the income recognized should be reduced by the maximum exposure.

**.62 *Involvement.*** The following scenarios describe some common forms of involvement that may expose syndicators to future losses or costs:

- The syndicator agrees to reimburse the partnership or partners for any loss of amounts invested.
- The syndicator guarantees a minimum return on amounts invested by the partnership or partners.
- The syndicator is required to operate properties belonging to the partnership or partners, or to support the operations of those properties, at its own risk.
- The syndicator is required to construct or renovate properties acquired, or to be acquired, by the partnership or partners.
- The syndicator guarantees obligations or debt of the partnership or partners.

**.63 *Collectibility.*** The following factors associated with syndication transactions may expose syndicators to future losses or costs beyond those normally associated with the collection of receivables:

- Collection may depend primarily on income, cash flows, gain on sale, or gain on refinancing, which are affected by future events that cannot be assured.
- Minimal levels of capital in the partnership, coupled with operating losses, may dilute the equity of the partnership in the property to such an extent that the risk of loss by default no longer sufficiently motivates the partnership or partners to honor their obligations to the syndicators.
- Certain partnership notes (for example, notes in payment of syndication fees) may be unsecured or may otherwise be subject to future subordination, as described in paragraph 17 of FASB Statement No. 66. Syndicators should determine whether any notes accounted for as proceeds of real estate sales are subject to future subordination, particularly if notes originally designated for payment of syndication fees are adjusted and reclassified as sales proceeds in conformity with paragraphs .28 to .31 of this SOP.

## Allocating Cash Payments

**.64** Because syndication fees have historically been paid in cash at the time of syndication, all payments should be allocated to unpaid syndication fees before being allocated to any other unpaid amounts. After the syndication fee has been fully paid, additional cash received should be allocated to unpaid fees for future services excluded from sales value, to the extent those services have been performed by the time the cash is received, before being allocated to the initial and continuing investment and to fees included in sales value. Such

additional cash received does not demonstrate an additional commitment to pay for the property, as described in paragraph 8 of FASB Statement No. 66, and applying it to the initial and continuing investment would thereby unsoundly accelerate the recognition of profit in full on the real estate sales portion of the transaction.

**.65** Some transactions provide for syndicators to both receive cash from the partnerships and pay cash to them. Payments received by syndicators in such transactions may effectively be refundable to the extent that the syndicators later make payments to the partnerships. Consequently, if the syndicators pay cash to the partnerships or unconditionally commit to pay cash at or near the time of syndication, the syndicators should account for those amounts as reductions of cash already received from the partnerships, rather than as separate cash outlays. The reductions are allocated first to partnership down payment, next to other fees excluded from sales value to the extent performed, and last to syndication fees.

### **Recognition of Partnership Interests Received or Retained**

**.66** As stated in paragraph .36 of this SOP, syndication services for which partnership interests are received or retained are not contributions of services to the partnership, as described in paragraph 32 of SOP 78-9 [section 10,240.32]. They are, instead, services for which a syndication fee is paid through receipt or retention of the partnership interest. Such accounting is consistent with the premise of this SOP that the guidance in FASB Statement No. 66 should be applied to the recognition of profit on real estate syndication transactions.

**.67** *Participation in Future Profits Without Risk of Loss.* Transfers of subordinate limited partnership interests by partnerships to syndicators are similar to transfers of rights to participate in future profits without risk of loss. The syndicators' profits are contingent upon the ability of the partnerships to produce sufficient profits to pay their majority security holders, and the syndicators are not liable for partnership losses. Paragraph 43 of FASB Statement No. 66 provides the following guidance for accounting for participations in future profits without risk of loss:

If the transaction otherwise qualifies for recognition of profit by the full accrual method, the transfer of risks and rewards of ownership and absence of continuing involvement criterion shall be considered met. The contingent future profits shall be recognized when they are realized. [Footnote omitted.]

**.68** *Partial Sale.* In general, syndicators should recognize as retained interests from partial sales of real estate those partnership interests received or retained that have the same pro rata rights as the majority class of ownership interests for all distributions. Partnership interests are typically received or retained as compensation for selling properties to partnerships, arranging sales of properties to partnerships by independent third parties, or performing other services in connection with syndication transactions.

**.69** If a syndicator receives or retains a partnership interest as compensation for syndication services performed, the syndication fee for performing the services should be accounted for as follows:

- a.** All real estate owned by the partnership should be assumed to have been sold to the partnership by the syndicator, as described in paragraph .25 of this SOP.

- b. The partnership interest received or retained by the syndicator should be accounted for as a retained interest from a partial sale of the real estate by the syndicator to the partnership, as described in paragraph .38 of this SOP.
- c. The amount of profit recognized as the syndication fee should be equal to the carrying amount of such a retained interest.

.70 Paragraph 33 of FASB Statement No. 66 states that a "sale is a partial sale if the seller retains an equity interest in the property or has an equity interest in the buyer." That Statement requires the use of partial sale accounting if properties acquired by the partnerships are owned by the syndicators before the syndication transactions. As noted in the preceding paragraph and in paragraph .25 of this SOP, even if a syndicator never owns a property and, for example, a transaction is a sale of securities, the guidance in FASB Statement No. 66 should be applied if real estate is the principal underlying asset.

.71 If a syndicator receives or retains a general partnership interest in a limited partnership as consideration for the portion of the syndication transaction classified as a real estate sale, the syndicator should recognize any associated profit in conformity with FASB Statement No. 66. Receipt or retention of a general partnership interest may expose a syndicator to losses or costs that should be evaluated as described in paragraphs .33 and .61 to .63 of this SOP.

## Appendix A

### Other Relevant Literature

A-1. This appendix provides background information on literature discussed only briefly in the body of this SOP. It also discusses literature that is not cited in the body of this SOP but that may be relevant, directly or by analogy, to the recognition of income from syndication activities.

### FASB Statement No. 5, *Accounting for Contingencies*

A-2. Paragraph 17 of FASB Statement No. 5, *Accounting for Contingencies*, states: "Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization."

### FASB Statement No. 13, *Accounting for Leases*

A-3. FASB Statement No. 13, *Accounting for Leases*, specifies the accounting by lessors of residual interests in real and personal property leased under leases accounted for as sales-type and direct financing leases. In general, unguaranteed residual values are determined at the inception of the leases, thereby affecting the amounts of income to be recognized over the lease terms. Residual values are required to be reviewed at least annually, and downward adjustments made currently, if declines in estimated residual values are deemed to be other than temporary.

### FASB Statement No. 66, *Accounting for Sales of Real Estate*

A-4. Paragraphs 29 and 30 of FASB Statement No. 66 provide the following guidance for estimating potential costs of support obligations:

29. *The seller is required to initiate or support operations or continue to operate the property at its own risk, or may be presumed to have such a risk, for an extended period, for a specified limited period, or until a specified level of operations has been obtained, for example, until rentals of a property are sufficient to cover operating expenses and debt service.* If support is required or presumed to be required<sup>10</sup> for an *extended* period of time, the transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement. If support is required or presumed to be required for a *limited* time, profit on the sale shall be recognized on the basis of performance of the services required. Performance of those services shall be measured by the costs incurred and to be incurred over the period during which the services are performed. Profit shall begin to be recognized when there is reasonable assurance that future rent receipts will cover operating expenses and debt service including payments due the seller under the terms of the transaction. Reasonable assurance that rentals will be adequate would be indicated by objective information regarding occupancy levels and rental rates in the immediate area. In assessing whether rentals will be adequate to justify recognition of profit, total estimated future rent receipts of the property shall be reduced by one-third as a reasonable safety

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<sup>10</sup> Support shall be presumed to be required if: (a) a seller obtains an interest as a general partner in a limited partnership that acquires an interest in the property sold; (b) a seller retains an equity interest in the property, such as an undivided interest or an equity interest in a joint venture that holds an interest in the property; (c) a seller holds a receivable from a buyer for a significant part of the sales price and collection of the receivable depends on the operation of the property; or (d) a seller agrees to manage the property for the buyer on terms not usual for the services to be rendered, and the agreement is not terminable by either the seller or the buyer.

factor unless the amount so computed is less than the rents to be received from signed leases. In this event, the rents from signed leases shall be substituted for the computed amount . . . .

30. If the sales contract does not stipulate the period during which the seller is obligated to support operations of the property, support shall be presumed for at least two years from the time of initial rental unless actual rental operations cover operating expenses, debt service, and other contractual commitments before that time. If the seller is contractually obligated for a longer time, profit recognition shall continue on the basis of performance until the obligation expires.

## **FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases***

**A-5.** Paragraphs 21 and 22 of FASB Technical Bulletin No. 88-1, *Issues Related to Accounting for Leases*, requires "wrap lease" transactions to be accounted for in the following manner:

### *Question 5*

21. An enterprise purchases an asset, leases the asset to a lessee, obtains nonrecourse financing using the lease rentals or the lease rentals and the asset as collateral, sells the asset subject to the lease and the nonrecourse debt to a third-party investor, and leases the asset back while remaining the substantive principal lessor under the original lease (commonly referred to as a wrap lease transaction). Other than as required by Statement 13, as amended by Statements 28, 66, and 98, should an enterprise ever recognize any profit on the wrap lease transaction at its inception? If not, how should the enterprise account for the transaction?

### *Response*

22. If the property involved is real estate, the provisions of Statement 98 apply to the sale-leaseback transaction. If the property involved is not real estate, the enterprise should account for the transaction as a sale-leaseback transaction. If the property involved is not real estate, the enterprise should account for the transaction as a sale-leaseback transaction in accordance with paragraphs 32-34 of Statement 13, as amended, and the lease to the end user should be accounted for as a sublease in accordance with paragraph 36 of Statement 13. Under Statement 13 the asset should be removed from the books of the original enterprise, the leaseback should be classified in accordance with paragraph 6 of Statement 13, and any gain on the transaction should be recognized or deferred and amortized in accordance with paragraph 33 of Statement 13, as amended. The enterprise would also reflect the retained residual interest, gross sublease receivable, nonrecourse third-party debt, the leaseback obligation, and the note receivable from the investor in the statement of financial position. As in accounting for a money-over-money lease transaction . . . , the sublease asset and the related nonrecourse debt should not be offset in the statement of financial position unless a right of setoff exists.

## **AICPA Statement of Position No. 78-9, *Accounting for Investments in Real Estate Ventures***

**A-6.** SOP 78-9 [section 10,240] provides guidance on accounting for investments in real estate ventures in financial statements prepared in conformity with generally accepted accounting principles. Paragraph 32 [section 10,240.32] states the following:

*Contribution of Services or Intangibles.* The division believes the accounting considerations that apply to real property contributed to a partnership or joint

venture also apply to contributions of services or intangibles. The investor's cost of such services or intangibles to be allocated to the cost of the investment should be determined by the investor in the same manner as for an investment in a wholly owned real estate project.

**A-7. Paragraph 37 [section 10,240.37] states the following:**

If services are performed for a venture by an investor and their cost is capitalized by the venture, profit may be recognized by the investor to the extent attributable to the outside interests in the venture if the following conditions are met:

- a. The substance of the transaction does not significantly differ from its form.
- b. There are no substantial uncertainties about the ability of the investor to complete performance (as may be the case if the investor lacks experience in the business of the venture) or the total cost of services to be rendered.
- c. There is a reasonable expectation that the other investors will bear their share of losses, if any.

The method of recognizing income from services rendered should be consistent with the method followed for services performed for unrelated parties.

### **FASB Emerging Issues Task Force Issue No. 85-37, *Recognition of Notes Received for Real Estate Syndication Activities***

**A-8.** Issue No. 85-37, *Recognition of Notes Received for Real Estate Syndication Activities*, discusses a number of methods of accounting for syndication transactions, including a method described as the "cash method," under which no carrying amount is recorded for notes receivable by syndicators from the partnerships except for portions of the notes that will be paid from the proceeds of the investors' contributions. The Emerging Issues Task Force (EITF) did not reach a consensus on the issue and referred it to the AICPA Real Estate Committee. However, the Securities and Exchange Commission (SEC) observer attending the EITF meeting stated that without a task force consensus, the SEC staff would challenge registrants that use a method other than the cash method. He also stated that the SEC objects to extending the 1980 AICPA Issues Paper *Accounting by Lease Brokers* to activities other than those of lease brokers. The SEC staff has also specifically objected to accretion of income on purchased, unguaranteed lease residuals and to income recognition and accretion of income on residual interests, realization of which depends on transactions whose occurrence in the future and whose terms are currently only anticipated.

### **AICPA Issues Paper, *Accounting by Lease Brokers***

**A-9.** The 1980 AICPA Issues Paper, *Accounting by Lease Brokers*, explicitly applies to equipment-leasing transactions, but the paper has been applied to real estate syndication transactions by analogy. Under lease-broker accounting, income is recognized at the inception of a lease based on cash received and the discounted amount of the expected residual (subject to an assessment of realizability). Until the FASB issued Technical Bulletin No. 86-2, *Accounting for an Interest in the Residual Value of a Leased Asset*, the residual could be accreted until realized. The amount of income to be recognized at the inception of a lease in money-over-money lease brokerage transactions was significantly restricted in FASB Technical Bulletin No. 88-1.

Appendix B

Examples

Example 1

B-1. The following examples illustrate the determination of sales value, the allocation of cash payments, and the calculation of syndication fees, as described in paragraphs .26 to .31, .34, and .35 of this SOP.

B-2. *Example 1a.* A syndicator arranges for a newly formed partnership to acquire a single-tenancy property using part of the proceeds raised through the sale of partnership interests to unrelated third parties, as follows:

- Limited partners contribute \$4,000, of which \$700 is retained for working capital, and the unrelated general partner contributes \$100.
- The partnership acquires real estate from the syndicator at the syndicator's cost of \$20,000. The partnership gives the following consideration:
  - \$3,000 in cash.
  - The assumption of a \$16,250 nonrecourse first mortgage note, payable in monthly installments over fifteen years with interest at a market rate.
  - A second mortgage note, payable to the syndicator for the balance of \$750. The second mortgage is payable on the same terms as the first mortgage.
- The cash flow on the property is currently sufficient to meet the required principal and interest payments on the first and second mortgage notes.
- In addition, the syndicator receives the following:
  - Syndication fee:

Cash	\$ 100
Note bearing a market rate of interest due in three years secured by a lien on the property that is not subject to future subordination	300
	<u>\$ 400</u>

- Other fees—rent-up fee for activities prior to acquisition (accounted for as part of sales value)

Cash	\$ 300
Note bearing a market rate of interest due in three years secured by a lien on the property that is not subject to future subordination	650
	<u>\$ 950</u>
Total fees	<u>\$ 1,350</u>



Sales Value

Purchase price	\$20,000
Other fees accounted for as part of sales value— rent-up fee for activities prior to acquisition	950
Adjusted sales value	<u>\$20,950</u>

Cash Down Payment

Per sales contract	\$ 3,000
Add: Fees paid in cash that are included in sales value	\$300
Less: Portion of syndication fee not paid in cash	<u>300</u> -0-
Adjusted cash down payment	<u>\$ 3,000</u>

Gain Calculation

Sales value	\$20,950
Syndicator's cost	20,000
Gain	<u>\$ 950</u>

Gain Recognition

Down-payment test:

$$\frac{\text{Down payment } \$3,000}{\text{Sales value } \$20,950} = 14\%$$

Required minimum down payment set forth in paragraph 54 of  
FASB Statement No. 66

15%

The sale does not meet the minimum required down-payment test for full profit recognition.

Use of the installment method<sup>2</sup> would result in profit recognition of:

$$\frac{\text{Down payment } \$3,000}{\text{Sales value } \$20,950} \times \$950 = \$136^3$$

Syndication Fee Recognition

The syndication fee of \$400 is deemed to have been received in cash and, accordingly, to have been collected. In addition, the syndicator's involvement with the property does not indicate that a funding obligation by the syndicator is likely. Therefore, the entire fee is recognizable currently. The collectibility of the balance of the amount designated as the note in payment of the syndication fee (\$300) is evaluated as part of the evaluation of the collectibility of all notes from the real estate sale.

If the \$300 note were unsecured or otherwise subject to future subordination, profit to the extent of the note would be recognized under the cost-recovery

<sup>2</sup> The method used is consistent with FASB Emerging Issues Task Force Issue No. 88-24, *Effect of Various Forms of Financing under FASB Statement No. 66*.

<sup>3</sup> Because the seller's receivable of \$1,700 (\$750 second mortgage plus \$300 designated for syndication fees plus \$650 designated for other fees) for the sales price and the fees exceeds the amount of deferred gain of \$814 (\$950 total gain less \$136 profit recognized), no additional gain is currently recognized.

method. Profit to be recognized under the installment method would thus be reduced to \$650 (\$950 total less \$300 under the cost-recovery method) and recognized as follows:

$$\frac{\text{Down payment \$3,000}}{\text{Sales value \$20,650}^4} \times \$650 = \$94$$

**B-3. Example 1b.** The same facts apply as in example 1a, except that the property is purchased from an independent third party for \$20,000.

<u>Sales Value</u>	
Same as in example 1a	<u>\$20,950</u>
<u>Cash Down Payment</u>	
Same as in example 1a	<u>\$ 3,000</u>
<u>Gain Calculation</u>	
Same as in example 1a	<u>\$ 950</u>
<u>Gain Recognition</u>	
Same as in example 1a	
The sale does not meet the minimum required down-payment test for full profit recognition.	
Use of the installment method would result in profit recognition of \$136.	

Syndication Fee Recognition  
Same as in example 1a

**B-4. Example 1c.** The same facts apply as in example 1a, except that the syndicator retains a 3 percent limited partnership interest.

<u>Sales Value</u>	
Same as in example 1a	<u>\$20,950</u>
<u>Cash Down Payment</u>	
Same as in example 1a	<u>\$ 3,000</u>
<u>Gain Calculation</u>	
Sales value	\$20,950
Syndicator's cost	\$20,000
Less: 3% limited partnership interest—partial sale	<u>112<sup>5</sup></u>
Gain	<u>\$ 1,062</u>

<sup>4</sup> In the calculation of profit under the installment method, the \$20,950 sales value determined in example 1a is reduced by the \$300 note that is being recognized under the cost-recovery method.

<sup>5</sup> The \$112 partial sale amount is computed by applying the limited partnership percentage (3 percent) to the difference between the syndicator's cost (\$20,000) and the amount of the nonrecourse first mortgage note (\$16,250) assumed at purchase by the partnership.

Gain Recognition

Down-payment test:

$$\frac{\text{Down payment } \$3,000}{\text{Sales value } \$20,950} = 14\%$$

Required minimum down payment set forth in paragraph 54 of  
FASB Statement No. 66

15%

The sale does not meet the minimum required down-payment test for full profit recognition.

Use of the installment method would result in profit recognition of—

$$\frac{\text{Adjusted cash down payment } \$3,000}{\text{Sales value } \$20,950} \times \$1,062 = \$152^6$$

Syndication Fee Recognition

Same as in example 1a

**B-5. Example 1d.** The same facts apply as in example 1a, except that the syndicator agrees to fund cash-flow deficiencies for the first three years, up to a maximum of \$1,500. In calculating the profit to be recognized based on performance of the services required (including reduction of rents by the one-third safety factor described in paragraph 29 of FASB Statement No. 66), there is a \$1,100 exposure to loss. Current forecasts indicate discounted cash-flow losses of \$500 in year 1, \$300 in year 2, \$200 in year 3, and positive cash flow thereafter. The partnership also pays an additional \$200 of the \$400 syndication fee in cash.

Sales Value

Same as in example 1a	<u>\$20,950</u>
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Cash Down Payment

Down payment as calculated in example 1a	\$ 3,000
Additional cash	<u>200</u>
Adjusted cash down payment	<u>\$ 3,200</u>

Gain Calculation

Gain as calculated in example 1a	\$ 950
Less: Syndicator's exposure to loss under paragraph 29 of FASB Statement No. 66	<u>1,100</u>
Gain	<u>NONE</u>

<sup>6</sup> Because the seller's receivable of \$1,700 (\$750 second mortgage plus \$300 designated for syndication fees plus \$650 designated for other fees) for the sales price and the fees exceeds the amount of deferred gain of \$910 (\$1,062 total gain less \$152 profit recognized), no additional gain is currently recognized.

Gain Recognition

Down-payment test:

$$\frac{\text{Down payment } \$3,200}{\text{Sales value } \$20,950} = 15\%$$

Required minimum down payment set forth in paragraph 54 of FASB Statement No. 66 15%

Although the sale meets the minimum required down-payment test for full profit recognition, no gain is recognizable because the exposure to loss exceeds the gain.

Syndication Fee Recognition

The syndicator would recognize \$250 in syndication fee income, which is equal to the \$400 syndication fee less the \$150 excess of the syndicator's expected funding obligation (\$1,100) over other fee income (\$950).

**Example 2**

**B-6.** The following example illustrates the adjustment of syndication fees when stated fees are not reasonable, as described in paragraphs .28 to .31 of this SOP. The property is an office building subject to lease on a long-term basis to parties with a satisfactory credit rating; cash flow is currently sufficient to service all indebtedness.

	<u>Case 1</u>	<u>Case 2</u>
Stated real estate sales price	<u>\$1,000</u>	<u>\$ 900</u>
Cost	<u>\$ 800</u>	<u>\$ 800</u>
Payments:		
Cash		
Stated syndication fees	\$ 40	\$ 140
Stated down payment	<u>100</u>	<u>0</u>
Total cash paid at closing	140	140
Assumption of existing noncourse debt for which the seller has no contingent liability	800	800
Second mortgage not payable to seller	<u>100</u>	<u>100</u>
Total payments	<u>\$1,040</u>	<u>\$1,040</u>
Required minimum down payment for full recognition of profit in conformity with FASB Statement No. 66	10%	10%
Reasonable fee <sup>7</sup>	\$ 100	\$ 100

<sup>7</sup> The syndication fee that is reasonable depends on circumstances unique to the individual transaction. The amount used in the example is not intended to serve as a benchmark for determining whether syndication fees are reasonable in practice.

	Case 1		Case 2	
	<i>Syndication Fees</i>	<i>Real Estate Sale</i>	<i>Syndication Fees</i>	<i>Real Estate Fees</i>
Stated terms	\$ 40	\$1,000	\$140	\$900
Reallocation of fees	60	(60)	(40)	40
Adjusted balances	<u>\$100</u>	<u>\$ 940</u>	<u>\$100</u>	<u>\$940</u>
			<i>Case 1</i>	<i>Case 2</i>
Syndication fee recognized in income at date of sale:				
Stated fee			\$ 40	\$140
Adjustment			60	(40)
Total			<u>\$100</u>	<u>\$100</u>
			<i>Case 1</i>	<i>Case 2</i>
Allocation of cash:				
Stated syndication fees			\$ 40	\$140
Syndication fee allocated from real estate sale			60	0
Syndication fee allocated to real estate sale			0	(40)
Adjusted syndication fee			100	100
Real estate down payment			40	40
Total Cash			<u>\$140</u>	<u>\$140</u>
			<i>Case 1</i>	<i>Case 2</i>
Cash down payment required for full profit recognition:				
10% of adjusted sales price			\$ 94	\$ 94
Real estate down payment			40	40
Additional cash required for full profit recognition			<u>\$ 54</u>	<u>\$ 54</u>
Total profit on real estate transaction:				
Adjusted sales price			\$940	\$940
Cost			800	800
Total profit			<u>\$140</u>	<u>\$140</u>
Profit on real estate sales transaction recognizable under installment method—greater of. <sup>8</sup>				
(a) $(\$40/\$940) \times \$140$			<u>\$ 6</u>	<u>\$ 6</u>
or				
(b) Total accounted for as real estate profit			\$140	\$140
Less: Second mortgage receivable			100	100
Less: Buyer's debt secured by the property for which the seller is contingently liable			0	0
Total profit recognizable on real estate sale			<u>\$ 40</u>	<u>\$ 40</u>

<sup>8</sup> The method used is consistent with FASB Emerging Issues Task Force Issue No. 88-24.

	<u>Case 1</u>	<u>Case 2</u>
Total profit recognizable at closing:		
Syndication fee	\$100	\$100
Real estate sale	<u>40</u>	<u>40</u>
Total	<u>\$140</u>	<u>\$140</u>

The remaining balance of \$100 in profit is deferred and recognized as cash payments are received by the syndicator.

Example 3

B-7. The following example illustrates the recognition of syndication fees received from blind pool transactions, as described in paragraph .32 of this SOP. The terms of the transaction are as follows:

- In June 19X1, syndication A raises \$50,000 for investment in real estate in a blind pool transaction; at the time the equity is raised, no properties have been acquired or identified for acquisition.
- The offering memorandum states that \$45,000 will be available for investment in property after payment of the following items:
  - \$3,000 in syndication fees
  - \$1,000 in expenses
  - \$1,000 set aside for working-capital funds

In addition, the offering memorandum states that it is anticipated that \$15,000 of debt financing will be obtained in connection with the property acquisition.

- In July 19X1, a property is acquired for \$15,000 cash and the assumption of an existing \$5,000 first mortgage loan. The partnership is to use an additional \$4,000 of its funds to renovate the property.

Syndication Fee Recognition

Assuming that the syndication fees to be recognized are nonrefundable and meet all conditions for recognition in income, as set forth in paragraphs .28 to .31 of this SOP, \$1,200 should be recognized in July 19X1, as follows:

Cash purchase price	\$15,000
Portion of purchase price financed with debt	5,000
Cash committed for renovation	<u>4,000</u>
Total invested	<u>\$24,000</u>

Total invested \$24,000

Cash committed for investment \$60,000

= 40%

The syndication fee to be recognized in July 19X1 is \$1,200 (40% × \$3,000 total syndication fee).

The remaining syndication fee of \$1,800 (\$3,000 total less \$1,200 recognized in July 19X1) would be recognized in income ratably as the syndication partnership invests in property acquisitions.

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The Real Estate Committee gratefully acknowledges the contributions of Judith Weiss, a former AICPA staff member.

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[The next page is 19,501.]





## Section 10,510

# Statement of Position 92-3 Accounting for Foreclosed Assets\*

April 28, 1992

### NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## Scope

.01 This Statement of Position (SOP) provides guidance on determining the balance sheet treatment of foreclosed assets<sup>1</sup> after foreclosure. (Paragraphs A-6 and A-7 of the appendix [paragraph .18] discuss the exclusion from this SOP of conclusions on the accounting treatment of results of operations related to foreclosed assets held for sale.) It applies to all reporting entities except those that account for assets at market value or fair value, such as broker-dealers, futures commission merchants, and investment companies. It applies to all assets obtained through foreclosure or repossession except for (a) inventories that are covered by chapter 4 of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*; (b) marketable equity securities that are covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (Statement) No. 12, *Accounting for Certain Marketable Securities*; and (c) foreclosed real estate previously owned by the lender and accounted for under FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*. Except for the requirements in paragraphs .12 and .17, the conclusions of this SOP do not apply to in-substance foreclosed assets (see paragraph A-10 of the appendix [paragraph .18]).

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<sup>1</sup> As used in this SOP, the term *foreclosed assets* includes all assets received in satisfaction of a receivable in a troubled debt restructuring, as the term is used in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*. It includes real property and personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts.

## Background

.02 Paragraph 29 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, issued in 1977, requires the following: "After a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash." That requirement has been interpreted in diverse ways.

.03 The American Institute of Certified Public Accountants' (AICPA's) Industry Audit Guide *Audits of Stock Life Insurance Companies* requires that foreclosed real estate be carried at the lower of cost (less accumulated depreciation) or market value, net of any encumbrances. Paragraphs 17 and 21 of SOP 75-2, *Accounting Practices of Real Estate Investment Trusts* [section 10,060.17 and .21] (as amended by SOP 78-2), require that estimated losses on individual loans and properties be based on net realizable value. The guidance in the AICPA Audit and Accounting Guide *Audits of Savings Institutions* (May 1994) and in the Industry Audit Guide *Audits of Finance Companies* is consistent with SOPs 75-2 [section 10,060] and 78-2. The AICPA Industry Audit Guide *Audits of Banks* (May 1994) states that subsequent to foreclosure, a loss on foreclosed real estate should be recognized if cost cannot be recovered through sale or use, but it does not indicate how the loss is to be measured. The AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* does not address accounting for foreclosed assets.\* [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.04 In practice, accounting by creditors for foreclosed assets, particularly real estate assets, is diverse. After foreclosure, some enterprises continue to write down the carrying amount of foreclosed assets for subsequent, further declines in fair value; others do not. After foreclosure, some enterprises discount projected cash flows related to foreclosed assets in estimating net realizable value of those assets; others do not.

.05 Sections 4(b)(1) and 4(b)(2)(A) of the Home Owners' Loan Act of 1933 as amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 generally provide that the director of the Office of Thrift Supervision prescribe uniform accounting and disclosure standards for savings associations, to be used in determining associations' compliance with applicable regulations, and incorporate generally accepted accounting principles into those standards to the same degree that such principles are used to determine compliance with regulations prescribed by federal banking agencies. Section 1215 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 also provides the following:

Before the end of the 1-year period beginning on the date of the enactment of this Act [August 9, 1989], each appropriate Federal banking agency (as defined in section 3(q) of the Federal Deposit Insurance Act) shall establish uniform accounting standards to be used for determining the capital ratios of all federally insured depository institutions and for other regulatory purposes. Each such agency shall report annually to the Chairman and ranking minority member of the Committee on Banking, Housing, and Urban Affairs of the Sen-

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\* The AICPA Audit and Accounting Guide *Banks and Savings Institutions* superseded the Guides *Audits of Savings Institutions* and *Audits of Banks* and refers readers to FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and SOP 92-3. [Footnote added, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

ate and the Chairman and ranking minority member of the Committee on Banking, Finance and Urban Affairs of the House of Representatives any differences between the capital standards used by such agency and capital standards used by any other such agency. Each such report shall contain an explanation of the reasons for any discrepancy in such capital standards, and shall be published in the Federal Register.

.06 The chairman of the Federal Home Loan Bank Board (now the Office of Thrift Supervision) asked the AICPA in 1987 to address the inconsistency between banks and savings and loan associations in accounting for loans and real estate assets. The AICPA's Accounting Standards Executive Committee (AcSEC) attempted to eliminate that inconsistency in 1988 and 1989 but decided to refer the matter to the FASB at that time. On April 4, 1989, soon after AcSEC's decision to refer the matter to the FASB, the chairman of the Federal Home Loan Bank Board wrote to the chairman of the Securities and Exchange Commission (SEC) asking that the SEC or its staff remove the inconsistency for public reporting entities. The SEC has not done so.

.07 Further, the chairman of the Federal Deposit Insurance Corporation, in a letter to the FASB dated November 8, 1989, asked the FASB to assist in developing "uniform accounting standards among depository institutions." In that letter, the chairman stated that "the accounting treatment in practice for certain transactions among participants in the financial services industry seems to be more a reflection of the type of charter than the substance of the transaction." Furthermore, the chairman "urge[d] the FASB to reconcile the different accounting practices outlined in [AICPA] guides for thrifts, banks, and finance companies." In early 1990, AcSEC decided that it could deal with the inconsistencies and diversity in accounting for foreclosed assets, and this SOP is a result of that decision.

.08 AcSEC believes that all enterprises, not just financial institutions, should account for foreclosed assets held for sale the same way, except that enterprises that account for assets at market value or fair value should not change their accounting. AcSEC's primary objectives in issuing this statement of position are to reduce the inconsistencies and diversity in accounting for foreclosed assets and to improve the understandability, comparability, and relevance of amounts reported as foreclosed assets in balance sheets. Another objective is to make all of the AICPA Audit and Accounting Guides and SOPs consistent on this matter. Achieving those objectives will also address the needs of Congress and the thrift and banking regulators.

.09 This SOP affects the following AICPA statements of position and industry audit and accounting guides:

- a. *Audits of Finance Companies*
- b. *Audits of Property and Liability Insurance Companies*
- c. *Audits of Stock Life Insurance Companies*
- d. *Guide for the Use of Real Estate Appraisal Information*

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

## Conclusions

### Held-for-Sale Presumption

.10 Most enterprises do not intend to hold foreclosed assets for the production of income but intend to sell them; in fact, some laws and regulations

applicable to financial institutions require the sale of foreclosed assets. Therefore, under this SOP, it is presumed that foreclosed assets are held for sale and not for the production of income. That presumption may be rebutted, except for in-substance foreclosed assets, by a preponderance of the evidence. If the held-for-sale presumption is not rebutted, the asset should be classified in the balance sheet as held for sale.

.11 The presumption of sale can be rebutted if (a) management intends to hold a foreclosed asset for the production of income, (b) that intent is not inconsistent with the enterprise's ability to do so or with laws or regulations, including the manner in which the laws or regulations are administered by federal or state regulatory agencies, and (c) that intent is supported by a preponderance of the evidence.

### Foreclosed Assets Held for Sale

.12 After foreclosure, foreclosed assets held for sale should be carried at the lower of (a) fair value<sup>2</sup> minus estimated costs to sell or (b) cost.<sup>3</sup> Such determination should be made on an individual asset basis. If the fair value of the asset minus the estimated costs to sell the asset is less than the cost of the asset, the deficiency should be recognized as a valuation allowance. If the fair value of the asset minus the estimated costs to sell the asset subsequently increases and the fair value of the asset minus the estimated costs to sell the asset is more than its carrying amount, the valuation allowance should be reduced, but not below zero. Increases or decreases in the valuation allowance should be charged or credited to income.<sup>4</sup>

.13 The amount of any senior debt (principal and accrued interest) to which the asset is subject should be reported as a liability at the time of foreclosure and not be deducted from the carrying amount of the asset; payments on such debt should be charged to the liability. Interest that accrues after foreclosure should be recognized as interest expense.

.14 FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, was extracted by the FASB from SOP 78-3, *Accounting for Costs to Sell and Rent, and Initial Rental Operations of Real Estate Projects*; SOP 80-3, *Accounting for Real Estate Acquisition, Develop-*

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<sup>2</sup> Fair value, as used in this SOP, is defined in paragraph 13 of FASB Statement No. 15 as follows: The fair value of the assets transferred is the amount that the . . . [creditor] could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved.<sup>6</sup>

<sup>6</sup> Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of *APB* [Accounting Principles Board] *Opinion No. 16* ["Business Combinations"], paragraphs 12-14 of *APB Opinion No. 21*, "Interest on Receivables and Payables," and paragraph 25 of *APB Opinion No. 29*, "Accounting for Nonmonetary Transactions."

<sup>3</sup> The cost of such assets at the time of foreclosure is the fair value of the asset foreclosed or repossessed. Any specific valuation allowance related to the loan should not be carried forward. This SOP provides no guidance for determining cost subsequent to foreclosure (see paragraphs A-6 and A-7 of the Appendix [paragraph .18]).

<sup>4</sup> Because the allowance is considered a valuation adjustment, insurance enterprises should report changes in the valuation allowance as realized gains and losses in income, not as unrealized gains and losses in equity.

*ment, and Construction Costs*, and the AICPA Industry Audit Guide *Accounting for Retail Land Sales*. These documents did not, in the opinion of AcSEC, apply to foreclosed real estate held for sale. AcSEC therefore believes that the fair-value test in this SOP, not the net-realizable-value test in FASB Statement No. 67, should be applied to foreclosed real estate held for sale, except when the foreclosed real estate was previously owned by the lender and accounted for under FASB Statement No. 67, in which case such foreclosed assets should be accounted for under FASB Statement No. 67.

## **Foreclosed Assets Held for the Production of Income**

.15 After foreclosure, assets determined to be held for the production of income (and not held for sale) should be reported and accounted for in the same way that they would be had the assets been acquired other than through foreclosure.

## **Change in Classification**

.16 If it is subsequently decided that a foreclosed asset classified as held for sale will be held for the production of income, the asset should be reclassified from the held-for-sale category. The reclassification should be made at the amount the asset's carrying amount would have been had the asset been held for the production of income since the time of foreclosure. Selling costs included in the valuation allowance should be reversed. The net effect should be reported in income from continuing operations in the period in which the decision not to sell the asset is made.

## **Effective Date and Transition**

.17 This SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992, with earlier application permitted. On initial application of this SOP, all enterprises should adjust the carrying amount of foreclosed assets held for sale to the lower of (a) the fair value of the asset minus the estimated costs to sell the asset or (b) the cost of the asset as of the date of the initial adoption of this SOP. For many enterprises, adoption of this SOP will result in a change in accounting principle. The nature of the change should be disclosed in the financial statements of the period in which the change is made. Any adjustment arising from the initial application of this SOP should be included in income from continuing operations in the period in which the change is made. No restatement of previously issued financial statements or cumulative-effect adjustment as of the beginning of the year this SOP is first applied is permitted.

## Appendix

### Discussion of Major Comments on the Exposure Draft

A-1. This appendix summarizes considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP.

A-2. In the exposure draft, AcSEC concluded that there is a rebuttable presumption that foreclosed assets are held for sale and that foreclosed assets held for sale should be carried at the lower of cost or fair value minus the estimated costs to sell. Few respondents objected to those conclusions.

### Held-for-Sale Presumption

A-3. Some respondents requested more explanation of the circumstances under which the held-for-sale presumption could be rebutted. After considering the concerns expressed by respondents about the rebuttable presumption, AcSEC decided not to give detailed, specific guidance, thereby allowing for the exercise of judgment in determining whether the presumption is rebutted by the facts in particular circumstances.

A-4. AcSEC recognizes that some enterprises may hold foreclosed assets for several years before sale and may even operate the assets, but concludes that a holding period in excess of one year does not, in and of itself, rebut the held-for-sale presumption. Further, AcSEC notes that if the form of the foreclosed asset is a majority interest in an enterprise, FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, requires the subsidiary to be consolidated unless control is likely to be temporary.

### Fair Value

A-5. Some respondents requested guidance on the determination of fair value. AcSEC recognizes that estimating fair value requires judgment. AcSEC concluded, however, that it would be inappropriate and is unnecessary to develop a new definition of fair value in this SOP, and that the definition of fair value in FASB Statement No. 15 should be used in this SOP. Moreover, AcSEC believes that the following discussion about fair value from Statement No. 15, particularly paragraph 82, will be helpful in implementing this SOP.

#### *Concept of Fair Value*

79. Some respondents to the Exposure Draft continued to argue that all troubled debt restructurings should be accounted for as modifications of the terms of debt and that none should be accounted for as transfers of assets (paragraphs 66 and 67). Others accepted the need to account for some troubled debt restructurings as asset transfers but held that obtaining assets through foreclosure or repossession under terms included in lending agreements should be distinguished from obtaining assets in exchange for cash or in other "asset swaps." They contended that (a) only the form of the asset is changed by foreclosure or repossession, (b) the substance of a secured loan is that the lender may choose either to postpone receipt of cash or take the asset to optimize cash receipts and recovery of its investment, and (c) foreclosure or repossession is not the completion of a lending transaction but merely a step in the transaction that begins with lending cash and ends with collecting cash.

80. The Board rejected those arguments for the reasons given in paragraphs 71-77, emphasizing that an event in which (a) an asset is transferred between debtor and creditor, (b) the creditor relinquishes all or part of its claim against the debtor, and (c) the debtor is absolved of all or part of its obligation to the creditor is the kind of event that is the basis of accounting under the existing

transaction-based accounting framework. To fail to recognize an event that fits the usual description of a transaction and to recognize only the lending and collection of cash as transactions would significantly change the existing accounting framework.

81. Use of the fair value of an asset transferred to measure the debtor's gain on restructuring and gain or loss on the asset's disposal or the creditor's cost of acquisition is not adopting some kind of "current value accounting." On the contrary, that use of fair value is common practice within the existing accounting framework. Paragraph 13 of this Statement explains briefly the meaning of *fair value* and refers to *APB Opinions No. 16, No. 21, and No. 29*, which use *fair value* in the same way and provide guidance about determining fair values within the existing accounting framework. The term *fair value* is used in essentially the same way as *market value* was used in the Discussion Memorandum to denote a possible attribute to be measured at the time a debt is restructured. *Fair value* is defined in paragraph 181 of *APB Statement No. 4* as "the approximation of exchange price in transfers in which money or money claims are not involved." Although a "money claim" is necessarily involved in transferring assets to settle a payable in a troubled debt restructuring, the troubled circumstances in which the transfer occurs make it obvious that the amount of the "money claim" does not establish an exchange price. Determining fair value of the assets transferred in a troubled debt restructuring is usually necessary to approximate an exchange price for the same reasons that determining fair value is necessary to account for transfers of assets in nonmonetary transactions (*APB Opinion No. 29*).

82. That point is emphasized in this Appendix because some respondents to the Exposure Draft apparently misunderstood the concept of fair value (paragraph 11 of the Exposure Draft and paragraph 13 of this Statement) and the discounting of expected cash flows specified in those paragraphs. *Paragraph 13 permits discounting of expected cash flows from an asset transferred or received in a troubled debt restructuring to be used to estimate fair value only if no market prices are available either for the asset or for similar assets. The sole purpose of discounting cash flows in that paragraph is to estimate a current market price as if the asset were being sold by the debtor to the creditor for cash. That estimated market price provides the equivalent of a sale price on which the debtor can base measurement of a gain on restructuring and a gain or loss on disposal of the asset and the equivalent of a purchase price on which the creditor can measure the acquisition cost of the asset. To approximate a market price, the estimate of fair value should use cash flows and discounting in the same way the marketplace does to set prices—in essence, the marketplace discounts expected future cash flows from a particular asset "at a rate commensurate with the risk involved" in holding the asset. An individual assessment of expected cash flows and risk may differ from what the marketplace's assessment would be, but the procedure is the same. [Emphasis added by AcSEC.]*

83. In contrast to the purpose of paragraph 13, *AICPA Statement of Position No. 75-2*<sup>31</sup> is concerned with different measures—net realizable value to a creditor of a receivable secured by real property and net realizable value of repossessed or foreclosed property. Its method of accounting for assets obtained by foreclosure or repossession thus differs from the method specified in this Statement. It proposes discounting expected cash flows at a rate based on the creditor's "cost of money" to measure the "holding cost" of the asset until its realizable value is collected in cash. The concept of fair value in paragraph 13 does not involve questions of whether interest is a "holding cost" or "period cost" because it is concerned with estimating market price, not net realizable value, however defined. Accounting for transfers of assets in troubled debt restructurings and for the assets after transfer is, of course, governed by this Statement.

<sup>31</sup> See paragraphs 59 and 60 of this Statement.

[Note: Paragraph 13 of Statement of Position 75-2, *Accounting Practices of Real Estate Investment Trusts*, has been effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. [Footnote added, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]]

## Results of Operations Related to Foreclosed Assets Held for Sale

**A-6.** In the exposure draft, AcSEC proposed that there should be no results of operations—revenues and expenses—from foreclosed assets while they are held for sale; net cash receipts related to foreclosed assets during the holding period would have been credited to the carrying amount of the asset, and net cash payments, except for capital additions and improvements, would have been charged to income as a loss on holding the foreclosed assets. Further, in the exposure draft, AcSEC concluded that no depreciation, depletion, or amortization expense should be recorded. Many respondents objected to the exclusion of the results of operating a foreclosed asset from income; many also objected to crediting net cash receipts to the carrying amount of the asset and charging net cash payments to income. They raised questions about the conservatism of such treatment, about whether the treatment was conceptually sound, and about whether it would be practical to implement. Some comment letters also raised questions about whether it is appropriate not to depreciate foreclosed assets held for sale. After considering the comments, AcSEC decided not to adopt the method proposed in the exposure draft.

**A-7.** AcSEC considered various other ways to account for operations during the period foreclosed assets are held for sale, such as—

- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance and depreciation expense on depreciable assets, for each reporting period as a gain or loss on holding the asset.
- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance and depreciation expense on depreciable assets held or expected to be held for more than a specified length of time (for example, one year).
- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance, and recognizing no depreciation expense.
- Crediting or debiting the net of revenues and expenses to the asset, and recognizing no depreciation expense. Changes in the valuation allowance would be included in income.

AcSEC believes that it should consider those options further and that its ultimate decision on the treatment of operations during the period foreclosed assets are held for sale should be exposed for public comment; AcSEC intends to undertake such a project. However, because AcSEC believes that its conclusion that foreclosed assets held for sale should be carried at the lower of fair value minus estimated costs to sell or cost would not change regardless of its conclusions on operations of foreclosed assets, AcSEC decided that it should issue the guidance in this SOP now, rather than delay issuing the guidance until the results of operations issues are resolved.



## Foreclosed Assets Held for the Production of Income

**A-8.** In the exposure draft, AcSEC proposed to require that foreclosed assets held for the production of income be carried at an amount not greater than the assets' net realizable value. AcSEC decided to eliminate that statement.

### Change in Classification

**A-9.** AcSEC also decided that, on reclassification of a foreclosed asset from the held-for-sale category, the asset should be measured and recorded as if the asset had been held for the production of income since foreclosure. That decision is consistent with the consensus of the Emerging Issues Task Force in Issue 2 of Issue 90-6, where the reversal of a decision to sell an asset acquired in a business combination gives rise to an accounting as if the asset had never been held for sale.

### In-Substance Foreclosed Assets

**A-10.** Many respondents asked for specific guidance on in-substance foreclosed assets, and they asked whether the SOP would apply to such assets. AcSEC concluded that, except for paragraphs .12 and .17, the guidance in this SOP need not be applied to in-substance foreclosures for the following reasons:

- a. The accounting for in-substance foreclosed assets was not explicitly addressed in the exposure draft.
- b. AcSEC would have found it difficult to resolve issues concerning senior debt related to in-substance foreclosed assets.

However, AcSEC notes that paragraph 34 of FASB Statement No. 15; paragraph 6 of AICPA Practice Bulletin 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed* [section 12,070.06\*]; and SEC Financial Reporting Release 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities*, include accounting guidance related to in-substance foreclosed assets indicating that in-substance foreclosed assets should be accounted for in the same way as assets that have actually been foreclosed or repossessed. Further, AcSEC concluded that for purposes of applying this SOP, the held-for-sale presumption could not be rebutted for in-substance foreclosed assets. Accordingly, after in-substance foreclosure, an in-substance foreclosed asset, like a foreclosed asset held for sale, would be reported in the balance sheet at the lower of (a) fair value minus estimated costs to sell or (b) cost.

### Carrying Amount of Assets at Foreclosure

**A-11.** Some respondents expressed concerns and opinions about the carrying amount of the foreclosed assets to be recognized at foreclosure. The exposure draft indicated that the attribute to be recognized at foreclosure should be the fair value of the collateral, implying that, if at the time of foreclosure the fair value of the collateral is greater than the recorded investment in the related loan, a credit to income would result. Some respondents suggested that no such credits should be permitted and that the carrying amount of the asset recognized at foreclosure should be the lower of the fair value of the collateral or the

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\* Practice Bulletin 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed*, was withdrawn in December 1994 by the Accounting Standards Executive Committee. [Footnote added, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

recorded investment in the loan. Notwithstanding those concerns, AcSEC notes that paragraph 28 of FASB Statement No. 15 requires that foreclosed assets be accounted for at their fair value at the time of foreclosure.

**A-12.** Some respondents also said that the definition of *fair value*, which is the definition in paragraph 13 of FASB Statement No. 15, implicitly contains a reduction for selling costs. For purposes of applying this SOP, AcSEC believes that the definition of fair value in paragraph 13 of FASB Statement No. 15 should be viewed as the cash sales/purchase price in a principal-to-principal transaction wherein no agents, dealers, brokers, or commission merchants are involved. If either principal decides to involve and pay outsiders to assist that principal, or to bring principals together, any amount paid by that principal is independent of the fair value of the asset and does not affect that fair value. Accordingly, immediately after foreclosure, a valuation allowance related to foreclosed assets held for sale should be recognized for estimated costs to sell through a charge to income.

## Offsetting of Debt

**A-13.** Contrary to what was proposed by AcSEC in the exposure draft, some respondents suggested that nonrecourse senior debt not assumed by the holder of the foreclosed asset be offset against the carrying amount of the asset. To protect its interest in the asset, the holder of the asset will have to settle the debt or have a subsequent transferee take the asset subject to the debt. If debt is offset, leverage is not portrayed, and the degree of possible gain is obscured. Moreover, offsetting nonrecourse senior debt against a foreclosed asset would be inconsistent with the manner in which such debt is portrayed when assets are purchased for cash and there is related nonrecourse debt. Therefore, AcSEC reaffirms that senior debt should not be offset against the asset.

## Transition

**A-14.** Comments were specifically requested on the transition proposed in the exposure draft. Most respondents agreed that determining the cumulative effect of the change in accounting principle would either be impossible or possible only at significant cost for enterprises that do not have available the fair value of foreclosed assets at earlier balance sheet dates, and that a restatement of previously issued financial statements or a cumulative effect adjustment should not be required. Further, AcSEC concluded that, because one of the principal objectives of this SOP is to have consistent accounting of foreclosed assets, those two alternatives should not be permitted.

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(1991-1992)**

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The Accounting Standards Executive Committee (AcSEC) gratefully acknowledges the contributions of Walter Schuetze, a former AcSEC member, who served as project chairman.

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[The next page is 19,551.]



## Section 10,520

# **Statement of Position 92-5 Accounting for Foreign Property and Liability Reinsurance**

June 1, 1992

### **NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## **Introduction**

.01 The promulgation of rules and regulations by state insurance departments and the adoption of specialized insurance industry accounting standards by the Financial Accounting Standards Board (FASB) have resulted in considerable uniformity in accounting practices in the insurance industry in the United States. Outside the United States, insurance accounting and reporting practices vary widely. The diversity in insurance accounting and reporting practices of foreign insurance companies has led to questions on how U.S. insurance companies should account for property and liability reinsurance assumed from foreign companies (foreign reinsurance).

.02 Reinsurers assuming business from domestic companies have historically had sufficient information to monitor and account for contract results. In contrast, some reinsurers assuming business from foreign companies do not receive such information, because in some foreign jurisdictions, insurance companies' accounting and reporting practices concerning periodic recognition of revenue and incurred claims are substantially different from U.S. practices. Therefore, reinsurers assuming business from foreign ceding companies cannot always obtain sufficient information to periodically estimate earned premiums for the business assumed from the foreign ceding companies.

.03 A significant amount of reinsurance is transacted through syndicates organized by Lloyd's of London. Lloyd's syndicates report the amounts of premiums, claims, and expenses recorded in an underwriting account for a particular year to the assuming companies that participate in the syndicates. The syndicates generally keep accounts open for three years. Traditionally, three years have been necessary to report substantially all premiums associated with an underwriting year and to report most related claims, although

claims may remain unsettled after the account is closed. A Lloyd's syndicate typically closes an underwriting account by reinsuring outstanding claims on that account with a syndicate for the next underwriting year. The ceding syndicate pays the assuming syndicate an amount based on the unearned premiums and outstanding claims in the underwriting account at the date of the assumption and distributes the remaining balance to its participants.

## Current Practices

.04 Three methods are currently used in the United States to account for foreign property and liability reinsurance: the periodic method, the zero balance method, and the open year method.

### Periodic Method

.05 The periodic method of accounting for reinsurance provides for current recognition of profits and losses. It is used when ultimate premiums and the period of recognition can be reasonably estimated currently. Premiums are recognized as revenue over the policy term, and claims, including an estimate of claims incurred but not reported, are recognized as they occur. The periodic method is consistent with current practice for primary insurance and domestic reinsurance for which sufficient information is available to reasonably estimate and recognize earned premiums and related claims. (Refer to FASB Statement of Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises*.)

.06 Some foreign ceding companies maintain the information necessary to estimate earned premiums, incurred claims, and related expenses currently. As a result, U.S. reinsurers doing business with these foreign ceding companies are able to account for reinsurance assumed by applying the same periodic method of accounting that they use to account for domestic reinsurance. Although not all foreign ceding companies maintain and report current information necessary to estimate earned premiums, incurred claims, and related expenses, some U.S. reinsurers have sufficient experience with the foreign business assumed to estimate earned premiums. When earned premiums can be estimated, sufficient information usually exists to estimate incurred claims and related expenses. Anticipated results based on either the reinsurer's experience or reported data make it possible to reasonably estimate underwriting results and use the periodic method.

### Zero Balance Method

.07 Many foreign ceding companies do not maintain the information necessary to estimate earned premiums. As a result, U.S. reinsurers doing business with these foreign companies generally are not able to apply the periodic method of accounting. Some of these companies use the zero balance method, which is a modified cash basis of accounting. This method is similar to the cost recovery method described in FASB Statement No. 60, paragraph 14. Because of the inherent lag in reporting claims, profits reported by foreign ceding companies in early years often exceed the total profits that will ultimately be realized. To avoid reporting overstated profits, companies using this method adjust the records with arbitrary provisions for claims incurred in amounts that exactly offset the cash basis profits.

### Open Year Method

.08 Under the open year method, underwriting results of foreign reinsurance are not included in the income statement until sufficient information be-

comes available to provide reasonable estimates of earned premiums. The open year method is similar to the deposit method as defined in FASB Statement No. 60. Because the measurement period extends over more than one accounting period, premiums, claims, and expenses are not immediately included in operating results. Instead, they are accumulated and reported in the balance sheet as an open underwriting balance. The underwriting balance is disaggregated and reported in the income statement as premiums, claims, and expenses only when earned premiums become reasonably determinable. If it is probable that a loss has been incurred before an underwriting balance is closed, a provision for a loss generally is recorded. Examples of situations in which a provision may be recorded before an underwriting balance is closed include catastrophic losses, higher-than-expected claim frequency, significant unanticipated adverse events, or a negative open year account. The accounting treatment is similar to that for premium deficiencies described in FASB Statement No. 60, paragraph 32.

## Comparison With Practices in Other Industries

.09 Deferral of revenue occurs in industries that sell goods subject to rights of return. If a right of return exists, current recognition of a sale is not permitted unless the amount of future returns is reasonably estimable. If that amount is not reasonably estimable, recognition of income is postponed until the return privilege has substantially expired. Income recognition is also postponed for certain real estate sales through the use of the installment and cost recovery methods. Those methods are analogous to the open year method.

## Discussion

.10 Methods that defer recognition of underwriting profits raise financial accounting issues concerning (a) whether premiums and claims should be reported as income currently, even though the related underwriting balance<sup>1</sup> is deferred, and (b) whether the underwriting balance should be recorded as deferred income or as an addition to claim liabilities. Most companies that follow the zero balance method record premium and claim amounts currently and defer recognition of profits by additions to claim liabilities. Although this presentation provides timely information on the volume of business being conducted by the enterprise, the usefulness of the information is limited because the related profit margins are not also reported.

.11 Current accounting literature supports alternative methods of financial presentation when profit recognition is deferred. For example, recognition as income of both revenues and related costs is deferred under the completed contract method until the contract is substantially completed. However, if either the installment method or cost recovery method is used to defer the recognition of gain on the sale of real estate, the sale and related costs are ordinarily reported on the date of the transaction. The deferred profit is reported separately in the income statement as a deduction from sales in the year the transaction occurs and as a separate item of revenue in future years' income statements, when the profit is recognized.

.12 Proponents of presenting premiums, claims, and expenses in the income statement when the amounts are reported to the reinsurer point out

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<sup>1</sup> The term *underwriting balance* refers to the excess of reported premiums over reported claims and expenses. This amount is not intended to represent income realized on a contract.

that excluding those amounts from the income statement until an underwriting year is closed does not reflect the economic substance of current period activities under the reinsurance contract. In response to criticism that presentation of the amounts in the income statement may cause profit margins to be misstated, they argue that disclosure of profits deferred and profits recognized provides sufficient information for users to evaluate operating results.

.13 Proponents of reporting deferred amounts in the balance sheet until the profits relating to the underwriting year are recognized point out that the income statement should reflect profit margins associated with the premium volume reported in the income statement, and that this can best be done by recognizing the related premiums in the periods the profits are recognized. They acknowledge that premiums, claims, and expenses associated with a contract in a period may be important information to users, but they argue that the information could be disclosed in the notes to the financial statements or in the statement of cash flows to avoid misstating the profit margins.

## Conclusions

.14 The periodic method should be used to account for foreign reinsurance except in the circumstance described in paragraph .15.

.15 If, due to local revenue recognition policies, the foreign ceding company cannot provide the information required by the assuming company to estimate both the ultimate premiums and the appropriate periods of recognition in accordance with U.S. generally accepted accounting principles, then the open year method should be used.<sup>2</sup> The presence of uncertainties that may be inherent in estimating earned premiums is not an acceptable basis for using the open year method. As discussed in paragraph .08, premiums, claims, commissions, and related direct taxes should not be reported currently as income under the open year method; instead, they should be included in the open underwriting balance to which they pertain. The underwriting balances should be aggregated and included in the balance sheet as a liability. Each underwriting balance should be kept open until sufficient information becomes available to record a reasonable estimate of earned premiums. The underwriting balance should be disaggregated and reported in the income statement as premiums, claims, commissions, and related direct taxes when earned premiums are reasonably determinable.

.16 If it becomes probable that a loss has been incurred before an underwriting balance is closed, a provision for the loss should be recorded.

.17 The periodic and open year methods are not interchangeable in the same circumstances. The periodic method should be used to account for foreign reinsurance. Only if reasonable estimates cannot be made currently, for the reason discussed in paragraph .15, should the open year method be used. The periodic and open year methods are not alternative accounting principles as discussed in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*. Rather, one or the other is to be used depending on the circumstances. As such, changes between these methods are not accounting changes. In addition, changes from the periodic method to the open year method would be seldom.

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<sup>2</sup> If the foreign ceding company maintains supplementary records that are sufficient to reasonably estimate earned premiums currently, then the U.S. assuming company should obtain the necessary information and use the periodic method to account for the foreign reinsurance.



.18 The zero balance method should not be used because it results in misstatement of the income statement by arbitrarily recognizing revenues and costs. The method also causes the profit to be reported in periods other than those in which the related premiums, claims, and expenses are reported.

## Disclosures

.19 Disclosure in the financial statements of an insurance company's accounting policies should include a description of the methods used to account for foreign reinsurance. In addition, for foreign reinsurance accounted for by the open year method, the following should be disclosed for each period for which an income statement is presented:

- The amounts of premiums, claims, and expenses recognized as income on closing underwriting balances
- The additions to underwriting balances for the year for reported premiums, claims, and expenses.

Also, the amounts of premiums, claims, and expenses in the underwriting account should be disclosed for each balance sheet presented.

## Effective Date and Transition

.20 This SOP should be applied prospectively to contracts or arrangements covered by it and entered into in fiscal years beginning on or after December 15, 1992. Retroactive application, by restating all prior years presented, is encouraged but not required.

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The task force gratefully acknowledges the contributions of the late John E. Hart, formerly the task force chairman.

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[The next page is 19,581.]

**Section 10,530****Statement of Position 92-6  
Accounting and Reporting by Health and  
Welfare Benefit Plans****August 3, 1992****NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Statement of Position (SOP) 92-6 is amended by SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*. SOP 94-4 is effective for financial statements for plan years beginning after December 15, 1994, except that the application of SOP 94-4 to investment contracts entered into before December 15, 1993, is delayed to plan years beginning after December 15, 1995. Earlier application of SOP 94-4 is encouraged. Accounting changes adopted to conform to the provisions of SOP 94-4 should be made as of the beginning of the year in which the change is adopted. The effect of initially applying SOP 94-4 should be reported in a manner similar to the cumulative effect of a change in accounting principle (APB Opinion No. 20, *Accounting Changes*, paragraph 20). Pro forma effects of retroactive application (APB Opinion No. 20, paragraph 21) are not required. Restatement of financial statements of prior years is not permitted.

**Scope**

- .01** Health and welfare benefit plans include plans that provide—
- a. Medical, dental, visual, psychiatric, or long-term health care; life insurance (offered separately from a pension plan); certain severance benefits; or accidental death or dismemberment benefits.
  - b. Benefits for unemployment, disability, vacations, or holidays.
  - c. Other benefits such as apprenticeships, tuition assistance, day care, dependent care, housing subsidies, or legal services.

This statement of position (SOP) applies to both defined-benefit and defined-contribution health and welfare benefit plans (referred to hereafter as *health and welfare benefit plans*).

**.02** Defined-benefit health and welfare plans specify a determinable benefit, which may be in the form of a reimbursement to the covered plan participant or a direct payment to providers or third-party insurers for the cost of specified services. Such plans may also include benefits that are payable as a lump sum, such as death benefits. The level of benefits may be defined or limited based on factors such as age, years of service, and salary. Contributions may be determined by the plan's actuary or be based on actual claims paid or other factors determined by the plan sponsor. Even when a plan is funded pursuant to agreements that specify a fixed rate of employer contributions (for example, a collectively bargained multiemployer plan), such a plan may nevertheless be a defined-benefit health and welfare plan if its substance is to provide a defined benefit.

**.03** Defined-contribution health and welfare plans maintain an individual account for each plan participant. They have terms that specify the means of determining the contributions to participants' accounts, rather than the amount of benefits the participants are to receive. The benefits a plan participant will receive are limited to the amount contributed to the participant's account, investment experience, expenses, and any forfeitures allocated to the participant's account. These plans also include flexible spending arrangements.

**.04** Health and welfare benefit plans generally are subject to certain fiduciary, reporting, and other requirements of the Employee Retirement Income Security Act of 1974 (ERISA). Plans that are unfunded (that is, those whose benefits are paid solely and directly out of the general assets of the employer), are fully insured (through the direct payment of premiums to the insurance company by the employer; see paragraphs .14 and .15), or are certain combinations thereof (for example, self-funded plans with stop-loss coverage; see paragraph .17) may not be required to include financial statements in their ERISA filings.<sup>1</sup> An understanding of the health and welfare benefit plan is needed to determine its accounting and reporting requirements. It is also important to consider the new forms of funding vehicles that are emerging, particularly with respect to postretirement health benefits.

**.05** This SOP describes generally accepted accounting principles (GAAP) that are particularly important to defined-benefit and defined-contribution health and welfare plans. Generally accepted accounting principles other than those discussed in this SOP may also apply. This SOP does not address the preparation of financial statements on a comprehensive basis of accounting other than GAAP; however, the presentation of a plan's benefit obligation information in GAAP-basis financial statements, as required by paragraph .20, is consistent with the disclosures required in financial statements prepared on such bases as the cash basis or modified cash basis, as defined by the requirements of financial reporting to the Department of Labor (DOL).

**.06** The most significant changes in accounting and reporting by health and welfare benefit plans that this SOP makes to the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* are the following:

- The objective of financial reporting by a defined-benefit health and welfare plan has been clarified and is the same as the objective of financial reporting by a defined-benefit pension plan (see paragraph .19).

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<sup>1</sup> Refer to appendix A of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*.

- Single-employer, multiemployer, and multiple-employer defined-benefit health and welfare plans should account for and separately report benefit obligations, including postretirement benefit obligations (see paragraphs .41 through .54). Information regarding benefit obligations should be presented on the face of one or more financial statements. Note disclosure is not appropriate (see paragraph .20).
- The requirement to recognize claims incurred but not reported (IBNR) has been clarified. For a self-funded plan, the cost of IBNR includes the present value of the estimated ultimate cost of settling the claims, including estimated costs to be incurred after the financial statement date (for example, the cost of disability; see paragraph .44).
- Benefit obligations should not include death benefits actuarially expected to be paid during the active service period of participants (see paragraph .41).
- Defined-contribution health and welfare plans are distinguished from defined-benefit health and welfare plans (see paragraphs .03 and .23).
- The calculation of the obligation for accumulated eligibility credits has been clarified and generally should consider mortality rates and the probability of employee turnover (see paragraph .48).

**.07** Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, does not apply to health and welfare benefit plans; however, as set forth in the guide, the methods of valuing plan investments and requirements for financial statement disclosures are the same as those specified in FASB Statement No. 35 and are not changed by this SOP.

**.08** FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, establishes standards of financial accounting and reporting by employers for health and welfare benefits expected to be provided to a participant during retirement. While FASB Statement No. 106 does not apply to health and welfare benefit plans, this SOP adopts certain of its measurement concepts (see paragraphs .49 through .54). Terminology used in discussing postretirement benefits in this SOP is intended to follow usage and definitions provided in FASB Statement No. 106.

**.09** FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, applies to financial instruments of a pension plan other than the plan's obligation for pension benefits. This SOP conforms to the relevant disclosure requirements of FASB Statement No. 105 for financial instruments of health and welfare benefit plans other than obligations for benefits (see paragraph .58).

## Background

**.10** Plan participants may be active or terminated employees (including retirees), as well as covered dependents and beneficiaries, of a single employer or group of employers. Employer contributions may be voluntary or required under the terms of a collective bargaining agreement negotiated with one or more labor organizations. Plans may require contributions from employers and participants (contributory plans) or from employers only (noncontributory plans). During periods of unemployment, a noncontributory plan may require contributions by participants to maintain their eligibility for benefits. Benefits

may be provided through insurance contracts paid for by the plan (an insured plan), from net assets accumulated in a trust established by the plan (a self-funded plan), or both.

.11 As noted above, a plan may establish a trust to hold assets to pay all or part of the covered benefits. The assets may be segregated and legally restricted under a trust arrangement (such as a voluntary employees' beneficiary association or a 501(c)(9) trust, a 401(h) account, or other funding vehicles). Generally, if a separate trust exists, financial statements are required under ERISA. A trust always exists for a multiemployer plan. Such trustee plans with more than 100 participants generally will require an audit. For ERISA filings, the DOL will not accept an accountant's report that covers the assets of more than one plan. For example, where the assets of more than one plan are held in a 501(c)(9) Voluntary Employees' Beneficiary Association (VEBA) trust, separate reports must be prepared for each plan. If the trustee of the VEBA is a bank or trust company, and the trust holds the assets of more than one plan sponsored by a single employer or by a group of companies under common control, it is a master trust subject to the DOL's master trust filing requirements.

.12 A health and welfare plan may process benefit payments directly or it may retain a third-party administrator (see paragraph .18). In either case, a plan that is fully or partially self-funded is obligated for the related benefits (see paragraphs .41 through .54).

## Arrangements With Insurance Companies

.13 The nature of, and method of accounting for, the assets and benefit obligations of a health and welfare benefit plan may be determined by the arrangement with the insurance company. The insurance company may assume all or a portion of the financial risk (see paragraphs .14 through .17), or it may provide only administrative services (see paragraph .18) or investment management services.<sup>2</sup> It is important to have an understanding of the insurance arrangement to determine whether any or all of the risks associated with benefit payments or claims have been transferred to the insurance company. Also, other arrangements are being developed that may involve new types of contracts that involve other parties, including those involving payments to providers, risk sharing of administrative expense with carriers, and so on. Details of these arrangements must also be reviewed carefully.

.14 In a fully insured, pooled arrangement, specified benefits are covered by the insurance company. The insurance company pools the experience of the plan with that of other similar businesses and assumes the financial risk of adverse experience. In such an arrangement, a plan generally has no obligation for benefits covered by the arrangement other than the payment of premiums due to the insurance company (see paragraph .45).

.15 In a fully insured experience-rated arrangement, specified benefits are paid by the insurance company that assumes all the financial risk. Contract experience is monitored by the insurance company. Contract experience may or may not include the experience of other similar contract holders. To the extent that benefits incurred plus risk charges and administration costs are less than premiums paid, the plan is entitled to an experience-rating refund or dividend (see paragraphs .34 and .35). If the total of benefits incurred, risk charges, and administrative costs exceeds premiums, the accumulated loss

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<sup>2</sup> Refer to chapter 7 of the guide.

is generally borne by the insurance company but may be carried over to future periods until it has been recovered (see paragraphs .46 and .47). The plan often has no obligation to continue coverage or to reimburse the carrier for any accumulated loss, although there are certain types of contracts that require additional payments by the plan.

.16 In a minimum premium plan arrangement, specified benefits are also paid by the insurance company. The insurance contract establishes a dollar limit, or *trigger point*. All claims paid by the insurance company below the trigger point are reimbursed by the plan to the insurance company. The insurance company is not reimbursed for benefits incurred that exceed the trigger point. This type of funding arrangement requires the plan to fund the full claims experience up to the trigger point. Minimum premium plan arrangements may have characteristics of both self-funded and fully insured experience-rated arrangements. Details of each arrangement must be reviewed carefully to determine the specific benefit obligations assumed by the insurance company.

.17 In a stop-loss insurance arrangement, a plan's obligation for any plan participant's claims may be limited to a fixed dollar amount, or the plan's total obligation may be limited to a maximum percentage (for example, 125 percent) of a preset expected claims level. These arrangements are commonly used with administrative service arrangements. The insurance company assumes the benefit obligation in excess of the limit. Stop-loss insurance arrangements may have characteristics of both self-funded and fully insured arrangements. Stop-loss arrangements of this type may be described by a variety of terms; therefore, details of all insurance or administrative arrangements should be reviewed carefully to determine if stop-loss provisions are included and to determine the specific benefit obligations assumed by the insurance company.

.18 In an administrative service arrangement, the plan retains the full obligation for plan benefits. The plan may engage an insurance company or other third party to act as the plan administrator. The administrator makes all benefit payments, charges the plan for those payments, and collects a fee for the services provided.

## Financial Statements of Defined-Benefit Health and Welfare Plans

.19 The objective of financial reporting by defined-benefit health and welfare plans is the same as that of defined-benefit pension plans; both types of plans provide a determinable benefit. Accordingly, the primary objective of the financial statements of a defined-benefit health and welfare plan is to provide financial information that is useful in assessing the plan's present and future ability to pay its benefit obligations when due. To accomplish that objective, a plan's financial statements should provide information about (a) plan resources and the manner in which the stewardship responsibility for those resources has been discharged, (b) benefit obligations, (c) the results of transactions and events that affect the information about those resources and obligations, and (d) other factors necessary for users to understand the information provided.<sup>3</sup>

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<sup>3</sup> It should be recognized that (a) information in addition to that contained in a plan's financial statements is needed in assessing the plan's present and future ability to pay its benefit obligations when due and (b) financial statements for several plan years may provide more useful information in assessing the plan's future ability to pay benefit obligations than can financial statements for a single year.

**.20** The financial statements of a defined-benefit health and welfare plan prepared in accordance with GAAP<sup>4</sup> should be prepared on the accrual basis of accounting and include—

- A statement of net assets available for benefits as of the end of the plan year (see paragraphs .25 through .38).
- A statement of changes in net assets available for benefits for the year then ended (see paragraphs .39 and .40).
- Information regarding the plan's benefit obligations as of the end of the plan year (see paragraphs .41 through .54).
- Information regarding the effects, if significant, of certain factors affecting the year-to-year change in the plan's benefit obligations (see paragraphs .55 and .56).

Information regarding the benefit obligations should be presented on the face of one or more financial statements. The information should be presented in such reasonable detail as is necessary to identify the nature and classification of the obligations.<sup>5</sup>

**.21** FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, provides that employee benefit plans other than pension plans (such as health and welfare plans, both defined benefit and defined contribution) that provide information similar to that required by FASB Statement No. 35 are not required to provide a statement of cash flows. However, FASB Statement No. 102 encourages that a statement of cash flows be included in the financial statements of an employee benefit plan when such a statement would provide relevant information about the ability of the plan to meet future obligations (for example, when the plan invests in assets that are not highly liquid or obtains financing for investments).

## Financial Statements of Defined-Contribution Health and Welfare Plans

**.22** The objective of financial reporting by a defined-contribution health and welfare plan is to provide financial information that is useful in assessing the plan's present and future ability to pay its benefits when due. To accomplish that objective, a plan's financial statements should provide information about (a) plan resources and the manner in which the stewardship responsibility for those resources has been discharged, (b) the results of transactions and events that affect the information about those resources, and (c) other factors necessary for users to understand the information provided.<sup>6</sup>

**.23** The financial statements of a defined-contribution health and welfare plan prepared in accordance with GAAP<sup>7</sup> should be prepared on the accrual basis of accounting and include—

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<sup>4</sup> Financial statements prepared on a comprehensive basis of accounting other than GAAP should disclose information regarding benefit obligations (see paragraphs 13.19 through 13.22 of the guide, which discuss auditor's report considerations).

<sup>5</sup> The appendix (paragraph .67) of this SOP provides illustrative financial statements of two health and welfare benefit plans.

<sup>6</sup> See footnote 3.

<sup>7</sup> See footnote 4.



- A statement of net assets available for benefits of the plan as of the end of the plan year (see paragraphs .25 through .38).
- A statement of changes in net assets available for benefits of the plan for the year then ended (see paragraphs .39 and .40).

Because a plan's obligation to provide benefits is limited to the amounts accumulated in an individual's account, information regarding benefit obligations is not applicable.

## ERISA Reporting Requirements

.24 ERISA established annual reporting requirements for employee benefit plans, including health and welfare benefit plans.<sup>8</sup> The financial statements required by ERISA are a statement of assets and liabilities and a statement of changes in net assets available for benefits. The schedules required by ERISA include assets held for investment purposes, transactions with parties in interest, loans or fixed-income obligations due that are in default or uncollectible, leases that are in default or uncollectible, and reportable transactions.

## Statement of Net Assets Available for Benefits

### Investments

.25 Plan investments, whether they are in the form of equity or debt securities, real estate, or other investments (*excluding insurance contracts and fully benefit-responsive investment contracts held by defined-contribution health and welfare benefit plans*), should be reported at their fair value at the financial statement date.<sup>9</sup> The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value should be measured by the market price if there is an active market for the investment. If there is no active market for the investment but there is a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows, discounted at a rate commensurate with the risk involved, may be used to estimate fair value.<sup>10</sup> [As amended, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4.] (See section 10,620.)

.26 Insurance contracts, as defined by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, should be presented in the same manner as specified in the annual report filed by the plan with certain govern-

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<sup>8</sup> ERISA annual reporting requirements, as well as the common exemptions, are described in appendix A of the guide.

<sup>9</sup> The accrual basis of accounting requires that purchases and sales of securities be recorded on a trade-date basis. However, if the settlement date is later than the financial statement date and (a) the fair value of the securities purchased or sold just before the financial statement date does not change significantly from the trade date to the financial statement date and (b) the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

<sup>10</sup> For an indication of the factors to be considered in determining the discount rate, see paragraph 27 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*. The fair value of an investment should be reported net of the brokerage commissions and other costs normally incurred in a sale, if significant (see also paragraphs 2.09 and 2.10 of the guide).

mental agencies pursuant to ERISA; that is, either at fair value or at amounts determined by the insurance enterprise (contract value). Plans not subject to ERISA should present insurance contracts as if the plans were subject to the reporting requirements of ERISA. [As amended, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4.] (See section 10,620.)<sup>[11]</sup>

.27 Investment contracts held by defined-benefit health and welfare benefit plans should be reported at their fair values. [Paragraph added, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4.] (See section 10,620.)

.28 Defined-contribution health and welfare benefit plans provide benefits based on the amounts contributed to employees' individual accounts plus or minus forfeitures, investment experience, and administrative expenses. In such plans, plan participants have a vested interest in monitoring the financial condition and operations of the plan since they bear investment risk under these plans, and plan transactions can directly affect their benefits (for example, investment mix, and risk and return). [Paragraph added, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4.] (See section 10,620.)

.29 Plan assets of defined-contribution health and welfare benefit plans should be measured and reported at values that are meaningful to financial statement users including plan participants. The contract value of a *fully benefit-responsive* investment contract held by a defined-contribution health and welfare benefit plan is the amount a participant would receive if he or she were to initiate transactions under the terms of the ongoing plan. Defined-contribution health and welfare benefit plans should report fully benefit-responsive investment contracts at contract value, which may or may not be equal to fair value. If, however, plan management is aware that an event has occurred that may affect the value of the contract (for example, a decline in the creditworthiness of the contract issuer or third-party guarantor—if different from the contract issuer—or the possibility of premature termination of the contract by the plan), pursuant to FASB Statement No. 5, *Accounting for Contingencies*, disclosure of the event or reporting the investment at less than contract value may be appropriate. [Paragraph added, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4.] (See section 10,620.)

.30 *Benefit responsiveness* is the extent to which a contract's terms permit and require withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Investment contracts frequently are negotiated directly between the plan and the issuer and generally prohibit assignment of contracts or their proceeds to another party. Investment contracts must transfer the risk of principal and accrued interest to a financially responsible third party (that is, they provide for all participant-initiated transactions permitted by an ongoing plan at contract value with no conditions, limits, or restrictions) to be considered fully benefit-responsive. The plan itself must also allow plan participants reasonable access to their funds. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon

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<sup>[11]</sup> [Footnote deleted to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally not be deemed to be fully benefit-responsive. However, in plans with a single investment fund that allow reasonable access to assets by inactive participants, restrictions on access to assets by active participants consistent with the objective of the plan (for example, retirement or health and welfare benefits) will not affect the benefit responsiveness of the investment contracts held by those single-fund plans. Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control the administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan. In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed income investment options to limit arbitrage among those investment options (*equity wash* provisions) would not affect a contract's benefit responsiveness. [Paragraph added, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4.] (See section 10,620.)

.31 If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive. Contracts that provide for prospective interest adjustments may still be fully benefit-responsive provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero. [Paragraph added, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4.] (See section 10,620.)

.32 Information regarding a plan's investments should be presented in enough detail to identify the types of investments and should indicate whether reported fair values have been measured by quoted prices in an active market or have been determined otherwise (paragraph .58 specifies additional disclosures related to investments). [Paragraph renumbered by the issuance of Statement of Position 94-4.]

## Contributions Receivable

.33 Contributions receivable are the amounts due, as of the date of the financial statements, to the plan from employers, participants, and other sources of funding (for example, state subsidies or federal grants), each of which should be separately identified. They include amounts due pursuant to firm commitments, as well as legal or contractual requirements. With respect to employers' contributions, evidence of a formal commitment may include (a) a resolution by the employer's governing body approving a specified contribution; (b) a consistent pattern of making payments after the end of the plan year, pursuant to an established funding policy that attributes such subsequent payments to the preceding plan year; (c) a deduction of a contribution for federal income tax purposes for periods ending on or before the financial statement date; or (d) the employer's recognition as of the financial statement date of a contribution payable to the plan.<sup>12</sup> Contributions receivable should

<sup>12</sup> The existence of an accrued liability in the employer's statement of financial position or a plan's benefit obligations exceeding its net assets available for benefit obligations does not, by itself, provide sufficient support for recognition of a contribution receivable by the plan.

include an allowance for estimated uncollectible amounts. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

## **Deposits With and Receivables From Insurance Companies and Other Service Providers**

.34 Whether a premium paid to an insurance company represents payment for the transfer of risk or merely represents a deposit will depend on the circumstances of the arrangement. As noted earlier, the nature of payments made to an insurance company should be analyzed to determine the extent to which financial risk has been transferred from the plan to the insurance company. Insurance companies may require that a deposit be maintained that can be applied against possible future losses in excess of current premiums. These deposits should be reported as plan assets until such amounts are used to pay premiums. Similarly, premium stabilization reserves, which exist when premiums paid to an insurance company exceed the total of claims paid and other charges, are held by an insurance company and used to reduce future premium payments. Premium stabilization reserves generally should be reported as assets of the plan until such amounts are used to pay premiums. Disclosure of the nature of this type of deposit or reserve should be made. If such reserves are forfeitable if the insurance contract terminates, this possibility should be considered in recognizing this asset. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

.35 Certain group insurance contracts covering health and welfare benefit plans include a provision for a refund, at the end of the policy year, of the excess of premiums paid over the total of paid claims, required reserves, and the fee charged by the insurance company. Often such experience-rating refunds (or dividends) are not determined by the insurance company for several months after the end of the policy year. In this event, and in cases when the policy year does not coincide with the plan's fiscal year, the refund due as of the financial statement date should be reported as a plan asset if it is probable that a refund is due and the amount can be reasonably estimated. If the amount of the refund cannot be reasonably estimated, that fact should be disclosed. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

.36 Service providers may require that deposits by the plan be applied against claims paid on behalf of plan participants. Such deposits should be reported as plan assets until the deposit is applied against paid claims. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

## **Operating Assets**

.37 Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) should be reported at cost less accumulated depreciation or amortization. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

## **Accrued Liabilities**

.38 A plan may have liabilities (other than for benefits) that should be accrued. Such liabilities may be for amounts owed for securities purchased, income taxes payable by the plan, or other expenses (for example, third-party administrator fees). These liabilities should be deducted to arrive at net assets available for benefits. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

## Statement of Changes in Net Assets Available for Benefits

.39 The statement of changes in net assets available for benefits should be presented in enough detail to identify the significant changes during the year including, as applicable—

- Contributions from employers, segregated between cash and noncash contributions. A noncash contribution should be reported at fair value at the date of the contribution. The nature of noncash contributions should be described either parenthetically or in a note.
- Contributions from participants, including those collected and remitted by the sponsor.
- Contributions from other identified sources (for example, state subsidies or federal grants).
- The net appreciation or depreciation<sup>13</sup> in fair value for each significant class of investments, segregated between investments whose fair values have been measured by quoted prices in an active market and those whose fair values have been otherwise determined.
- Investment income, excluding the net appreciation or depreciation.
- Income taxes paid or payable, if applicable.
- Payments of claims, excluding payments made by an insurance company pursuant to contracts that are excluded from plan assets.
- Payments of premiums to insurance companies to purchase contracts that are excluded from plan assets.<sup>14</sup>
- Operating and administrative expenses.
- Other changes (such as transfers of assets to or from other plans), if significant.

[Paragraph renumbered by the issuance of Statement of Position 94-4.]

.40 The list of minimum disclosures is not intended to define the degree of detail or the manner of presenting the information, and subclassifications or additional classifications may be useful. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

## Benefit Obligations

.41 Benefit obligations<sup>15</sup> for health and welfare benefit plans should include the actuarial present value, as applicable, of the following:

- Claims payable and currently due for active and retired participants
- Premiums due under insurance arrangements
- Claims incurred but not reported to the plan for active participants<sup>16</sup>

<sup>13</sup> Net appreciation or depreciation includes realized gains and losses on investments that were both purchased and sold during the period. Ordinarily, information regarding the net appreciation or depreciation in the fair value of investments is found in the notes to the financial statements.

<sup>14</sup> Refer to paragraphs 7.25 and 7.26 of the guide for further discussion of allocated insurance contracts.

<sup>15</sup> Administrative expenses expected to be paid by the plan (not those paid by the sponsor) that are associated with providing benefit obligations shall be reflected by appropriately adjusting the assumed rates of return. The adjustment of the assumed rates of return shall be separately disclosed.

<sup>16</sup> IBNR may be computed in the aggregate for active participants and retirees. When the IBNR for retirees is not included in the postretirement benefit obligation, it may be included in claims incurred but not reported.

- Accumulated eligibility credits for active participants
- Postretirement benefits for—
  - Retired participants, including their beneficiaries and covered dependents
  - Active or terminated participants who are fully eligible to receive benefits
  - Active participants not yet fully eligible to receive benefits

Benefits expected to be earned for future service by active participants (for example, vacation benefits) during the term of their employment should not be included. Benefit obligations should be reported as of the end of the plan year.<sup>17</sup> The effect of plan amendments should be included in the computation of the expected and accumulated postretirement benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods. For example, if a plan amendment grants a different benefit level for employees retiring after a future date, that increased or reduced benefit level should be included in current-period measurements for employees expected to retire after that date. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

.42 As noted previously (see paragraph .20), information regarding benefit obligations may be presented either in a separate statement or with other information on another financial statement. However, all the information must be located in one place. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

## Claims

.43 In an insured health and welfare benefit plan, claims payable and currently due and claims incurred but not yet reported to the plan will be paid by the insurance company. Consequently, they should be excluded from the benefit obligations of the plan. Benefit obligations of a self-funded plan should present the amount of claims payable and currently due for active and retired participants, dependents, and beneficiaries and IBNR for active participants. IBNR for retired participants is included in the postretirement benefit obligation.<sup>18</sup> [Paragraph renumbered by the issuance of Statement of Position 94-4.]

.44 For a self-funded plan, the cost of IBNR should be measured at the present value, as applicable, of the estimated ultimate cost to the plan of settling the claims. Estimated ultimate cost should reflect the plan's obligation to pay claims to or for participants (for example, continuing health coverage or long-term disability), regardless of status of employment, beyond the financial statement date pursuant to the provisions of the plan or regulatory requirements. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

## Premiums Due Under Insurance Arrangements

.45 Benefits to participants may be provided through insurance arrangements that transfer the risks of loss or liability to an insurance company (see paragraphs .14 through .17). Group insurance contracts for health and welfare plans are usually written for a one-year period, although the contract may pro-

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<sup>17</sup> Postretirement benefit obligations should be determined as of the end of the plan year or, if used consistently from year to year, as of a date not more than three months prior to that date, in accordance with paragraph 72 of FASB Statement No. 106.

<sup>18</sup> See footnote 16.

vide for annual renewal. The contract generally specifies, among other things, the schedule of benefits, eligibility rules, premium rate per eligible participant, and the date that premiums are due. The benefit obligations should include any obligation for premiums due but not paid. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

**.46** If the insurance contract requires payment of additional premiums (for example, retrospective premiums) when the loss ratio exceeds a specified percentage, an obligation for the estimated additional premiums should be included in the benefit obligations. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

**.47** Experience ratings determined by the insurance company or by estimates (see paragraph .15) may result in a premium deficit. Premium deficits should be included in the benefit obligations if (a) it is probable that the deficit will be applied against the amounts of future premiums or future experience-rating refunds<sup>19</sup> and (b) the amount can be reasonably estimated. If no obligation is included for a premium deficit because either or both of the conditions are not met, or if an exposure to loss exists in excess of the amount accrued, disclosure of the premium deficit should be made if it is reasonably possible that a loss or an additional loss has been incurred. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

## **Accumulated Eligibility Credits**

**.48** Plans may provide for the payment of insurance premiums or benefits for a period of time for those participants who have accumulated a sufficient number of eligibility credits or hours. Eligible participants are provided with insurance coverage during periods of unemployment, when employer contributions to the plan would not otherwise provide coverage or benefits. At the financial statement date, such accumulated eligibility credits represent an obligation of the plan arising from prior employee service for which employer contributions have been received. This benefit obligation is generally determined by applying current insurance premium rates to accumulated eligibility credits or, for a self-funded plan, by applying the average cost of benefits per eligible participant to accumulated eligibility credits. In either case, the obligation for accumulated eligibility credits should consider assumptions for mortality and expected employee turnover or other appropriate adjustments, to reflect the obligation at the amount expected to be paid. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

## **Postretirement Benefit Obligations**

**.49** Health and welfare benefit plans may continue to provide benefits to participants after retirement (postretirement benefits). Those benefits may commence immediately upon termination of service or payment may be deferred until the participant attains a specified age. If a plan provides postretirement benefits to participants, an estimated amount for those benefits, as described below should be included in the benefit obligations. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

**.50** The postretirement benefit obligation as of the measurement date is the actuarial present value of all future benefits attributed to plan participants' services rendered to that date, assuming the plan continues in effect and all assumptions about future events are fulfilled. Postretirement benefits comprise

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<sup>19</sup> This determination should consider (a) the extent to which the insurance contract requires payment of such deficits and (b) the plan's intention, if any, to transfer coverage to another insurance company.

benefits expected to be paid to or on behalf of any retired or active *participant*, terminated participant, beneficiary, or covered dependent who is expected to receive benefits under the health and welfare benefit plan. Postretirement benefits expected to be paid to or for an active participant, beneficiary, or covered dependent who is still earning his or her postretirement benefits (that is, one who is not yet fully eligible) should be measured over the participant's credited period of service up to the date when full eligibility for benefits is attained.<sup>20</sup> [Paragraph renumbered by the issuance of Statement of Position 94-4.]

.51 If a multiemployer health and welfare benefit plan provides postretirement benefits, the benefit obligations must include the postretirement benefit obligation. Consideration should be given to the promises currently made to employees and the history of making such payments to retirees. The fact that benefits may be reduced or even potentially eliminated would not ordinarily affect the promise made as of the end of the plan year unless the change meets the substantive plan criteria of FASB Statement No. 106 (for example, an amendment is in place or has been communicated to employees). The fact that the contributing employers of a multiemployer plan do not record a similar obligation under FASB Statement No. 106 does not affect the accounting for the obligations by the plan. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

.52 The postretirement benefit obligation should be measured using the plan's written provisions to the extent possible, as well as the substantive plan if it differs from the written plan. In many health and welfare benefit plans, postretirement benefits are not defined as a specified amount for each year of service. FASB Statement No. 106, paragraphs 23 through 44, describes the measurement of the postretirement benefit obligation. For multiemployer plans that do not have date-of-hire information as required by paragraph 44 of FASB Statement No. 106, reasonable estimates thereof should be used to measure the obligation. Death or disability benefits provided outside of a pension plan (when the employee is considered to be retired) should also be included in the calculation of the postretirement benefit obligation. Benefits that are provided through an insurance contract should be excluded.<sup>21</sup> [Paragraph renumbered by the issuance of Statement of Position 94-4.]

.53 In measuring the postretirement benefit obligation explicit assumptions must be used, each of which represents the best estimate of a particular future event. All assumptions should presume that the plan will continue in its present form, unless there is evidence to the contrary. Principal actuarial assumptions used should include—

- Discount rates, used to reflect the time value of money in determining the present value of future cash outflows currently expected to be required to satisfy the liability in the due course of business.
- The timing and amount of future postretirement benefit payments (taking into consideration per capita claims cost by age, health care cost-trend rates, current Medicare reimbursement rates, retirement age, dependency status, and mortality).

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<sup>20</sup> For example, if a participant has worked eight years and must work another sixteen to be fully eligible for benefits after retirement, one-third of the postretirement benefits have been earned and should be included in the postretirement benefit obligation if it is probable that the employee will work the remaining sixteen years.

<sup>21</sup> Insured plans should be reviewed carefully to determine the extent to which postretirement benefits are insured. Currently, except for single-premium life insurance contracts, few, if any, insurance contracts unconditionally obligate an insurance company to provide most forms of postretirement benefits.



- Salary progression (for pay-related plans).
- The probability of payment (considering turnover, retirement age, dependency status, and mortality).
- Participation rates (for contributory plans).

[Paragraph renumbered by the issuance of Statement of Position 94-4.]

**.54** The postretirement benefit obligation information should include the following classifications:

- Obligations related to retired plan participants, including their beneficiaries and covered dependents
- Obligations related to active or terminated participants who are fully eligible to receive benefits
- Obligations related to other plan participants not yet fully eligible for benefits

Separate disclosure for each classification for each significant benefit (for example, medical and death) may be appropriate. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

## Changes in Benefit Obligations

**.55** Information regarding changes in the benefit obligations within a plan period should be presented to identify significant factors affecting year-to-year changes in benefit obligations. Like the benefit obligation information (see paragraph .42), the changes should be presented within the body of the financial statements. Providing such information in the following three categories will generally be sufficient: (a) claims payable and premiums due to insurance companies, (b) IBNR and eligibility credits, and (c) postretirement benefit obligations. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

**.56** Minimum disclosure regarding changes in benefit obligations should include the significant effects of (a) plan amendments, (b) changes in the nature of the plan (mergers or spinoffs), and (c) changes in actuarial assumptions (health care cost-trend rate or interest rate). Changes in actuarial assumptions are to be considered as changes in accounting estimates and, therefore, previously reported amounts should not be restated. The significant effects of other factors may also be identified. These include, for example, benefits accumulated,<sup>22</sup> the effects of the time value of money (for interest), and benefits paid. If presented, benefits paid should not include benefit payments made by an insurance company pursuant to a contract that is excluded from plan assets. However, amounts paid by the plan to an insurance company pursuant to such a contract (including purchases of annuities with amounts allocated from existing investments with the insurance company) should be included in benefits paid.<sup>23</sup> If only the minimum disclosure is presented, pre-

<sup>22</sup> Actuarial experience gains or losses may be included with the effects of additional benefits accumulated rather than separately disclosed. If the effects of changes in actuarial assumptions cannot be separately determined, those effects should be included in benefits accumulated and described accordingly.

<sup>23</sup> Because of the use of different actuarial assumptions, the amount paid by the plan to an insurance company may be different from the previous measure of the actuarial present value of the related accumulated plan benefits. If that information is available, it should be presented as an actuarial experience gain or loss.

sensation in a statement format will necessitate an additional unidentified "other" category to reconcile the initial and ultimate amounts. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

## Additional Financial Statement Disclosures

.57 Disclosure of a health and welfare benefit plan's accounting policies should include—<sup>24</sup>

- A description of the methods and significant assumptions used to determine the fair value of investments and the reported value of insurance contracts.
- A description of the methods and significant actuarial assumptions used to determine the plan's benefit obligations. Any significant changes in assumptions made between financial statement dates and their effects should be described.

[Paragraph renumbered by the issuance of Statement of Position 94-4.]

.58 The plan's financial statements should also disclose other information.<sup>25</sup> Separate disclosures may be made to the extent that the plan provides both health and other welfare benefits. The disclosures should include, when applicable—

- A brief, general description of the plan agreement, including, but not limited to, participants covered, vesting, and benefit provisions. If a plan agreement or a description thereof providing this information is otherwise published or made available, the description in the financial statement disclosures may be omitted, provided that a reference to the other source is made.
- A description of significant plan amendments adopted during the period, as well as significant changes in the nature of the plan (for example, a plan spin-off or merger with another plan) and changes in actuarial assumptions.
- The funding policy and any changes in the policy made during the plan year. If the benefit obligations exceed the net assets of the plan, the method of funding this deficit, as provided for in the plan agreement or collective bargaining agreement, also should be disclosed.<sup>26</sup> For a contributory plan, the disclosure should state the method of determining participants' contributions.
- The federal income tax status of the plan. There is no determination letter program for health and welfare plans; however a 501(c)(9) VEBA trust must obtain a determination letter to be exempt from taxation.
- The policy regarding the purchase of contracts with insurance companies that are excluded from plan assets. Consideration should be given to disclosing the type and extent of insurance coverage, as well as the extent to which risk is transferred (for example, coverage period and claims reported or claims incurred).

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<sup>24</sup> See Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies*.

<sup>25</sup> Certain of the disclosures relate to plans with accumulated assets rather than those with trusts that act more as conduits for benefit payments or insurance premiums.

<sup>26</sup> If significant plan administration or related costs are being borne by the employer, that fact should be disclosed.

- Identification of investments that represent 5 percent or more of total plan assets. Consideration should be given to disclosing provisions of insurance contracts included as plan assets that could cause an impairment of the asset value upon liquidation or other occurrence (for example, surrender charges and market value adjustments).
- The amounts and types of securities of the employer and related parties included in plan assets, and the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer and related parties.
- Significant real estate or other transactions in which the plan and any of the following parties are jointly involved: the sponsor, the plan administrator, employers, or employee organizations.
- Unusual or infrequent events or transactions occurring after the financial statement date, but before issuance of the financial statements, that might significantly affect the usefulness of the financial statements in an assessment of the plan's present and future ability to pay benefits. For example, a plan amendment adopted after the latest financial statement date that significantly increases future benefits attributable to an employee's service rendered before that date, a significant change in the market value of a significant portion of the plan's assets, or the emergence of a catastrophic claim should be disclosed. If reasonably determinable, the effects of such events or transactions should be disclosed. If such effects are not reasonably determinable, the reasons why they are not quantifiable should be disclosed.
- Material lease commitments, other commitments, or contingent liabilities.
- The assumed health care cost-trend rate(s) used to measure the expected cost of benefits covered by the plan for the next year, a general description of the direction and pattern of change in the assumed trend rates thereafter, the ultimate trend rate(s), and when that rate is expected to be achieved.
- For health and welfare benefit plans providing postretirement health care benefits, the effect of a one-percentage-point increase in the assumed health care cost-trend rates for each future year on the postretirement benefit obligation.
- Any modification of the existing cost-sharing provisions that are encompassed by the substantive plan(s) and the existence and nature of any commitment to increase monetary benefits provided by the plan and their effect on the plan's financial statements.
- Termination provisions of the plan and priorities for distribution of assets, if applicable.
- Restrictions, if any, on plan assets (for example, legal restrictions on multiple trusts).
- For benefit-responsive investment contracts in the aggregate by investment option:
  - The average yield for each period for which a statement of net assets available for benefits is presented
  - The crediting interest rate as of the date of each statement of net assets available for benefits presented

- The amount of valuation reserves recorded to adjust contract amounts (for example, due to problems with the creditworthiness of the contract issuer or third-party guarantor)
- The fair values of fully benefit-responsive investment contracts reported at contract value, in accordance with FASB Statement No. 107
- A general description of the basis and frequency of determining crediting interest-rate resets and any minimum crediting interest rate under the terms of fully benefit-responsive investment contracts and any limitations on related liquidity guarantees (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives).
- For ERISA-covered plans, if a fully benefit-responsive investment contract does not qualify for contract-value reporting in the DOL Form 5500 but is reported in the financial statements at contract value, and the contract value does not approximate fair value, the DOL's rules and regulations require that a statement explaining the differences between amounts reported in the financial statements and DOL Form 5500 be added to the financial statements.

This list does not include information that, in accordance with ERISA requirements, must be disclosed in the schedules filed as part of a plan's annual report. It is important to note that any information required by ERISA to be disclosed in the schedules must be disclosed in the schedules; disclosure of the information in the footnotes to the financial statements but not in the schedules is not acceptable to the DOL. [As amended and renumbered, effective for financial statements for plan years beginning after December 15, 1994, by Statement of Position 94-4.] (See section 10,620.)

**.59** FASB Statement No. 105 requires all entities, including health and welfare benefit plans, to disclose information principally about financial instruments with off-balance-sheet risk. However, the disclosure requirements in paragraphs 17, 18, and 20 of FASB Statement No. 105 do not apply to (a) financial instruments of a pension plan, including plan assets, when subject to the accounting and reporting requirements of FASB Statement No. 87, *Employers' Accounting for Pensions*; (b) employers' and plans' obligations for pension benefits, postretirement health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements; (c) insurance contracts, other than financial guarantees and investment contracts as discussed in FASB Statement Nos. 60, *Accounting and Reporting by Insurance Enterprises*, and 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*; and (d) unconditional purchase obligations subject to the disclosure requirements of FASB Statement No. 47, *Disclosure of Long-Term Obligations*. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

**.60** Some examples of financial instruments of employee benefit plans with off-balance-sheet risk that are included within the scope of FASB Statement No. 105 are obligations to repurchase securities sold, outstanding commitments to purchase or sell financial instruments at predetermined prices, futures contracts, and interest-rate and foreign-currency swaps. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

**.61** FASB Statement No. 105 requires entities to disclose the following information about financial instruments with off-balance-sheet credit risk:

- The face or contract amount (or notional principal amount if there is no face or contract amount)
- The nature and terms, including, at a minimum, a discussion of (a) the credit and market risk of those instruments, (b) the cash requirements of those instruments, and (c) the related accounting policy pursuant to the requirements of APB Opinion 22
- The amount of the accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

FASB Statement No. 105 requires entities to disclose the following information about financial instruments with concentrations of credit risk:

- Information about the (shared) activity, region, or economic characteristic that identifies the concentration
- The amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

[Paragraph renumbered by the issuance of Statement of Position 94-4.]

## Terminating Plans

.62 The auditing interpretation "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting" (AICPA, *Professional Standards*, vol. 1, AU section 9508.33–38) contains applicable guidance regarding the auditor's reporting responsibilities for terminating plans. For purposes of this discussion, a terminating plan includes all plans about which a termination decision has been made regardless of whether the terminating plan will be replaced. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

.63 When the decision has been made to terminate a plan,<sup>27</sup> or a wasting trust—that is, a plan under which participants no longer accrue benefits but that will remain in existence as long as necessary to pay already accrued benefits—exists, complete and prominent disclosure of the relevant circumstances is essential in all subsequent financial statements issued by the plan.

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<sup>27</sup> See paragraph 12.11 of the guide, which states that the auditor should obtain from the plan trustee, administrator, or administrative agent written representation about whether there is a present intention to terminate the plan. Refer also to paragraph 10.33 of the guide, which states that the auditor should consider confirming with the plan's actuary knowledge of an intent on the part of the employer to terminate the plan.

If the decision to terminate a plan is made before the end of the plan year, it is also necessary for the plan's year-end financial statements to be prepared on the *liquidation* basis of accounting, as described below. If the decision is made after the year end but before the year-end financial statements have been issued, the decision is generally a *type two* subsequent event requiring the disclosure described in SAS No. 1, *Codification of Auditing Standards and Procedures* [section 560.05]. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

.64 Plan financial statements for periods ending after the termination decision are prepared on the liquidation basis of accounting. For plan assets, changing to the liquidation basis will usually cause little or no change in values, most of which are current market values. Assets that may not be carried at market values include operating assets, insurance contracts carried at *contract values*, or large blocks of stock or other assets that cannot be readily disposed of at their quoted market prices. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

.65 Benefit obligations should be determined on a liquidation basis, and their value may differ from the actuarial present value of benefit obligations reported for an ongoing plan. Consideration should be given upon termination to whether any or all benefits become vested. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

## Effective Date and Transition

.66 This SOP is effective for audits of financial statements of single-employer plans for plan years beginning after December 15, 1992, except that the application of this SOP to plans of single employers with no more than 500 participants in the aggregate is effective for plan years beginning after December 15, 1994. This SOP is effective for audits of financial statements of multiemployer plans for plan years beginning after December 15, 1995. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this SOP shall be made retroactively. Financial statements of prior plan years are required to be restated to comply with the provisions of this SOP *only* if they are presented together with financial statements for plan years beginning after December 15, 1992. If accounting changes were necessary to conform to the provisions of this SOP, that fact shall be disclosed when financial statements for the year in which this SOP is first applied are presented either alone or with financial statements of prior years. [Paragraph renumbered by the issuance of Statement of Position 94-4.]

.67\*

## Appendix

### Illustrations of Financial Statements: Employee Health and Welfare Benefit Plans

**A-1.** This appendix illustrates certain applications of the provisions of this SOP to the annual financial statements of two hypothetical health and welfare benefit plans that have assets in underlying trusts. They are—

- a.* Allied Industries Benefit Plan, a multiemployer plan that displays the benefit obligation information in separate financial statements (exhibit A).
- b.* Classic Enterprises Benefit Plan, a single-employer plan that displays the benefit obligation information on the face of the financial statements along with the net asset information (exhibit B).

**A-2.** The plan in exhibit A pays all benefits directly from plan assets. The plan in exhibit B obtains insurance for current benefits from its assets. It is assumed that both plans provide health benefits and life insurance coverage to both active and retired participants. Exhibit A also assumes that the plan provides long-term disability benefits and limited coverage during periods of unemployment based on accumulated eligibility credits.

**A-3.** The examples do not illustrate other provisions of this SOP that might apply in circumstances other than those assumed. The format presented and the wording of the accompanying notes are illustrative only and are not necessarily the only possible presentations. For purposes of illustration, two-year comparative financial statements are shown. (Generally accepted accounting principles encourage but do not require comparative financial statements; however, the alternative method of reporting under ERISA requires comparative statements of net assets available for benefits.)

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\* Renumbered by the issuance of Statement of Position 94-4.

Exhibit A

ALLIED INDUSTRIES BENEFIT PLAN

Allied Industries Benefit Plan  
Statements of Net Assets Available for Benefits  
December 31, 19X2 and 19X1

<u>Assets</u>	<u>19X2</u>	<u>19X1</u>
Investments, at fair value (see note 3)		
U.S. government securities	\$5,000,000	\$4,000,000
Corporate bonds and debentures	2,000,000	1,600,000
Common stock	<u>1,000,000</u>	<u>600,000</u>
Total investments	<u>8,000,000</u>	<u>6,200,000</u>
Receivables		
Participating employers' contributions	500,000	430,000
Participants' contributions	100,000	80,000
Accrued interest and dividends	<u>50,000</u>	<u>40,000</u>
Total receivables	<u>650,000</u>	<u>550,000</u>
Cash	<u>140,000</u>	<u>115,000</u>
TOTAL ASSETS	<u>8,790,000</u>	<u>6,865,000</u>
 <u>Liabilities</u>		
Due to broker for securities purchased	250,000	240,000
Accounts payable for administrative expenses	<u>25,000</u>	<u>25,000</u>
TOTAL LIABILITIES	<u>275,000</u>	<u>265,000</u>
NET ASSETS AVAILABLE FOR BENEFITS	<u>\$8,515,000</u>	<u>\$6,600,000</u>

The accompanying notes are an integral part of the financial statements.



**Allied Industries Benefit Plan**  
**Statements of Changes in Net Assets Available for Benefits**  
**Years Ended December 31, 19X2 and 19X1**

	<u>19X2</u>	<u>19X1</u>
Contributions		
Participating employers	\$15,000,000	\$14,500,000
Participants	<u>3,000,000</u>	<u>2,800,000</u>
Total contributions	<u>18,000,000</u>	<u>17,300,000</u>
Investment income		
Net appreciation in fair value of investments	300,000	200,000
Interest	500,000	450,000
Dividends	<u>50,000</u>	<u>50,000</u>
	850,000	700,000
Less investment expenses	<u>15,000</u>	<u>25,000</u>
Net investment income	<u>835,000</u>	<u>675,000</u>
TOTAL ADDITIONS	<u>18,835,000</u>	<u>17,975,000</u>
Benefits paid to participants		
Health care	16,000,000	15,750,000
Disability and death	<u>770,000</u>	<u>750,000</u>
	16,770,000	16,500,000
Administrative expenses	<u>150,000</u>	<u>175,000</u>
TOTAL DEDUCTIONS	<u>16,920,000</u>	<u>16,675,000</u>
NET INCREASE DURING YEAR	1,915,000	1,300,000
Net assets available for benefits		
Beginning of year	<u>6,600,000</u>	<u>5,300,000</u>
End of year	<u>\$ 8,515,000</u>	<u>\$ 6,600,000</u>

The accompanying notes are an integral part of the financial statements.

**Allied Industries Benefit Plan**  
**Statements of Plan's Benefit Obligations**  
**December 31, 19X2 and 19X1**

	<u>19X2</u>	<u>19X1</u>
Amounts currently payable to or for participants, beneficiaries, and dependents		
Health claims payable	\$ 1,100,000	\$ 975,000
Death and disability benefits payable	<u>100,000</u>	<u>75,000</u>
	<u>1,200,000</u>	<u>1,050,000</u>
Other obligations for current benefit coverage, at present value of estimated amounts		
Claims incurred but not reported	350,000	290,000
Accumulated eligibility credits	200,000	225,000
Long-term disability benefits	<u>800,000</u>	<u>485,000</u>
	<u>1,350,000</u>	<u>1,000,000</u>
Total obligations other than postretirement benefit obligations	<u>2,550,000</u>	<u>2,050,000</u>
Postretirement benefit obligations		
Current retirees	3,900,000	3,500,000
Other participants fully eligible for benefits	2,100,000	2,000,000
Other participants not yet fully eligible for benefits	<u>5,000,000</u>	<u>4,165,000</u>
	<u>11,000,000</u>	<u>9,665,000</u>
PLAN'S TOTAL BENEFIT OBLIGATIONS	<u>\$13,550,000</u>	<u>\$11,715,000</u>

The accompanying notes are an integral part of the financial statements.

**Allied Industries Benefit Plan**  
**Statements of Changes in Plan's Benefit Obligations**  
**Years Ended December 31, 19X2 and 19X1**

	<u>19X2</u>	<u>19X1</u>
Amounts currently payable to or for participants, beneficiaries, and dependents		
Balance at beginning of year	\$ 1,050,000	\$ 850,000
Claims reported and approved for payment	16,920,000	16,700,000
Claims paid (including disability)	<u>(16,770,000)</u>	<u>(16,500,000)</u>
Balance at end of year	<u>1,200,000</u>	<u>1,050,000</u>
Other obligations for current benefit coverage, at estimated amounts		
Balance at beginning of year	1,000,000	925,000
Net change during year:		
Long-term disability benefits	315,000	50,000
Other	<u>35,000</u>	<u>25,000</u>
Balance at end of year	<u>1,350,000</u>	<u>1,000,000</u>
Total obligations for current benefit coverage	<u>2,550,000</u>	<u>2,050,000</u>
Postretirement benefit obligation		
Balance at beginning of year	9,665,000	8,665,000
Increase (decrease) during the year attributable to:		
Benefits earned and other changes	1,250,000	1,000,000
Plan amendment	(175,000)	—
Changes in actuarial assumptions	<u>260,000</u>	<u>—</u>
Balance at end of year	<u>11,000,000</u>	<u>9,665,000</u>
PLAN'S TOTAL BENEFIT OBLIGATIONS AT END OF YEAR	<u><u>\$13,550,000</u></u>	<u><u>\$11,715,000</u></u>

The accompanying notes are an integral part of the financial statements.

**Allied Industries Benefit Plan  
Notes to Financial Statements**

**NOTE 1: DESCRIPTION OF PLAN**

The following description of the Allied Industries Benefit Plan (the Plan) provides only general information. Participants should refer to the Plan agreement for a complete description of the Plan's provisions.

*General.* The Plan provides health and other benefits covering all participants in the widgets industry in the Greater Metropolis area. The Plan and related trust were established on May 8, 1966, pursuant to a collective bargaining agreement between the Allied Employers' Trade Association and the Allied Union, Local 802. It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

*Benefits.* The Plan provides health benefits (medical, hospital, surgical, major medical, and dental), permanent disability benefits, and death benefits to full-time participants (with at least 450 hours of work in the industry during a consecutive three-month period) and to their beneficiaries and covered dependents. Retired employees are entitled to similar health benefits (in excess of Medicare coverage) provided they have attained at least age sixty-two and have fifteen years of service with participating employers before retirement.

The Plan also provides health benefits to participants during periods of unemployment, provided they have accumulated in the current year or in prior years credit amounts (expressed in hours) in excess of the hours required for current coverage. Accumulated eligibility credits equal to one year's coverage may be carried forward.

Health, disability, and death claims of active and retired participants, dependents, and beneficiaries are processed by the Administrator Group, but the responsibility for payments to participants and providers is retained by the Plan.

In 19X2 the board of trustees amended the Plan to increase the deductible under major medical coverage from \$100 to \$300 and to extend dental coverage to employees retiring after December 31, 19X2. The amendment will not affect participating employers' contributions to the Plan in 19X3 under the current collective bargaining agreement.

*Contributions.* Participating employers contribute 5.5 percent of wages pursuant to the current collective bargaining agreement between employers and the union (expiring February 19, 19X5). Employees and retirees may contribute specified amounts, determined periodically by the Plan's actuary, to extend coverage to eligible dependents.

*Other.* The Plan's board of trustees, as Sponsor, has the right under the Plan to modify the benefits provided to active employees. The Plan may be terminated only by joint agreement between industry and union, subject to the provisions set forth in ERISA.

**NOTE 2: SUMMARY OF ACCOUNTING POLICIES**

*A. Valuation of Investments.* The Plan's investments are stated at fair value. Securities traded on the national securities exchange are valued at the last reported sales price on the last business day of the plan year. Investments traded in the over-the-counter market and listed securities for which no sale was reported on that date are valued at the average of the last reported bid and

asked prices. For certain corporate bonds that do not have an established fair value, the Plan's board of trustees has established a fair value based on yields currently available on comparable securities of issuers with similar credit ratings.

**B. Postretirement Benefits.** The postretirement benefit obligation represents the actuarial present value of those estimated future benefits that are attributed to employee service rendered to December 31. Postretirement benefits include future benefits expected to be paid to or for (1) currently retired or terminated employees and their beneficiaries and dependents and (2) active employees and their beneficiaries and dependents after retirement from service with the participating employers. Prior to an active employee's full eligibility date, the postretirement benefit obligation is the portion of the expected postretirement benefit obligation that is attributed to that employee's service in the industry rendered to the valuation date.

The actuarial present value of the expected postretirement benefit obligation is determined by an actuary and is the amount that results from applying actuarial assumptions to historical claims-cost data to estimate future annual incurred claims costs per participant and to adjust such estimates for the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as those for death, disability, withdrawal, or retirement) between the valuation date and the expected date of payment.

For measurement purposes, a 9.5 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 19X3; the rate was assumed to decrease gradually to 8.0 percent for 19X8 and to remain at that level thereafter. These assumptions are consistent with those used to measure the benefit obligation at December 31, 19X1.

The following were other significant assumptions used in the valuations as of December 31, 19X2 and 19X1.

Weighted-average discount rate	8.0%—19X2; 8.25%—19X1
Average retirement age	60
Mortality	1971 Group Annuity Mortality Table

The foregoing assumptions are based on the presumption that the Plan will continue. Were the Plan to terminate, different actuarial assumptions and other factors might be applicable in determining the actuarial present value of the postretirement benefit obligation.

**C. Other Plan Benefits.** Plan obligations at December 31 for health claims incurred by active participants but not reported at that date, for accumulated eligibility of participants, and for future disability payments to members considered permanently disabled at December 31 are estimated by the Plan's actuary in accordance with accepted actuarial principles. Such estimated amounts are reported in the accompanying statement of the Plan's benefit obligations at present value, based on an 8.0 percent discount rate. Health claims incurred by retired participants but not reported at year end are included in the postretirement benefit obligation.

### NOTE 3: INVESTMENTS

The Plan's investments are held by a bank-administered trust fund. During 19X2 and 19X1 the Plan's investments (including investments bought, sold, and held during the year) appreciated in value by \$300,000 and \$200,000, respectively, as follows:

Statements of Position

	19X2		19X1	
	<i>Net Increase (Decrease) in Value During Year</i>	<i>Fair Value at End of Year</i>	<i>Net Increase (Decrease) in Value During Year</i>	<i>Fair Value at End of Year</i>
Fair value as determined by quoted market price:				
U.S. government securities	\$200,000	\$5,000,000	\$ (75,000)	\$4,000,000
Corporate bonds and debentures	(25,000)	1,750,000	50,000	1,375,000
Common stocks	<u>100,000</u>	<u>1,000,000</u>	<u>200,000</u>	<u>600,000</u>
	275,000	7,750,000	175,000	5,975,000
Fair value as estimated by Plan's board of trustees:				
Corporate bonds	<u>25,000</u>	<u>250,000</u>	<u>25,000</u>	<u>225,000</u>
	<u>\$300,000</u>	<u>\$8,000,000</u>	<u>\$200,000</u>	<u>\$6,200,000</u>

The fair value of individual investments that represent 5.0 percent or more of the Plan's net assets are as follows:

	19X2	19X1
Commonwealth Power Co., 9.0% bonds due 2014 (\$500,000 face amount)	\$475,000	\$450,000
ABC Company common stock (2,000 shares)	500,000	450,000
U.S. Treasury bond, 8.5% due 19X6 (\$360,000 face amount)		350,000

**NOTE 4: BENEFIT OBLIGATIONS**

The Plans deficiency of net assets over benefit obligations at December 31, 19X2 and 19X1, relates primarily to the postretirement benefit obligation, the funding of which is not covered by the contribution rate provided by the current bargaining agreement. It is expected that the deficiency will be funded through future increases in the collectively bargained contribution rates.

The weighted-average health care cost-trend rate assumption (see note 2B) has a significant effect on the amounts reported in the accompanying financial statements. If the assumed rates increased by one percentage point in each year, it would increase the obligation as of December 31, 19X2 and 19X1, by \$2,600,000 and \$2,500,000, respectively.

**NOTE 5: OTHER MATTERS**

The trust established under the Plan to hold the Plan's assets is qualified pursuant to Section 501(c)9 of the Internal Revenue Code, and, accordingly, the trust's net investment income is exempt from income taxes. The Plan has obtained a favorable tax determination letter from the Internal Revenue Service, and the Plan sponsor believes that the Plan, as amended, continues to qualify and to operate as designed.

## Exhibit B

## CLASSIC ENTERPRISES BENEFIT PLAN

**Classic Enterprises Benefit Plan  
Statements of Benefit Obligations and  
Net Assets Available for Benefits  
December 31, 19X2 and 19X1**

	<u>19X2</u>	<u>19X1</u>
<u>Benefit Obligations</u> (see note 4)		
Amounts due insurance companies	\$1,200,000	\$1,000,000
Postretirement benefit obligations	<u>11,000,000</u>	<u>9,665,000</u>
Total benefit obligations	<u>12,200,000</u>	<u>10,665,000</u>
<u>Net Assets</u>		
<u>Investments at fair value</u> (see note 3)		
U.S. government securities	\$5,000,000	\$4,000,000
Corporate bonds and debentures	2,000,000	1,600,000
Common stock	<u>1,000,000</u>	<u>600,000</u>
Total investments	<u>8,000,000</u>	<u>6,200,000</u>
Receivables		
Sponsor's contributions	500,000	430,000
Participants' contributions	100,000	80,000
Accrued interest and dividends	<u>50,000</u>	<u>40,000</u>
Total receivables	<u>650,000</u>	<u>550,000</u>
Cash	75,000	60,000
Insurance premium deposits	<u>65,000</u>	<u>55,000</u>
TOTAL ASSETS	<u>8,790,000</u>	<u>6,865,000</u>
<u>Liabilities</u>		
Due to broker for securities purchased	250,000	240,000
Accounts payable for administrative expenses	<u>25,000</u>	<u>25,000</u>
TOTAL LIABILITIES	<u>275,000</u>	<u>265,000</u>
NET ASSETS AVAILABLE FOR BENEFITS	<u>8,515,000</u>	<u>6,600,000</u>
EXCESS OF BENEFIT OBLIGATIONS OVER NET ASSETS AVAILABLE FOR BENEFITS	<u>\$3,685,000</u>	<u>\$4,065,000</u>

The accompanying notes are an integral part of the financial statements.



**Classic Enterprises Benefit Plan**  
**Statement of Changes in Benefit Obligations and**  
**Net Assets Available for Benefits**  
**Years Ended December 31, 19X2 and 19X1**

	<u>19X2</u>	<u>19X1</u>
<u>Net Increase in Benefit Obligations</u>		
Increase (Decrease) during the year attributable to:		
Benefits earned and other changes	\$ 1,510,000	\$ 1,000,000
Additional amounts payable to insurance company	200,000	100,000
Plan amendment	(175,000)	—
	<u>1,535,000</u>	<u>1,100,000</u>
<u>Net Increase in Net Assets Available for Benefits</u>		
Contributions		
Sponsor	15,000,000	14,500,000
Participants	3,000,000	2,800,000
Total contributions	<u>18,000,000</u>	<u>17,300,000</u>
Investment income		
Net appreciation in fair value of investments	300,000	200,000
Interest	500,000	450,000
Dividends	50,000	50,000
	<u>850,000</u>	<u>700,000</u>
Less investment expenses	15,000	25,000
Net investment income	<u>835,000</u>	<u>675,000</u>
TOTAL ADDITIONS	<u>18,835,000</u>	<u>17,975,000</u>
Insurance premiums paid for health benefits, net of experience-rating adjustments of \$250,000 for 19X1 received in 19X2 and \$275,000 for 19X0 received in 19X1	16,035,000	15,750,000
Insurance premiums paid for death benefits	780,000	750,000
	<u>16,815,000</u>	<u>16,500,000</u>
Administrative expenses	105,000	175,000
TOTAL DEDUCTIONS	<u>16,920,000</u>	<u>16,675,000</u>
NET INCREASE	<u>1,915,000</u>	<u>1,300,000</u>
<u>Increase (Decrease) in Net Assets Available for</u>		
<u>Benefits Over Benefit Obligations</u>	(380,000)	(200,000)
<u>Excess of Benefit Obligations Over Net Assets Available for Benefits</u>		
Beginning of year	4,065,000	4,265,000
End of year	<u>\$ 3,685,000</u>	<u>\$ 4,065,000</u>

The accompanying notes are an integral part of the financial statements.

**Classic Enterprises Benefit Plan  
Notes to Financial Statements**

**NOTE 1: DESCRIPTION OF PLAN**

The following description of the Classic Enterprises Benefit Plan (the Plan) provides only general information. Participants should refer to the Plan agreement for a complete description of the Plan's provisions.

*General.* The Plan provides health and death benefits covering substantially all active and retired employees of Classic Enterprises (the Sponsor). It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

*Benefits.* The Plan provides health benefits (medical, hospital, surgical, major medical, and dental) and death benefits to full-time employees of the Sponsor (with at least 1,000 hours of service each year) and to their beneficiaries and covered dependents. Retired employees are entitled to similar health and death benefits provided they have attained at least age fifty-five and have at least ten years of service with the Sponsor.

Current health claims of active and retired participants and their dependents and beneficiaries are provided under group insurance contracts with ABC Carrier, which are experience rated after the anniversary dates of the policies (generally March 31). Death benefits are covered by a group-term policy with DEF Carrier.

*Contributions.* The Sponsor's policy is to contribute the maximum amounts allowed as a tax deduction by the Internal Revenue Code. Under present law, the Sponsor is not permitted to deduct amounts for future benefits to current employees and retirees.

Employees and retirees may contribute specified amounts, determined periodically by the Plan's insurance companies, to extend coverage to eligible dependents.

In 19X2 the Plan was amended to increase the deductible under major medical coverage from \$100 to \$300 and to extend dental coverage to employees retiring after December 31, 19X2. The amendment is not expected to significantly affect the Sponsor's contribution to the Plan in 19X3.

*Other.* Although it has not expressed any intention to do so, the Sponsor has the right under the Plan to modify the benefits provided to active employees, to discontinue its contributions at any time, and to terminate the Plan subject to the provisions set forth in ERISA.

**NOTE 2: SUMMARY OF ACCOUNTING POLICIES**

*A. Valuation of Investments.* The Plan's investments are stated at fair value. Securities traded on the national securities exchange are valued at the last reported sales price on the last business day of the plan year. Investments traded in the over-the-counter market and listed securities for which no sale was reported on that date are valued at the average of the last reported bid and asked prices. For certain corporate bonds that do not have an established fair value, the Classic Enterprises Benefits Committee has established a fair value based on yields currently available on comparable securities of issuers with similar credit ratings.

*B. Plan Benefits.* The postretirement benefit obligation (see note 4) represents the actuarial present value of those estimated future benefits that are attributed to employee service rendered to December 31. Postretirement bene-

fits include future benefits expected to be paid to or for (1) currently retired employees and their beneficiaries and dependents and (2) active employees and their beneficiaries and dependents after retirement from service with the Sponsor. Prior to an active employee's full eligibility date, the postretirement benefit obligation is the portion of the expected postretirement benefit obligation that is attributed to that employee's service rendered to the valuation date.

The actuarial present value of the expected postretirement benefit obligation is determined by an actuary and is the amount that results from applying actuarial assumptions to historical claims-cost data to estimate future annual incurred claims costs per participant and to adjust such estimates for the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as those for death, disability, withdrawal, or retirement) between the valuation date and the expected date of payment, and to reflect the portion of those costs expected to be borne by Medicare, the retired participants, and other providers.

For measurement purposes at December 31, 19X2, a 9.5 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 19X3; the rate was assumed to decrease gradually to 8.0 percent for 19X8 and to remain at that level thereafter. These assumptions are consistent with those used to measure the benefit obligation at December 31, 19X1.

The following were other significant assumptions used in the valuations as of December 31, 19X2 and 19X1.

Weighted-average discount rate	8.0%
Average retirement age	60
Mortality	1971 Group Annuity Mortality Table

The foregoing assumptions are based on the presumption that the Plan will continue. Were the Plan to terminate, different actuarial assumptions and other factors might be applicable in determining the actuarial present value of the postretirement benefit obligation.

NOTE 3: INVESTMENTS

The Plan's investments are held by a bank-administered trust fund. During 19X2 and 19X1, the plan's investments (including investments bought, sold, and held during the year) appreciated in value by \$300,000 and \$200,000, respectively, as follows:

	19X2		19X1	
	Net Increase (Decrease) in Value During Year	Fair Value at End of Year	Net Increase (Decrease) in Value During Year	Fair Value at End of Year
Fair value as determined by quoted market price:				
U.S. government securities	\$200,000	\$5,000,000	\$ (75,000)	\$4,000,000
Corporate bonds and debentures	(25,000)	1,750,000	50,000	1,375,000
Common stocks	100,000	1,000,000	200,000	600,000
	<u>275,000</u>	<u>7,750,000</u>	<u>175,000</u>	<u>5,975,000</u>
Fair value as estimated by Classic Enterprise Benefits Plan Investment Committee:				
Corporate bonds	25,000	250,000	25,000	225,000
	<u>\$300,000</u>	<u>\$8,000,000</u>	<u>\$200,000</u>	<u>\$6,200,000</u>

The fair value of individual investments that represent 5.0 percent or more of the Plan's net assets is as follows:

	19X2	19X1
Commonwealth Power Co., 9.0% bonds due 2014 (\$500,000 face amount)	\$475,000	\$450,000
ABC Company common stock (2,000 shares)	500,000	450,000
U.S. Treasury bond, 8.5% due 19X6 (\$360,000 face amount)		350,000

NOTE 4: BENEFIT OBLIGATIONS

Health costs incurred by participants and their beneficiaries and dependents are covered by insurance contracts maintained by the Plan. It is the present intention of the Sponsor and the Plan to continue obtaining insurance coverage for benefits. As stated in note 1, the Sponsor is not permitted under present tax law to deduct amounts for future benefits (beyond one year). Insurance premiums for future years in respect of the Plan's postretirement benefit obligation will be funded by Sponsor contributions to the Plan in those later years.

The postretirement benefit obligation at December 31, 19X2 and 19X1, principally health benefits, related to the following categories of participants (including their beneficiaries and dependents):

	<u>19X2</u>	<u>19X1</u>
Current retirees	\$ 3,900,000	\$3,500,000
Other participants fully eligible for benefits	2,100,000	2,000,000
Participants not yet fully eligible for benefits	5,000,000	4,165,000
	<u>\$11,000,000</u>	<u>\$9,665,000</u>

The health care cost-trend rate assumption (see note 2B) has a significant effect on the amounts reported. If the assumed rates increased by one percentage point in each year, that would increase the obligation as of December 31, 19X2 and 19X1, by \$2,600,000 and \$2,500,000, respectively.

#### NOTE 5: OTHER MATTERS

The trust established under the Plan to hold the Plan's net assets is qualified pursuant to Section 501(c)9 of the Internal Revenue Code, and, accordingly, the trust's net investment income is exempt from income taxes. The Sponsor has obtained a favorable tax determination letter from the Internal Revenue Service and the Sponsor believes that the Plan, as amended, continues to qualify and to operate as designed.

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The Employee Benefit Plans Committee gratefully acknowledges the contributions of Dale L. Gerboth, Melissa A.R. Krause, and Harvey J. Nuland, former committee members; Daniel J. Cronin; the Office of Chief Accountant, Pension and Welfare Benefits Administration; and the Office of the Inspector General, U.S. Department of Labor.

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**Section 10,540****Statement of Position 93-1  
Financial Accounting and Reporting  
for High-Yield Debt Securities by  
Investment Companies**

January 28, 1993

**NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

**Introduction**

.01 High-yield debt securities consist of high-yielding corporate and municipal debt obligations. These securities are frequently referred to as *junk bonds*. The issuance of high-yield debt securities has increased significantly over the past decade. They have supplied significant capital for business expansion and corporate restructuring. These securities are inherently different from investment-grade issues. They present additional credit, liquidity, and market risks for all participants in this marketplace: holders, issuers, underwriters, and broker-dealers.

.02 Recent estimates place the U.S. high-yield debt securities market at between \$180 and \$250 billion, with over 3300 individual security issues outstanding. Mutual funds and insurance companies each hold approximately 30 percent of such securities, and pension funds hold about 15 percent.

.03 High-yield debt securities are corporate and municipal debt securities having a lower-than-investment-grade credit rating (BB+ or lower by Standard & Poor's, or Ba or lower by Moody's). Because high-yield debt securities typically are used when lower-cost capital is not available, they have interest rates several percentage points higher than investment-grade debt and often have shorter maturities.

.04 High-yield debt securities typically are unsecured and subordinate to other debt outstanding. Many issuers of high-yield debt securities are highly leveraged, with limited equity capital. That, plus a market for such securities that may not always be liquid, may increase the market risk, liquidity risk, and credit risk of those securities.

.05 High-yield debt securities may be issued or traded at significant discounts from their face amounts (principal).

.06 Interest for some high-yield debt securities is not paid currently. Instead, interest may be deferred and paid at maturity (zero-coupon bonds) or in periodic interest payments that do not commence until a specific date in the securities' life cycle (step bonds), or interest may be paid in the form of additional debt securities of the issuer bearing similar terms (payment-in-kind bonds, or PIKs).

## Market Risk

.07 In contrast to investment-grade bonds (the market prices of which change primarily as a reaction to changes in interest rates), the market prices of high-yield bonds (which are also affected by changes in interest rates) are influenced much more by credit factors and financial results of the issuer and by general economic factors that influence the financial markets as a whole.

.08 Such factors often make it difficult to substantiate the market valuation of high-yield bonds.

## Liquidity Risk

.09 The market risk is often heightened by the absence of centralized high-yield bond exchanges and relatively thin trading markets, which make it more difficult to liquidate holdings quickly and increase the volatility of the market price. There is generally no centralized or regulated procedure for pricing high-yield debt issues.

## Credit Risk

.10 Issues of high-yield debt securities are more likely to default on interest or principal than are issues of investment-grade securities. Most high-yield debt securities currently outstanding have been issued since 1985. Accordingly, there is little long-term record on how they perform over all parts of the business cycle.

.11 Adverse economic developments in 1990 and 1991 contributed to defaults on principal and interest payments by many issuers of high-yield debt securities. Those developments emphasized the need for taking great care in valuation, income recognition, and financial statement disclosure by holders of these securities.

## Current Literature

.12 Although none of the current financial reporting or auditing literature specifically addresses the issues discussed in this statement of position (SOP), various sources in that literature provide indirect guidance, including the following:

- Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*



- FASB Statement No. 95, *Statement of Cash Flows*
- FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies*
- APB Opinion No. 29, *Accounting for Nonmonetary Transactions*
- FASB Emerging Issues Task Force (EITF) Issue No. 86-15, *Interest-Rate Debt*
- EITF Issue No. 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*
- AICPA Statement on Auditing Standards (SAS) No. 73, *Using the Work of a Specialist*
- AICPA Audit and Accounting Guide *Audits of Investment Companies*

## Scope

.13 This SOP amends the Audit and Accounting Guide *Audits of Investment Companies* and is applicable to entities to which that guide applies.

.14 This SOP addresses the following reporting and accounting issues encountered by investment companies holding high-yield debt securities in their portfolios. Securities that have no credit rating should be classified as high-yield debt securities if they otherwise have the characteristics of such securities.

- a. How should interest income from step bonds and payment-in-kind bonds be measured and reported in investment company financial statements?
- b. How should previously recorded income and purchased interest be treated when recoverability becomes doubtful in connection with defaults or potential defaults by issuers?
- c. How should additional expenditures made by investment companies in support of high-yield debt securities be accounted for?
- d. What audit procedures to determine the reasonableness of valuations of high-yield debt securities should be considered?

## Accounting for Income on Step-Interest and PIK Debt Securities

### Discussion

.15 High-yield debt securities (junk bonds) take various forms. The most common forms may include zero-coupon bonds, PIK bonds, and deep-discount step bonds.

### **PIK Bonds**

.16 Issuers of PIK bonds typically have the option at each interest payment date of making interest payments in cash or in additional debt securities. Those additional debt securities are referred to as *baby* or *bunny bonds*. Baby bonds generally have the same terms, including maturity dates and interest rates, as the original bonds (parent PIK bonds). Interest on baby bonds may also be paid in cash or in additional like-kind debt securities at the option of the issuer.

### **Step Bonds**

.17 Step bonds generally are characterized by a combination of deferred-interest payment dates and increasing interest payment amounts over the bond lives. Thus, they bear some similarity to zero-coupon bonds and to traditional debentures.

## **Current Practices: Income Recognition**

.18 Present income-recognition practices for high-yield debt securities vary.

### **PIK Bonds**

.19 The most common methods currently used for revenue recognition on PIK bonds are the effective-interest method and the market-value method.

.20 *Effective-interest method.* Under the effective-interest method, also referred to in accounting literature as the interest method, PIK bonds and the additional debt securities issued in connection with interest payments on them are treated as a combined instrument, based on the assumption that all principal amounts will be paid at maturity. Interest income is recorded by the effective interest method, so that at final maturity the bonds' carrying amount will be equal to the aggregate principal amount of the original bonds and all baby bonds received. The realizable value of the bonds' interest previously accrued and recorded is evaluated periodically. Any adjustments are recorded as charges to interest income and reserves against interest receivable.

.21 *Market-value method.* Under the market-value method, interest income is accrued daily on the basis of the face value and the stated interest rate of the PIK bond. Each day, the related interest receivable is marked to market, thereby reflecting the current economic value of interest income recognized. The market price of the parent PIK bond generally includes accrued interest. To the extent that any accrued interest is determined to have been included in the quoted market price of the parent PIK bond, it is eliminated each day to avoid double counting of interest income.

.22 Further, the interest ex-date represents the first date that a PIK bond's market value does not include an interest component and interest income is fully accrued. From that date through the payment date, generally a period of one to two weeks, the bond theoretically trades without interest. (This is similar in concept to the ex-date for traditional equity securities paying periodic dividends.) Accordingly, from the interest ex-date through the interest payment date, no adjustment is necessary to reduce the bond market value for interest.

.23 At the payment date, the basis of the baby bonds actually received is compared with the amount accrued at the interest ex-date based on the current market value of the parent bond. Because interest receivable is being marked

to market daily, no further adjustment to interest receivable generally is necessary. However, if the basis (that is, the current market value) of the baby bonds received and the accrued interest on the parent bond are different, the resulting adjustment is charged or credited to interest income.

.24 Should the reporting entity sell a PIK bond between interest payment dates, the proceeds received are allocated to interest accrued and bond basis in a manner that is consistent with the market valuation as of the trade date. The same is true for any purchases made between interest payment dates.

.25 One variation of the market-value method is to adjust the amount of interest income accrued by the interest method to the value of the bonds at the interest ex-date.

.26 A second variation is to accrue interest income daily on the basis of the coupon rate and adjust the interest income for the market value of the bonds received at the payment date only.

### **Step Bonds**

.27 Currently, two methods are most commonly followed for revenue recognition on step bonds.

.28 *Effective-interest method.* Under the effective-interest method, also referred to in accounting literature as the interest method, total expected interest—the combination of the aggregate coupon-interest payments and the original issue discount—to be earned over the life of the bond is determined and the effective-interest rate is applied to recognize interest income daily for the bond. This method ignores any adjustment of interest rates and treats the bond as a zero-coupon instrument.

.29 *Bifurcation method.* The bifurcation method assumes that the bond is a discount bond only for the portion of its life during which payment of interest is deferred. During that period, an effective-interest rate is used. For the remainder of the bond's life for which a stated coupon rate exists, the stated interest rate is used to record interest income.

## **Views on the Issues**

### **PIK Bonds**

.30 Some believe that accounting for PIK bonds should follow the guidance for monetary assets that do not pay interest periodically, such as zero-coupon bonds, and that their interest should be accounted for by accretion by the effective-interest method. That is generally considered to be the method to use in recognizing income for tax purposes. It would allow consistency between tax and financial reporting treatments.

.31 Others contend that, because of the significant uncertainties concerning the realizability of income from PIK bonds, income should reflect the current values of the underlying investments regardless of stated coupon rates. They believe that the use of current value presents a more accurate picture of the current value of income received from PIK bonds.

### **Step Bonds**

.32 Some believe that because there are differing interest payments throughout the lives of step bonds, including periods of no interest payments, step bonds have the same characteristics as zero-coupon bonds. They would therefore account for interest income by the effective-interest method.

.33 Others believe that the contractual nature of the interest payment schedules connected with these bonds should govern the accounting treatment. Thus, for periods of no interest payments, the effective-interest method should be used; when interest payments are being made, they should be used to account for income.

## Conclusions

### *PIK Bonds*

.34 Because PIK bonds generally possess many of the characteristics of zero-coupon bonds and because the effective-interest method provides the most analogous accounting treatment, it should be used to determine interest income. PIK bonds typically trade flat (that is, interest receivable is included in the market value quote obtained each day). Accordingly, that portion of the quote representing interest income needs to be identified. The sum of the acquisition amount of the bond and the discount to be amortized should not exceed the undiscounted future cash collections that are both reasonably estimable and probable. To the extent that interest income to be received in the form of baby bonds is not expected to be realized, a reserve against income should be established (that is, it should be determined periodically that the total amount of interest income recorded as receivable, plus the initial cost of the underlying PIK bond, does not exceed the current market value of those assets).

### *Step Bonds*

.35 Income on step bonds should be recognized using the effective-interest method, which is a systematic and rational method for accruing income throughout a bond's life and is not affected by the timing of cash payments. Additionally, to the extent that interest income is not expected to be realized, a reserve against income should be established. The sum of the acquisition amount of the bond and the discount to be amortized should not exceed the undiscounted future cash collections that are both reasonably estimable and probable.

### *Securities and Exchange Commission (SEC) Yield Calculations*

.36 SEC yield-formula calculations are required to be made using the specific guidelines presented in SEC Release No. 33-6753. Yields calculated that way may not be the same as the effective interest reported in the financial statements. The ultimate realizable value and the potential for early retirement of securities should be considered when computing SEC yields. Management's best estimates of ultimate realizable value must be reasonable. Because current values of many high-yield debt securities have declined significantly, computed yields for many of them may be higher than rates expected to be ultimately realized. To avoid unsound yield information, consideration should be given to capping yields of individual securities at some reasonable level and examining the underlying economic viability of the issuers.

.37 An investment company's portfolio should indicate all high-yield and restricted debt securities whose values have been estimated by its directors.

## Accounting for Accrued Income and Purchased Interest in Connection With Defaulted Debt Securities

### Discussion

.38 Interest receivable from debt securities generally comprises two distinct components: interest purchased from the previous bondholder and inter-

est accrued by the investment company during the holding period. If market prices fluctuate significantly or issues of debt securities have defaulted, a judgment to write off interest receivable may be required. Both components of interest receivable must be evaluated.

.39 Writeoffs of interest receivable differ from traditional writeoffs of trade accounts receivable. They can significantly affect an investment company's statement of operations, the performance measurement ratios of expenses to average net assets, and net investment income to average net assets.

## Current Practices

.40 Current practice for the writeoff of interest receivable is diverse. Most investment companies record the writeoff of accrued interest as a reduction of interest income. Many investment companies record the writeoff of purchased interest as an increase to the cost basis of securities, whereas others record such writeoffs as a reduction of interest income.

## Views on the Issues

.41 Many believe that, to the extent that a writeoff is related to interest recognized by the investment company, it should be treated as a reduction of interest income. They further believe that treatment of interest writeoffs as expenses would present misleading expense ratios to users of financial statements of investment companies and cause difficulties in comparisons of performance information from different investment companies. They also believe that a writeoff of purchased interest is better presented as an adjustment to the cost basis of the security, because it was incurred simultaneously and integrally with the original purchase of the investment. Additionally, because purchased interest is not recorded as income, they believe it should not be treated as an offset to revenue.

## Conclusion

.42 The portion of interest receivable on defaulted debt securities written off that was recognized as interest income should be treated as a reduction of interest income. Writeoffs of purchased interest should be reported as increases to the cost basis of the security and treated as unrealized losses until the security is sold.

.43 Those reserves should be recorded when they become probable and estimable in accordance with the guidance provided by FASB Statement No. 5, *Accounting for Contingencies*.

## Accounting for Expenditures in Support of Defaulted Debt Securities

### Discussion

.44 The market for many high-yield debt securities is relatively thin. When issuers of such securities default, the bondholders often become active in any negotiations and in the workout process. This process often results in new terms that restructure the high-yield obligations to allow the issuer to continue to meet its ongoing interest obligations and maintain some, if not all, of the principal value to the holders of the obligations.

.45 Adverse economic developments often lead to increases in the default rates of high-yield debt securities. In addition to occasional capital infusions, professional fees to legally restructure the investments are frequently incurred by the bondholders.

### **Current Practices**

.46 Current accounting and disclosure practices concerning additional capital infusions to specific projects underlying a bond issue and professional fees incurred in connection with the restructuring of debt securities held as investments are diverse. Some record expenditures for both capital infusions and professional fees as additions to the original investment cost basis; others record expenditures for professional fees as operating expenses.

### **Views on the Issues**

.47 Some believe that expenditures incurred to support the operations of a project or operator underlying a bond issue, either in the form of capital infusions or professional fees, should be charged to operations because such expenditures have no certain future economic benefit and do not increase the bond issuer's obligation payable to the bondholder. Others believe that such expenditures should be recorded as additions to the cost basis of the investment because they are made solely to enhance or protect the realizable value of the high-yield security.

### **Capital Infusions**

.48 Capital infusions are expenditures made directly to the issuer to ensure that operations are completed, thereby allowing the issuer to generate cash flows to service the debt. Such expenditures are generally nonrecurring. In certain cases, bondholders may receive additional promissory notes, or the original bond instrument may be amended to provide for repayment of the capital infusions. However, regardless of whether or not additional promissory notes are received, some believe capital infusions generate a future economic benefit. They believe that such capital infusions should in all cases be considered additions to the cost of the investment. Further, they note that, because investment companies report their investment portfolios at market values, those additional capital infusions, if treated as additions to the cost of the investment and if unaccompanied by a corresponding increase in market value, will be reflected in net assets through an increase in unrealized losses. Thus, the issue is a matter of classification between gain or loss and net investment income in the statement of operations, and such expenditures generally are viewed as a part of the cost of the investment rather than as a cost of operations.

### **Workout Expenditures**

.49 Workout expenditures under this SOP consist of professional fees (legal, accounting, appraisal) paid to entities unaffiliated with the investment company's advisor or sponsor, which generally are incurred in connection with (a) capital infusions, (b) restructurings or plans of reorganization, (c) ongoing efforts to protect or enhance an investment, or (d) the pursuit of other claims or legal actions. Some believe that such expenditures incurred to maintain an investment company's position in high-yield debt securities among other bondholders or with the issuer should be reported as operating expenses by the investment company. Others believe that such costs are also incurred principally

to maintain or prevent substantial diminution in future realizable value and therefore should be reported as additions to the cost basis.

## Conclusion

.50 All capital infusions, as defined in paragraph .48, should be recorded as additions to the cost bases of related securities because the nature of capital infusions is to enhance or prevent substantial diminution in the value of the investment.

.51 Workout expenditures that are incurred as part of negotiations of the terms and requirements of capital infusions, or that are expected to result in the restructuring of or a plan of reorganization for an investment should be recorded as realized losses. Ongoing expenditures to protect or enhance an investment, or expenditures incurred to pursue other claims or legal actions, should be treated as operating expenses.

## Audit Procedures to Be Considered in Evaluating Valuations of High-Yield Debt Securities

### Discussion

.52 Market-value risk for holders of high-yield debt securities is compounded by the relatively thin trading market in such securities, which increases price volatility and makes it difficult to liquidate holdings efficiently at any specific time. Determination of market prices is difficult given the illiquid or sometimes nonexistent trading market. Furthermore, there are no standardized procedures or central markets for pricing most high-yield debt securities. In addition, few third-party pricing services currently exist, except for those used by investment companies; these could be used by auditors to obtain market prices of issues in support of investment companies' valuations.

### Current Practices

.53 Auditors generally corroborate market values of investment companies' high-yield debt securities with independent pricing services. Some auditors use one pricing service; others obtain at least two prices for each security by using two or more services. Some auditors perform extensive procedures to determine the reasonableness of valuations obtained from pricing services; others rely on the expertise of the independent pricing services and perform only exception reviews.

.54 Based on pricing, high-yield debt securities can be viewed as being one of three types:

- a. Securities for which there is an active market and for which independent prices are readily available
- b. Securities for which the market is less active and for which limited price information is available
- c. Securities for which there is no market or a thin market and that are priced by the investment company

## Views on the Issues

.55 Some believe that the current practice of monitoring prices on an exception basis in connection with obtaining prices from independent pricing services is adequate. They believe it is common knowledge that exact measures of individual high-yield bond values do not exist because there is no central exchange. They further believe that review procedures focused on significant changes in prices would identify unsound price valuations and that, for securities whose values are estimated by the investment company's directors, the combination of reviews of an investment company's portfolio by accounting managers acts as an adequate check to ensure that pricing practices are reasonable.

.56 Others believe that more specific guidance on reviewing the reasonableness of prices used is required for auditors. They also believe there is significant diversity in the extent and frequency of reviews of the methods applied by pricing services.

## Conclusion

.57 Given the complexities of pricing high-yield debt securities, as well as the potentially volatile market conditions surrounding those securities, certain additional pricing valuation audit procedures should be considered by auditors when reviewing the valuations of high-yield debt securities. The auditor may conclude that additional procedures are not warranted based on an assessment of control procedures applied by the investment company.

.58 Pricing services may be evaluated in accordance with SAS No. 73, *Using the Work of a Specialist*. Such procedures may include the following:

- Review of the methods used for determining daily prices and the consistency of those methods from period to period
- Consideration of the experience of the individuals involved in determining prices and of the quality control procedures in place
- Review of recent trading volumes and comparison of prices to those obtained from market makers

.59 The SEC's Financial Reporting Release (FRR) 404.03(b) discusses directors' valuation of securities for which readily available market prices do not exist. FRR 404.03(c) suggests certain procedures that the auditor should consider when reviewing securities valued in good faith by directors. In addition to those procedures the auditor may also wish to consider the following:

- Review of the methods used by management to determine and update daily prices and of the consistency of this methodology from period to period and across similar securities
- Review of recent trading transactions subsequent to the reporting date to determine whether significant price changes have occurred
- Consideration of the experience of individuals involved in determining prices
- Review of procedures used to assess the credit risk of issuers

SAS No. 57, *Auditing Accounting Estimates*, provides guidance to auditors on obtaining sufficient competent evidential matter to support significant accounting estimates in audits of financial statements conducted in accordance with generally accepted auditing standards.



**.60** Furthermore, good-faith security value estimates may present the auditor with unique reporting problems. The board of directors' fair valuation procedures are designed to approximate the values that would have been established by market forces and are therefore subject to uncertainties.

**.61** The auditor should not modify the auditor's opinion if he or she concludes, based on an examination of the available evidence, that the process used to estimate value is reasonable, the documentation supportive, and the range of possible values not significant. The auditor may, however, choose to emphasize the existence of the matter by inserting an explanatory paragraph in the audit report.

## **Effective Date and Transition**

**.62** This SOP is effective for financial statements and for audits of such financial statements for fiscal years ending after December 15, 1993, and for interim periods within such years. This SOP need not be applied to financial statements for fiscal years ending before its effective date that, for comparative purposes, are provided with financial statements for fiscal years ending after its effective date. The effect of this SOP should be disclosed in the period in which it is first applied. Early application of this SOP is encouraged.

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[The next page is 19,681.]

**Section 10,550****Statement of Position 93-2  
Determination, Disclosure, and Financial  
Statement Presentation of Income, Capital  
Gain, and Return of Capital Distributions by  
Investment Companies**

February 1, 1993

**NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least two thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

**Introduction**

.01 Amounts distributed by an investment company as net investment income or capital gains often are not equal to the corresponding income or gain amounts shown in the company's financial statements. The principal cause is that fund distributions are based on income and gain amounts determined in accordance with federal income tax regulations, whereas the corresponding financial statement amounts are determined in accordance with generally accepted accounting principles (GAAP). The differences created can be temporary, meaning that they will reverse in the future, or they can be permanent. Some investment companies treat portions of those distributions as a return of capital for financial statement purposes.

.02 Situations often arise that create a book return of capital but not a tax return of capital, because distributions are determined in accordance with federal income tax regulations by investment companies. Accordingly, return of capital is frequently different for GAAP and federal income tax purposes because of differences between book and tax income (see illustration 1 in the appendix [paragraph .15]).

## Securities and Exchange Commission Guidance

.03 Distributions that result in a book return of capital are currently required by section 19a-1 of the Investment Company Act of 1940, as amended, to be disclosed to shareholders by investment companies at the time of distribution. Because of the differences engendered by the current tax regulations between a book return of capital and a tax return of capital, reporting book returns of capital has become irrelevant. This statement of position (SOP) provides guidance on the disclosure of tax return of capital for financial statement purposes and should help the industry comply with the section 19a-1 requirement.

### Scope

.04 This SOP provides guidance for financial statement presentation and disclosure of distributions to shareholders, including tax return of capital, for investment companies that are registered under the Investment Company Act of 1940, as amended, and that qualify as regulated investment companies under subchapter M of the Internal Revenue Code. It amends the AICPA's Audit and Accounting Guide *Audits of Investment Companies*.

### Present Practices

.05 Investment companies' net assets consist of four components:

- a. Undistributed net investment income
- b. Undistributed net realized gains
- c. Unrealized appreciation
- d. Shareholder capital

Those components must be disclosed separately on the balance sheet or in a note to the financial statements. For financial statement purposes, an investment company has two pools from which distributions of earnings to shareholders may be made: net investment income and net realized capital gains. They traditionally have been separated in a fund's statement of operations and statement of changes in net assets and in the balance sheet analysis of net assets. This distinction helps shareholders understand the contribution of each aspect of investment activity to the investment company's overall operations. Additionally, the statement of changes in net assets presents, in comparative form, changes in net assets resulting from operations, net equalization<sup>1</sup> credits or debits, distributions to shareholders classified as distributions from net investment income, net realized gains from investment transactions and other sources, and capital share transactions.<sup>2</sup>

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<sup>1</sup> Equalization, a book accounting practice unique to the investment company industry, prevents the continuing shareholder interest in undistributed income from being affected by changes in the number of shares outstanding by applying a portion of the proceeds from sales and costs of repurchases of capital shares to undistributed income (see *Audits of Investment Companies*, paragraph 1.32).

<sup>2</sup> For further discussion on the statement of changes in net assets presentation, see *Audits of Investment Companies*, paragraphs 5.36 and 5.37.

**.06** For tax purposes, U.S. investment companies are corporations, or business trusts treated as corporations, subject to taxation on income and net capital gains unless certain requirements are met. To maintain its favorable status as a regulated investment company and avoid federal excise tax or a tax on income, a company must comply with a complex array of tax rules on distributions. In particular, distributions of net investment income and realized capital gains by investment companies are governed principally by the requirements of subchapter M and the excise tax requirements of the Internal Revenue Code.

**.07** Tax regulations that incorporate specific rules for determining the nature of fund income and the timing of its recognition also require designation of the nature and source of distributions. Excise tax requirements, enacted as part of the 1986 Tax Reform Act, add another element of complexity by defining a measurement period for investment income and net realized capital gains that may differ from a fund's fiscal year, as well as specific dates by which distributions of such income and gains must be paid to avoid an excise tax. Accordingly, distributions may occur in excess of GAAP-basis undistributed net investment income and undistributed net realized gains, resulting in a prepayment of future earnings that does not constitute a return of capital for tax purposes.

**.08** Varied interpretations of the two-pool concept and different practices in the recognition of revenue and expense for financial statement and income- or excise-tax purposes have led to diverse reporting and disclosure practices for distributions by investment companies. In particular, investment companies have not followed a consistent approach to the determination and disclosure of a book or tax return of capital.

## Views on the Issue

**.09** For financial reporting purposes, strict application of the two-pool concept would result in a book return of capital when distributions from net investment income exceed the total of GAAP-basis undistributed net investment income from prior periods and the current period (including net equalization debits or credits for funds that practice equalization) or when distributions from net realized capital gains exceed GAAP-basis undistributed net realized capital gains from prior periods and the current period.

**.10** To avoid a book return of capital occurring when one pool is overdistributed while the other is underdistributed, an alternative treatment, which aggregates the two pools into one pool, recognizes a book return of capital only if the sum of distributions exceeds the aggregate total of undistributed net investment income and undistributed net realized capital gains. (See illustrations 2, 3A, and 3B in the appendix [paragraph .15].) Such treatment averts the need, for financial statement purposes, to charge paid-in capital due to a book return of capital caused by book-tax temporary differences. In practice under this aggregate one-pool approach, when net realized capital losses are reported for the year, no distribution of undistributed net investment income made to fulfill tax distribution requirements is considered a book return of capital.

**.11** For tax purposes, a return of capital generally occurs when distributions by an investment company exceed the aggregate amount of undistributed net investment company taxable income and net realized capital gains calculated in accordance with tax regulations—that is, distributions exceed current

tax earnings and profits when there is an accumulated tax deficit, or current and accumulated tax earnings and profits when there are accumulated tax earnings and profits. This characterization is of primary importance to the shareholders because such an event requires shareholders to adjust the tax basis of their shares and to exclude the return of capital from current taxable income.

## Conclusion

.12 Investment companies prepare their financial statements on the basis of GAAP. Although book returns of capital may occur, they have little relevance to investment company shareholders. In contrast, tax returns of capital have a high degree of relevance and must be separately reported to shareholders for income-tax purposes. To report book returns of capital when such returns have not occurred for tax purposes would be confusing to shareholders.

.13 Distributions made by investment companies often are different from the aggregate GAAP-basis financial statement total of net investment income (including net equalization credits or debits and undistributed net investment income) and accumulated net realized capital gains (total GAAP-basis net income and realized capital gains). The following accounting and reporting guidelines apply to investment company distributions.

- a. Payments to shareholders of net investment income and net realized capital gains should be charged to GAAP-basis undistributed net investment income or accumulated net realized capital gains to the extent thereof, with any excess over the total of such net investment income and realized capital gains deducted from paid-in capital, except as described in *b*, below. (See illustrations 3A and 3B in the appendix [paragraph .15].)
- b. Payments in excess of total GAAP-basis net investment income and realized capital gains may be charged to undistributed net investment income or accumulated net realized capital gains, as appropriate, to the extent that the overdistributions are the result of specific book-tax temporary differences.<sup>3</sup> Accordingly, amounts distributed in excess of total GAAP-basis net investment income and realized capital gains attributable to temporary differences should be shown as distributions in excess of such income or capital gain amounts, or both, in the statement of changes in net assets, and as accumulated distributions in excess of net investment income or realized capital gain (negative balances) in the analysis of components of net assets to the extent of the specific temporary differences. Payments in excess of total GAAP-basis net investment income and realized capital gains that are the result of permanent book-tax differences should be deducted from paid-in capital in the analysis of components of net assets. Also, if in a subsequent period a portion or all of a temporary difference becomes a permanent difference, the amount of the permanent difference should be reclassified to paid-in capital.<sup>4</sup>

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<sup>3</sup> Among the more common items that create book-tax temporary differences are deferred capital losses due to wash sales; average cost versus specific identification cost; treatment of options, futures, and forward contracts; foreign currency gain or loss treatment (IRS Section 988); use of capital-loss carryforwards; straddles; tax accretion of market discount; defaulted bond income; and post-October 31 losses.

<sup>4</sup> Items considered permanent differences include equalization credits or debits and the expiration of capital-loss carryforwards.

- c. The primary reason(s) for any significant difference between total GAAP-basis net income and realized capital gains and actual distributions should be disclosed in the notes to the financial statements.
- d. If, at a fund's fiscal year end, a distribution is a tax return of capital, as defined in paragraph .11 of this SOP, the amount should be presented separately as such in the statement of changes in net assets and deducted from paid-in capital in the analysis of components of net assets. The distribution of capital should also be reflected in the per share table. (See illustrations 3A, 3B, and 4 in the appendix [paragraph .15].) Because certain state securities regulations may govern changes to a fund's capital accounts, consideration should be given to consulting with the board of directors/trustees and legal counsel when adjustments to capital seem appropriate.
- e. With respect to interim financial statements prepared in accordance with GAAP, if management determines that for the fund's fiscal year a tax return of capital is likely to occur, although the exact dollar amount may not be estimable, that fact should be disclosed in the interim financial statements.

## Effective Date and Transition

.14 This SOP is effective for annual financial statements for fiscal years ending after December 15, 1993, and for interim statements for periods in such years. Restatement of comparative financial statements, including the supplementary per share information, is permitted but not required. If financial statements are not restated upon adoption of this SOP, the appropriate components of capital in the statement of net assets should be reclassified to conform with paragraph .13. Early application of this SOP is encouraged. The effect of changes caused by adopting this SOP should be disclosed in the period in which it is first applied.

.15

Appendix

Illustrations

Illustration 1

Book Return of Capital but no Tax Return of Capital

Year 1	Book income	\$10
	Tax income*	15
	Distribution to shareholder	15
Year 2	Book income	15
	Tax income†	10
	Distribution to shareholder	10
	Cumulative book income	25
	Cumulative tax income	25
	Cumulative distributions to shareholder	25

\* Amount is greater because of a timing difference that increases investment company taxable income in Year 1. During Year 1, because of the distribution of taxable income to meet tax requirements and avoid payment of a tax on income, a book return of capital is created.

† Amount is less because the Year 1 timing difference reverses in Year 2. At the end of Year 2, cumulative distributions are equal to cumulative income and, on a cumulative basis, no book return of capital has occurred.



**Illustration 2****Comparison of the GAAP-Basis Two-Pool and Aggregate One-Pool Approaches With the Tax-Basis One-Pool Concept**

	<i>GAAP Basis</i>		<i>Tax-Basis One-Pool</i>
	<i>Two-Pool</i>	<i>Aggregate One-Pool</i>	
Income			
Net investment income	\$10	\$10	\$10
Net realized capital gains	<u>2</u>	<u>2</u>	<u>2</u>
Total	<u>\$12</u>	<u>\$12</u>	<u>\$12</u>
Distributions			
Net investment income	\$11	\$11	\$10
Net realized capital gains	<u>1</u>	<u>1</u>	<u>2</u>
Total	<u>\$12</u>	<u>\$12</u>	<u>\$12</u>
Book overdistribution	Yes (\$10-\$11)	No	N/A
Tax return of capital	No	No	No

In this example, although distributions of net investment income exceeded net investment income earned, net realized capital gains were underdistributed. As distributions in the aggregate did not exceed total income, the aggregate one-pool method indicates no return of capital.

Illustration 3A

(Aggregate One-Pool Concept)

The Effect of a Temporary Difference on Distributions and Recommended Financial Statement Presentation

	(1)	(2)	(3)	(4)	(5)
Fact Situation					
GAAP Basis:					
Net investment income	\$10	\$10	\$10	\$10	\$10
Net realized gain	<u>5</u>	<u>5</u>	<u>5</u>	<u>5</u>	<u>5</u>
GAAP Income/Gain	15	15	15	15	15
Tax Temporary Adjustments:					
Tax writeoff of income	(2)	(2)	(2)	(2)	—
Wash sales (deferred loss)	<u>5*</u>	<u>5*</u>	<u>5*</u>	<u>5*</u>	—
Capital loss carryforwards used	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	(5)
Taxable Income/Gain	<u>\$18</u>	<u>\$18</u>	<u>\$18</u>	<u>\$18</u>	<u>\$10</u>
Distributions as Designated					
During the Year:					
Net investment income	\$ 8	\$10	\$12	\$12	\$10
Realized gains	<u>10</u>	<u>8</u>	<u>5</u>	<u>10</u>	<u>5†</u>
Total Distributions	<u>\$18</u>	<u>\$18</u>	<u>\$17</u>	<u>\$22</u>	<u>\$15</u>

Illustrations of Notes to Financial Statements

\* Net investment income and net realized gains differ for financial statements and tax purposes primarily because of the deferral of wash-sales losses.

The character of distributions made during the year from net investment income or net realized gains may differ from their ultimate characterization for federal income tax purposes due to GAAP/tax differences in the character of income and expense recognition.

† Despite a carryforward loss, a taxable distribution of realized gains was made, which will be treated as an ordinary income distribution for federal income tax purposes.

	(1)	(2)	(3)	(4)	(5)
<u>Recommended Presentation (a)</u>					
Statement of Changes:					
Distribution from net investment income	\$ 8	\$ 8	\$ 8	\$ 8	\$10
Distribution in excess of net investment income	—	—	—	—	—
Distribution from realized gains	5	5	5	5	—
Distribution in excess of realized gains	5	5	4	5	5(c)
Tax return of capital distribution	—	—	—	4(b)	—
	<u>\$18</u>	<u>\$18</u>	<u>\$17</u>	<u>\$22</u>	<u>\$15</u>
<u>Effect on Statement of Net Assets—Increase (Decrease)</u>					
Undistributed net investment income	\$ 2	\$ 2	\$ 2	\$ 2	\$—
Accumulated undistributed realized gains	(5)	(5)	(4)	(5)	5(d)
Paid-in capital	—	—	—	4(b)	(5)(d)
	<u>\$(3)</u>	<u>\$(3)</u>	<u>\$(2)</u>	<u>\$(7)</u>	<u>\$—</u>

(a) Per share data table presentation should conform to that shown in the statement of changes. Presentation of distributions is determined based on their tax-basis characteristics and then adjusted based on the source of the distributions, i.e., generally the lesser of book or tax.

(b) In the event that the \$4 overdistribution is not a tax return of capital, but merely a "spillover" distribution ("ex" date falls within fiscal period; payable date is in subsequent period), the amount would be shown as an "excess distribution" in the statement of changes and no deduction from paid-in capital would be necessary.

(c) The amount shown as a distribution in excess of net realized gains is limited by the amount of the lost capital-loss carryforward.

(d) The portion of the loss carryforward, in an amount equal to the distribution in excess of net realized gains, should be reclassified to paid-in capital.

Illustration 3B

(Aggregate One-Pool Concept)

The Effect of a Permanent Difference on Distributions and Recommended Financial Statement Presentation

	(1)(c)	(2)	(3)	(4)
Fact Situation				
GAAP Basis—				
Net investment income	\$10	\$10	\$10	\$10
Net realized gain	<u>5</u>	<u>5</u>	<u>5</u>	<u>5</u>
GAAP Income/Gain	15	15	15	15
Permanent Tax Adjustments—				
Market discount/IRC Section 988 reclassification (a)				
Net investment income	3	(3)	—	—
Realized gain/loss	(3)	3	—	—
Capital loss carryforwards:				
Used (temporary)	—	—	(5)	(5)
Expired (permanent)	<u>—</u>	<u>—</u>	<u>—</u>	<u>(—)(e)</u>
Taxable Income/Gain	<u>\$15</u>	<u>\$15</u>	<u>\$10</u>	<u>\$10</u>
Distributions as Designated During the Year:				
Net investment income	\$13	\$ 7	\$10	\$10
Realized gains	<u>2</u>	<u>8</u>	<u>—</u>	<u>—</u>
Total Distributions	<u>\$15</u>	<u>\$15</u>	<u>\$10</u>	<u>\$10</u>

	(1)(c)	(2)	(3)	(4)
<u>Recommended Presentation (b)</u>				
Statement of Changes:				
Distribution from net investment income	\$10	\$ 7	\$10	\$10
Distribution in excess of net investment income	—	—	—	—
Distribution from realized gains	2	5	—	—
Distribution in excess of realized gains	<u>3</u>	<u>3</u>	<u>—</u>	<u>—</u>
	<u>\$15</u>	<u>\$15</u>	<u>\$10</u>	<u>\$10</u>
 <u>Effect on Statement of Net Assets—Increase (Decrease)</u>				
Undistributed net investment income	\$—	\$— (d)	\$—	\$—
Accumulated undistributed realized gains	—	— (d)	5	10(e)
Paid-in capital	<u>—</u>	<u>— (d)</u>	<u>—</u>	<u>5(e)</u>
	<u>\$—</u>	<u>\$—</u>	<u>\$ 5</u>	<u>\$ 5</u>

(a) Reclassification of realized loss on foreign currency to ordinary income as required by Section 988 of the Internal Revenue Code.

(b) Per share data table presentation should conform to that shown in the statement of changes. The financial statement presentation of distributions is determined based on their tax-basis characteristics and then adjusted based on the source of the distribution, i.e., generally the lesser of book or tax.

(c) This example demonstrates the circumstances and presentation that would be involved in reclassifying realized gains on discounted securities to ordinary income when a fund chooses not to accrete market discount.

(d) The 988 reclassification will not reverse. Thus, the remaining balances in undistributed realized gains (\$3) and net investment income (\$3) have been closed to paid-in-capital with zero net effect.

(e) Expired capital-loss carryforward of \$5 should be closed out to paid-in capital.

Illustration 4

Illustrative Financial Statement Presentation of Various Distribution Situations\*

	(1)	(2)	(3)(d)	(4)
Fact Situation				
Net investment income	\$100	\$100	\$100	\$100(e)
Net equalization credits (debits)	20	20	(20)	20
GAAP income	\$120	\$120	\$ 80	\$120
Distributions during the year	\$100	\$120	\$ 80	\$115

Recommended Presentation (a)

Statement of Changes:				
Distribution from net investment income	\$100	\$100	\$ 80	\$100
Distribution in excess of net investment income	—	—	—	10
Tax return of capital distribution	—	20	—	5(f)
	\$100	\$120	\$ 80	\$115

Effect on Statement of Net Assets—  
Increase (Decrease)

Undistributed net investment income	\$ 20(b)	\$— (c)	\$—	\$10
Paid-in capital	—	\$— (c)	—	(5)
	\$ 20	\$—	\$—	\$ 5

\* Examples (1), (2), and (3) assume no book/tax differences other than equalization and no beginning balances. Example (4) is a tax-exempt fund.

Illustration of Note to Financial Statements—Applicable to Fact Situation (1)

Equalization is a permanent book/tax difference that causes a difference between investment income and distributions.

(a) Per share data table presentation should conform to that shown in the statement of changes.

(b) Distribution of investment excludes net equalization credits.

(c) Distribution of investment income and net equalization credits with tax return of capital requires presentation not only of the tax return of capital distribution, but also reclassification of equivalent amounts representing the distributed net equalization credits from undistributed net investment income to paid-in capital.

(d) Distribution of investment income with consideration of equalization debits, assuming, for example, that book and tax equalization are the same.

(e) Net of \$10 expenses.

(f) \$100 net investment income plus \$10 disallowed expenses equals \$110 net earnings and profits. Distribution of \$115 is \$100 tax-exempt, \$10 taxable, and \$5 return of capital.

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## Section 10,560

# **Statement of Position 93-3 Rescission of Accounting Principles Board Statements**

March 19, 1993

### **NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least two thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## **Introduction**

.01 The Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) issued thirty-one Opinions. The APB also issued four Statements:

- a. APB Statement No. 1, *Statement by the Accounting Principles Board*, April 1962
- b. APB Statement No. 2, *Disclosure of Supplemental Financial Information by Diversified Companies*, September 1967
- c. APB Statement No. 3, *Financial Statements Restated for General Price-Level Changes*, June 1969
- d. APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, October 1970

## **Conclusions**

.02 In order to make clear that APB Statement Nos. 1, 2, 3, and 4 do not, and never did, have standing as rules or standards under the AICPA's Rules of Conduct or Code of Professional Conduct and to eliminate misunderstanding and attendant confusion, and because those Statements<sup>1</sup> effectively have been superseded by pronouncements of the Financial Accounting Standards Board

<sup>1</sup> APB Statements have not been included in the FASB's *Original Pronouncements*, paperback edition, for the past several years. However, they are included in the FASB's *Original Pronouncements* loose-leaf service.

(FASB), the Accounting Standards Executive Committee (AcSEC) of the AICPA hereby formally rescinds APB Statement Nos. 1, 2, 3, and 4 enumerated in paragraph .01 hereof.

## Current Literature

.03 Opinions of the APB, to the extent that they have not been superseded by pronouncements of the FASB, are part of the literature encompassed by the AICPA's Code of Professional Conduct, specifically rule 203 thereof, and, as such, must be followed by an AICPA member's client in the preparation of its financial statements in order for the member to issue an unmodified report about whether the client's financial statements have been prepared in conformity with generally accepted accounting principles (GAAP). Thus, APB Opinions, to the extent that they have not been superseded by pronouncements of the FASB, are rules or standards that must be observed in the practice of public accountancy by members of the AICPA. The various APB Opinions contained legends explaining their authority. These are cited in appendix A [paragraph .12].

.04 In Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, APB Statements are not included in categories (a) through (d), which constitute pronouncements covered by rule 203 or by another source of established accounting principles. However, APB Statements are referred to as "other accounting literature" that may be considered in the absence of a pronouncement covered by Rule 203 or another source of established accounting principles. Other accounting literature includes, for example, FASB and Governmental Accounting Standards Board (GASB) Concepts Statements; APB Statements; AICPA Issues Papers; AICPA Technical Practice Aids; accounting textbooks; and articles. Paragraph 11 of SAS No. 69 states that FASB Statements of Financial Accounting Concepts would normally be more influential than other sources in the other accounting literature category.

.05 APB Statement Nos. 2, 3, and 4 carried the following legends:<sup>2</sup>

### *Statement 2*

This Statement is not an "Opinion of the Accounting Principles Board" as contemplated in the Special Bulletin, *Disclosure of Departures from Opinions of the Accounting Principles Board*, October 1964. It is being issued as a special report for the information and assistance of members of the Institute and others interested in the subject. The Board may issue similar Statements in the future when it appears that preliminary analyses or observations on accounting matters should be issued in advance of research and study by the Board.

### *Statements 3 and 4*

Statements of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles. This Statement is not an "Opinion of the Accounting Principles Board" covered by action of the Council of the Institute in the Special Bulletin, *Disclosures of Departures from Opinions of the Accounting Principles Board*, October, 1964.

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<sup>2</sup> APB Statement No. 1 was the APB's commentary on the AICPA's Accounting Research Studies 1 and 3 and, as such, neither required nor carried a legend.

.06 Statements issued by the APB were never rules or standards that had to be observed by members of the AICPA in the practice of public accountancy. APB Statements are not comprehended by rule 203 of the Code of Professional Conduct. Nonetheless, some who are not familiar with the distinction between Opinions and Statements issued by the APB have cited, and continue to cite, APB Statements as being rules or standards that must be observed by members of the AICPA in the practice of public accountancy.

.07 The FASB effectively superseded APB Statement No. 2 with Statement of Financial Accounting Standards No. 14, *Financial Reporting for Segments of a Business Enterprise*. FASB Statement No. 89, *Financial Reporting and Changing Prices*, effectively superseded APB Statement No. 3. The FASB's various Statements of Financial Accounting Concepts effectively superseded APB Statement No. 4.

.08 Although APB Statement No. 3 is being rescinded because of subsequent FASB action with regard to inflation accounting, it is recognized that the FASB addressed only the presentation of partial price-level data. Since APB Statement No. 3 provided guidance for a comprehensive application of price-level adjusted financial statements, this SOP is not precluding such a presentation (to the extent it is not inconsistent with guidance in FASB Statement No. 89 regarding historical cost/constant purchasing power accounting, such as the classification of assets and liabilities as monetary or nonmonetary) should a company wish to do so.<sup>3</sup>

.09 Various APB Opinions, FASB Statements, and AICPA publications refer to APB Statements. The FASB Concepts Statements subsequently issued discuss essentially the same matters, and, therefore, this SOP has no impact on those pronouncements. In a few instances, the matter in the APB Statement is not included elsewhere in FASB pronouncements, and as indicated in appendix B [paragraph .13], AcSEC agrees with the relevant comments from those APB Statements and this rescission is not expected to affect practice. Further, various FASB Concepts Statements also refer to APB Statements. The references are listed in appendix B [paragraph .13].

.10 AcSEC believes the rescission of the APB Statements should have no effect on financial reporting and should eliminate any confusion over the status of the pronouncements.

## Effective Date and Transition

.11 This SOP is effective upon issuance.

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<sup>3</sup> AcSEC agrees with the conclusions of the APB, expressed in paragraph 26 of APB Statement No. 3, regarding general price-level financial statements of companies operating in hyperinflationary economies. Paragraph 26 states:

The Board recognizes that the degree of inflation or deflation in an economy may become so great that conventional statements lose much of their significance and general price-level statements clearly become more meaningful, and that some countries have experienced this degree of inflation in recent years.<sup>5</sup> The Board concludes that general price-level statements reported in the local currency of those countries are in that respect in conformity with accounting principles generally accepted in the United States, and that they preferably should be presented as the basic foreign currency financial statements of companies operating in those countries when the statements are intended for readers in the United States.<sup>6</sup>

<sup>5</sup> Although the Board believes that this conclusion is obvious with respect to some countries, it has not determined the degree of inflation or deflation at which general price level statements clearly become more meaningful.

<sup>6</sup> This paragraph applies only to statements prepared in the currency of the country in which the operations reported on are conducted. Only conventional statements of foreign subsidiaries should be used to prepare historical-dollar consolidated statements.

## Appendix A

### Legends Included in APB Opinions 1 Through 31

**A-1.** APB Opinions 1 through 5, issued between 1962 and 1964, carried the following legend:

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter. Except where formal adoption by the Council or the membership of the Institute has been asked and secured, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from the Board's recommendations must be assumed by those who adopt other practices. Recommendations of the Board are not intended to be retroactive, nor applicable to immaterial items.

**A-2.** APB Opinions 6 through 15, issued between 1965 and 1969, carried the following legend:

Opinions present the considered opinion of at least two-thirds of the members of the Accounting Principles Board, reached on a formal vote after examination of the subject matter.

Except as indicated in the succeeding paragraph, the authority of the Opinions rests upon their general acceptability. While it is recognized that general rules may be subject to exception, the burden of justifying departures from Board Opinions must be assumed by those who adopt other practices.

Action of Council of the Institute (Special Bulletin, *Disclosure of Departures from Opinions of the Accounting Principles Board*, October 1964) provides that:

- a. "Generally accepted accounting principles" are those principles which have substantial authoritative support.
- b. Opinions of the Accounting Principles Board constitute "substantial authoritative support."
- c. "Substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board.

The Council action also requires that departures from Board Opinions be disclosed in footnotes to the financial statements or in independent auditors' reports when the effect of the departure on the financial statements is material.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive. They are not intended to be applicable to immaterial items.

**A-3.** APB Opinions 16 through 27, issued between 1970 and 1972, carried the following legend:

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.

Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered. Unless otherwise stated, Opinions of the Board are not intended to be retroactive. Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, *Disclosure of Departures from Opinions of the Accounting Principles Board*, October 1964). Members of the Institute must assume the burden of justifying any such departures.

**A-4.** APB Opinions 28 through 31, issued in 1973, carried the following legend:

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board.

Board Opinions need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Rule 203 of the Institute's Rules of Conduct prohibits a member from expressing his opinion that financial statements are presented in conformity with generally accepted accounting principles if the statements depart in a material respect from such principles unless he can demonstrate that due to unusual circumstances application of the principles would result in misleading statements—in which case his report must describe the departure, its approximate effects, if practicable, and the reasons why compliance with the established principles would result in misleading statements.

Pursuant to resolution of Council, this Opinion of the APB establishes, until such time as they are expressly superseded by action of FASB, accounting principles which fall within the provisions of Rule 203 of the Rules of Conduct.

## Appendix B

### References in APB Opinions, FASB Statements, and AICPA Publications to APB Statements

#### Introduction

**B-1.** Various APB Opinions, FASB Statements, and AICPA publications refer to APB Statements. Those are listed below along with references to FASB Concepts Statements discussing essentially the same matters that were subsequently issued.

**B-2.** To use the reference to revenue recognition as an illustration, APB Statement No. 4, paragraph 150, stated:

Realization principle—revenue is generally recognized when both of the following conditions are met: (1) the earning process is complete or virtually complete, and (2) an exchange has taken place . . . .

**B-3.** Paragraph 83 of the more recently issued FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, discusses revenues and gains. The FASB states that recognition involves consideration of two factors—(a) being realized or realizable and (b) being earned:

- (a) Revenues and gains generally are not recognized until realized or realizable.
- (b) Revenues are not recognized until earned . . . revenues are considered to have been earned when an entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

**B-4.** Another illustration is paragraph 35 of APB Statement No. 4, which lists “present characteristics and limitations of financial accounting and financial statements” and includes:

*Substance Over Form.* Although financial accounting is concerned with both the legal and economic effects of transactions and other events and many of its conventions are based on legal rules, the economic substance of transactions and other events are usually emphasized when economic substance differs from legal form.

**B-5.** Subsequently issued FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, has several paragraphs on point.

Paragraph 59—The reliability of a measure rests on the faithfulness with which it represents what it purports to represent . . . .

Paragraph 63—Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent.

Paragraph 160 (appendix C)—Substance over form is an idea that also has its proponents, but it is not included [in the FASB Concepts Statement] because it would be redundant. The quality of reliability and, in particular, of representational faithfulness leaves no room for accounting representations that subordinate substance to form. Substance over form is, in any case, a rather vague idea that defies precise definition.

**B-6.** AcSEC believes the FASB Concepts Statements have effectively superseded the discussion of these matters in APB Statement No. 4 as well as substantially all of those listed on the following pages of this appendix.

**B-7.** In addition, the only reference to APB Statements in GASB rules appears in the *Codification of Governmental Accounting and Financial Reporting Standards* as a footnote to paragraph 1600.125, where, in a discussion of recognition of revenues and expenses in proprietary funds, a general reference is made to the more detailed discussion in APB Statement No. 4, paragraphs 147–163. Again, the rescission should have no impact.

## FASB Concepts Statements

**B-8.** Various Concepts Statements refer to APB Statement No. 4, as listed below. However, since the Concepts Statements stand on their own, superseding APB Statement No. 4 has no impact on financial reporting.

<i>Concepts Statement</i>	<i>Topic</i>
No. 1, paragraph 3	Objectives—financial reporting
No. 1, paragraph 57	Background information
No. 2, paragraph 91	Conservatism
No. 2, paragraphs 82–83	Verifiability
No. 2, paragraph 145	Background information
No. 4, footnote 2	Nonreciprocal transfers
No. 5, footnote 1	Financial statements
No. 5, footnote 4	Financial disclosure
No. 5, footnote 50	Revenue recognition
No. 5, footnote 51	Revenue recognition
No. 5, footnote 52	Revenue recognition
No. 6, footnote 52	Transactions, events, circumstances
No. 6, footnote 53	Nonmonetary transactions
No. 6, footnote 57	Expense recognition
No. 6, paragraph 153	Background information

**B-9.** A footnote to Concepts Statement No. 5 indicates that pronouncements such as APB Statement No. 4 will continue to serve their intended purpose: “They describe objectives and concepts underlying standards and practices existing at the time of their issuance.” Since the issuance of APB Statement No. 4 in 1970, it has not been updated for any subsequently issued APB or FASB pronouncement.

References in APB Opinions, FASB Statements, and AICPA Publications to APB Statements

Similar Discussion in FASB Concepts Statement

Literature Citing APB Statement	APB Statement Reference	Topic	Similar Discussion in FASB Concepts Statement
APB Opinion 22, footnote 1	APBS 4, chapters 6, 7, and 8	GAAP is on three levels: pervasive, broad operating, and detailed principles	See footnote 1 below
APB Opinion 29, pars. 3a and 3b, footnote 2	APBS 3, pars. 17–19 and app. B	Monetary and nonmonetary items	See footnote 2 below
APB Opinion 29, pars. 3c and 3d, footnote 3	APBS 4, pars. 180–183	Exchanges and nonreciprocal transfers	FASBC No. 6, pars. 135 and 137, and see footnote 2 below
FASBS No. 2, par. 42 <sup>3</sup>	APBS 4, par. 57	Economic resources	FASBC No. 6, par. 25
FASBS No. 2, pars. 47–48 <sup>3</sup>	APBS 4, pars. 147 and 156–160	Expense recognition	FASBC No. 5, pars. 85–87 FASBC No. 6, pars. 144–152
FASBS No. 2, par. 50 <sup>3</sup>	APBS 4, par. 160	Expense recognition	FASBC No. 5, pars. 85–87 FASBC No. 6, pars. 144–152
FASBS No. 5, par. 67 <sup>3</sup>	APBS 4, par. 35	Financial accounting and reporting	FASBC No. 1, par. 21

APBS = APB Statement; FASBS = FASB Statement of Financial Accounting Standards; FASBC = FASB Statement of Financial Accounting Concepts.

<sup>1</sup> The footnote reference to APB Statement No. 4 is intended to provide background information and does not affect the Opinion. FASB Concepts Statements do not refer to three levels of principles.

<sup>2</sup> The footnote reference to definitions of certain terms in APB Opinion 29 indicates that a “more complete explanation” of the terms can be found in the APB Statement. Further monetary and nonmonetary items are discussed in FASB Statement No. 89, par. 96.

<sup>3</sup> Citation is in the Basis of Conclusions rather than the actual standard.



## References in APB Opinions, FASB Statements, and AICPA Publications to APB Statements—continued

*Similar Discussion in FASB  
Concepts Statement*

<i>Literature Citing APB Statement</i>	<i>APB Statement Reference</i>	<i>Topic</i>	<i>Similar Discussion in FASB Concepts Statement</i>
FASBS No. 5, par. 70 <sup>3</sup>	APBS 4, par. 58	Economic obligations	FASBC No. 6, par. 35
FASBS No. 5, par. 74(e) <sup>3</sup>	APBS 4, par. 183	Impairment of assets when damaged	FASBC No. 6, par. 32
FASBS No. 5, pars. 77 and 78 <sup>3</sup>	APBS 4, pars. 147 and 156–160	Expense recognition and the matching concept	FASBC No. 5, pars. 85–87 FASBC No. 6, pars. 144–152
FASBS No. 5, pars. 82 and 83 <sup>3</sup>	APBS 4, pars. 35 and 171	Conservatism	FASBC No. 2, pars. 92–97
FASBS No. 7, par. 32 footnote 16 <sup>3</sup>	APBS 4, par. 160	Expense recognition	FASBC No. 5, pars. 85–87 FASBC No. 6, pars. 144–152
FASBS No. 14, par. 66 <sup>3</sup>	APBS 4, par. 90	Verifiability	FASBC No. 2, pars. 81–89
FASBS No. 14, par. 67 <sup>3</sup>	APBS 4, pars. 87–94	Other qualitative objectives	FASBC No. 2
FASBS No. 15, pars. 71, 72, 73, 75, 81, 92, 95, 96, and 112, and footnote 32 <sup>3</sup>	APBS 4, various	General discussion as background	FASBC Nos. 2, 5, and 6
FASBS No. 16, par. 27 <sup>3</sup>	APBS 4, par. 147	Matching	FASBC No. 5, pars. 85–87 FASBC No. 6, pars. 144–152
FASBS No. 19, par. 136 <sup>3</sup>	APBS 4, par. 152	Revenue recognition	FASBC No. 5, par. 84(e)
FASBS No. 19, pars. 179, 181, and 182 <sup>3</sup>	APBS 4, pars. 156–160	Expense recognition and the matching concept	FASBC No. 5, pars. 85–87 FASBC No. 6, pars. 144–152

APBS = APB Statement; FASBS = FASB Statement of Financial Accounting Standards; FASBC = FASB Statement of Financial Accounting Concepts.

<sup>3</sup> Citation is in the Basis of Conclusions rather than the actual standard.

# References in APB Opinions, FASB Statements, and AICPA Publications to APB Statements—continued

Similar Discussion in FASB

Concepts Statement

Literature Citing APB Statement	APB Statement Reference	Topic	Concepts Statement
FASBS No. 34, par. 37, footnotes 6 and 7 <sup>3</sup>	APBS 4, pars. 163 and 164	Monetary and nonmonetary items	FASBC No. 2, par. 65 FASBC No. 5, par. 67(a) FASBC No. 6, par. 246
SOP 75-2 (REITs), par. 27*	APBS 4, par. 183	Foreclosed assets are not subsequently written up	See footnote 4 below
SOP 81-1 (Construction Contracts), par. 3	APBS 4, pars. 150, 152, and 174	Revenue recognition	FASBC No. 5, pars. 83 and 84(c), and footnote 53
SOP 85-3 (Agriculture), par. 24	APBS 4, par. 16	Revenue recognition	FASBC No. 5, pars. 84(c) and 84(e)
SOP 85-3, par. 32	APBS 4, par. 152	Inventories carried at market price	See footnote 5 below
SOP 89-5 (Prepaid Health Care), par. 54	APBS 4, par. 157	Expense recognition	FASBC No. 5, par. 86(a) FASBC No. 6, par. 146
<i>Audits of Airlines</i> , chapter 3, par. 1 and footnote 1	APBS 4, par. 150	Revenue recognition	FASBC No. 5, par. 83
<i>Audits of Employee Benefit Plans</i> , chapter 13, footnote 40	APB 4, par. 133	Financial position	FASBC No. 5, par. 26

APBS = APB Statement; FASBS = FASB Statement of Financial Accounting Standards; FASBC = FASB Statement of Financial Accounting Concepts.

<sup>3</sup> Citation is in the Basis of Conclusions rather than the actual standard.

\* Paragraph 27 of Statement of Position 75-2, *Accounting Practices of Real Estate Investment Trusts*, has been effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, and FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. [Footnote added, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

<sup>4</sup> FASB Statement No. 15 contains the guidance on foreclosed assets. Also see SOP 92-3, *Accounting for Foreclosed Assets*.

<sup>5</sup> The same point is made in ARB 43, chapter 4, par. 16.

References in APB Opinions, FASB Statements, and AICPA Publications to APB Statements—continued

Similar Discussion in FASB  
Concepts Statement

Literature Citing APB Statement	APB Statement Reference	Topic	Similar Discussion in FASB Concepts Statement
AU sec. 334.02	APB 4, par. 35	Substance over form	FASBC No. 2, pars. 58, 63, and 160
AU sec. 9508.33	APB 4, par. 117	Liquidation basis of accounting	See footnote 6 below
AU sec. 420.02, footnote 2 and AU sec. 9420.53, footnote 4	APB 4, pars. 95-97	Comparability	FASBC No. 2, pars. 111-119
AU sec. 9410.16	APB 4, par. 106	Adequate disclosure	FASBC No. 5, pars. 7-9
AU sec. 411.02	APB 4, par. 138	Description of GAAP	Deletion has no effect on auditing guidance

APBS = APB Statement; FASBS = FASB Statement of Financial Accounting Standards; FASBC = FASB Statement of Financial Accounting Concepts.

<sup>6</sup> APBS 4, par. 117, states, "An enterprise is not viewed as a going concern if liquidation appears imminent." AcSEC agrees with this statement.

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## Section 10,570

# **Statement of Position 93-4 Foreign Currency Accounting and Financial Statement Presentation for Investment Companies**

April 22, 1993

### NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least two thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## Introduction

.01 The purpose of this statement of position (SOP) is to provide guidance on computing and reporting foreign currency (FC) transaction gains or losses under U.S. generally accepted accounting principles for investment companies that invest in (a) securities denominated or expected to settle in currencies other than the U.S. dollar or (b) currencies other than the U.S. dollar, and for companies that have FC transactions. For illustrative purposes, this SOP assumes that the U.S. dollar is the functional currency of the reporting investment company. This guidance on accounting and financial statement presentation applies to all investment companies covered by the AICPA Audit and Accounting Guide *Audits of Investment Companies* that follow U.S. generally accepted accounting principles.

.02 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 52, *Foreign Currency Translation*, requires that all assets, liabilities, and operations of a foreign entity be measured using the functional currency of that entity. *Functional currency* is defined as the currency of the primary economic environment in which the entity operates—that is, the currency in which the entity primarily generates and expends cash. Paragraphs 79 through 81 of FASB Statement No. 52 provide for two broad classes of foreign operations. The first class includes foreign operations that are relatively self-contained and integrated within a particular country or economic environment. For this class, the FC is the functional currency. In the second class, the day-to-day operations of the foreign entity are dependent on

the economic environment of the parent's currency, and changes in the foreign entity's individual assets and liabilities directly affect the cash flows of the parent company. For this class, the functional currency of the foreign operation is the parent company's currency. Generally, the second class of foreign operations more closely resembles that of U.S. investment companies investing primarily in foreign securities than the first class does. For instance, U.S. closed-end single-foreign-country funds generate and expend cash primarily in their local currency, yet such funds have adopted the U.S. dollar as the functional currency for financial reporting purposes because, among other reasons, cash flows related to the funds' individual assets and liabilities directly affect the U.S. dollar cash flows to shareholders (sales of fund shares are to U.S. shareholders in U.S. dollars, and dividends and distributions are paid to shareholders in U.S. dollars).

.03 Inconsistent application of the functional currency concepts of FASB Statement No. 52 by funds investing in foreign securities has contributed to a diversity of accounting practices for FC transactions. However, because these funds follow value accounting, the net increase or decrease in net assets from operations is the same under each variation although the financial statement presentations of the FC transactions differ. For instance, some funds treat the FC rate variance between the trade and settlement dates as an adjustment to cost and proceeds, whereas other funds treat it as a component of net investment income or realized FC gain or loss. Similarly, some funds include the FC gain or loss resulting from income receivable or expense payable with the related income or expense, whereas others treat it as a separate component of net investment income or realized FC gain or loss. Because the U.S. dollar is generally the reporting currency of these funds, they typically adopt the U.S. dollar as their functional currency. If the facts and circumstances warrant otherwise, a fund may conclude that a currency other than the U.S. dollar should be its functional currency. However, in the value accounting environment, that distinction does not affect the reported amounts of U.S.-dollar-denominated net assets or net changes in net assets.

.04 FC transactions are denominated in a currency other than the fund's functional currency. These transactions may produce payables and receivables that are fixed in terms of the amount of FC that will be paid or received. A change in the exchange rate between the functional currency and the FC increases or decreases the expected functional currency value upon settlement of the transaction or disposition of the security.

.05 The ongoing revaluation of investments and receivables or payables representing unsettled FC transactions is classified as unrealized FC gain or loss. On settlement (when there is actual cash flow), a realized FC gain or loss is recorded. An FC gain or loss (whether realized or unrealized) results from one or more of the following sources:

- The cost of securities held versus their carrying value based on current exchange rates
- Payables or receivables for securities bought or sold at the transaction date versus actual amounts at settlement date or payable or receivable based on current exchange rates
- Interest, dividends, and withholding taxes accrued versus the amount received or receivable based on current exchange rates
- Expenses accrued versus the amount paid or payable in FC, based on current exchange rates

- Marking to market of forward exchange contracts or foreign exchange futures contracts

.06 Each of the sources of FC gain or loss identified in paragraph .05 is discussed later in this SOP.

## Current Literature

.07 With the exception of the investment companies audit guide, FASB Statement No. 52 is the only current pronouncement available on the subject of this SOP. Paragraph 2.100 of the audit guide suggests that "foreign currency transaction gains and losses may be accounted for separately or may be combined for reporting purposes with the type of transaction that gave rise to the gain or loss." It also states, in paragraph 2.96, that the approach of not requiring separate disclosure of the portion of the changes in market value that results from FC rate changes continues to be followed in practice.

## Scope

.08 This SOP provides guidance on measurement and financial statement presentation and disclosure for foreign currency transactions by investment companies. It amends the AICPA Audit and Accounting Guide *Audits of Investment Companies*.

.09 Some funds invest in countries that are highly inflationary, as that term is defined in FASB Statement No. 52, paragraph 11. Accordingly, the separate measurement and disclosure of the FC element may not be meaningful and the disclosures recommended by this SOP may not be appropriate for such situations.

## Conclusions

.10 Each transaction denominated in an FC can initially be measured only in that currency. Any differences between originally recorded amounts and currently consummated or measured amounts in the reporting currency are a function of two factors—(a) foreign exchange rate changes and (b) changes in market prices. Those effects should be identified, computed, and reported other than for gains and losses on investments. The current guidance in paragraphs 2.96 and 2.100, which allows the practice of not separately disclosing the portion of the changes in market values of investments and realized gains and losses thereon that result from FC rate changes, continues to be permitted. However, separate reporting of such gains and losses is allowable and, if adopted by the reporting entity, should conform to the guidance presented herein.

## Securities

### Purchased Interest

.11 Purchased interest represents the interest accrued between the last coupon date and the settlement date of the purchase. It should be recorded in the functional currency as interest receivable at the spot rate on the purchase trade date, and marked to market using each valuation date's spot rate. After the settlement date, daily interest income should be accrued at the daily spot rate. It may be impractical to prepare the foregoing calculations daily, and, therefore, the use of a weekly or monthly average rate may be appropriate in

many cases, especially if the exchange rate does not fluctuate significantly. However, if the exchange rate fluctuation is significant, the calculation should be made daily.

## Marking to Market

.12 A fund investing in foreign securities generally invests in such securities to reap the potential benefits offered by the local capital market. It may also invest in such securities as a means of investing in the FC market or of benefiting from the FC rate fluctuation. The extent to which separate information regarding FC gains or losses will be meaningful will vary depending on the circumstances, and separate information may not measure with precision foreign exchange gains/losses associated with the economic risks of foreign currency exposures. An FC rate fluctuation, however, may be an important consideration in the case of foreign investments, and a reporting entity may choose to identify and separately report any resulting FC gains or losses as a component of unrealized market gain or loss on investments.

.13 The market value of securities should initially be determined in the FC and translated at the spot rate on the purchase trade date. The unrealized gain or loss between the original cost (translated on the trade date) and the market value (translated on the valuation date) comprises the following elements:

- a. Movement in market price
- b. Movement in FC rate

.14 Such movements may be combined as permitted by current guidance. If separate disclosure of the FC gains and losses is chosen, the movement in market prices should be measured as the difference between the market value in FC and the original cost in FC translated at the spot rate on the valuation date. The effect of the movement in the foreign exchange rate should be measured as the difference between the original cost in FC translated at the current spot rate and the historical functional currency cost. These values can be computed as follows:

- a. (Market value in foreign currency minus original cost in foreign currency) times valuation date spot rate equals unrealized market value appreciation or depreciation.
- b. (Cost in foreign currency times valuation date spot rate) minus cost in functional currency equals the unrealized foreign currency gain or loss.

It is recognized that the preceding formulas could be refined to isolate and report the rate change element in the changes in the gains or losses on investments between valuation dates. However, the cost of doing so would not be justified for the relatively minor improvement thereof. Furthermore, such refinement would (a) be a departure from the method required for federal income tax reporting for realized FC gains/losses on debt securities and (b) represent a departure from the practice of those investment companies that presently separately report in their financial statements the effects of foreign exchange on securities gains or losses.

.15 For short-term securities held by a fund that follows the amortized cost method of valuation, the amortized cost value should be substituted for market value in the formulas given in paragraph .14 if separate reporting is chosen by the reporting entity.



## Sale of Securities

.16 If separate reporting of FC gains and losses on sales of securities is chosen by the reporting entity, the computation of the effects of market change and the FC rate change is similar to that described in paragraph .14 above. *Market value* in the formula given in paragraph .14 should be replaced with *sale proceeds* and *valuation date* should be replaced with *sale trade date*. Accordingly—

- a. (Sale proceeds in foreign currency minus original cost in foreign currency) times sale trade date spot rate equals realized market gain or loss on sale of security.
- b. (Cost in foreign currency times sale trade date spot rate) minus cost in functional currency equals realized foreign currency gain or loss.

.17 The sale of a security results in a receivable for the security sold. The related receivable should be recorded on the trade date at the spot rate. On the settlement date, the difference between the recorded receivable amount and the actual FC received converted into the functional currency at the spot rate is recognized as a realized FC gain or loss.

## Sale of Interest

.18 Interest sold represents the accrued interest receivable between the last coupon date and the settlement date of sale of the security. The difference between the recorded interest receivable amount and the actual FC received (converted into the functional currency at the spot rate) should be recognized as a realized FC gain or loss.

## Income

### Interest

.19 Interest on securities denominated in an FC is calculated at the stated rate of interest in the FC. The interest should be accrued daily in the FC at the stated interest rate and translated into the functional currency at the daily spot rate. It may be impractical to prepare such a calculation daily, and, therefore, the use of a weekly or monthly average rate may be appropriate in many cases, especially if the exchange rate does not fluctuate significantly. However, if the exchange rate fluctuation is significant, the calculation should be made daily.

.20 The related receivable balance along with purchased interest, if any, should be accumulated in the FC and translated into the functional currency daily using the spot rate for that date. The difference between the income accrued in the functional currency and the FC receivable at the valuation date spot rate is unrealized FC gain or loss.

.21 When the interest is received and recorded in the functional currency at the spot rate on that date, the unrealized FC gain or loss should be reclassified as realized FC gain or loss.

### Accretion and Amortization

.22 Accretion of discounts and amortization of premiums on bonds should be calculated daily in the FC. The resulting amount of income or offset to income should be translated into the functional currency using that day's spot rate. The same FC amount should be recorded as an addition to cost for accre-

tion of discounts and a reduction to cost for amortization of premiums. Accordingly, cost consists of the original cost, translated at the spot rate in effect on the trade date the bond was bought and adjusted for discount accretion or premium amortization at the spot rate on the date of adjustment. As stated in paragraph .19 of this SOP, use of a weekly or monthly average rate may be appropriate in certain circumstances.

.23 On maturity, the carrying cost (including accretion or amortization) of the security in the FC equals the proceeds. However, this will not be the case in the functional currency. The original cost is translated into the functional currency at the spot rate on the trade purchase date and the accretion or amortization is translated at periodic spot rates. The proceeds are translated into the functional currency at the spot rate on the maturity date. The difference between the proceeds and the accumulated cost in the functional currency is realized FC gain or loss.

## Dividends

.24 Dividend income on securities denominated in FC should be recorded on the ex-date, at the spot exchange rate of the FC to the reporting currency on that date. The related dividend receivable should be translated into the functional currency daily at the spot rate, and the difference between the dividend accrued in the functional currency and the FC receivable at the valuation date spot rate is unrealized FC gain or loss. When the dividend is received, the unrealized FC gain or loss should be reclassified as realized FC gain or loss.

.25 The preceding approach to measuring investment income ensures that investment income accrued on foreign securities reflects the investment transaction without regard to the FC gain or loss created in the time between the accrual and collection of the income.

## Withholding Tax

.26 Whenever tax is withheld from investment income at the source, the amounts withheld that are not reclaimable should be accrued along with the related income on each income recognition date if the tax rate is fixed and known. If the tax withheld is reclaimable from the local tax authorities, it should be recorded as a receivable and not as an expense. When the investment income is received net of the tax withheld, a separate realized FC gain or loss should be computed on the gross income receivable and the accrued tax expense. If the tax rate is not known or estimable, such expense or receivable should be recorded on the date the net amount is received; accordingly, there would be no FC gain or loss. However, if a receivable is recorded, there may be an FC gain or loss through the date such receivable is collected.

## Expenses

.27 The accounting for expenses payable in an FC is identical to that for investment income receivable in an FC. An expense should be accrued as incurred and translated into the functional currency at the spot rate each day. The use of an average weekly or monthly FC rate would be acceptable if the FC rate does not fluctuate significantly. The related accrued expense balance should be accumulated in the FC and translated into the functional currency daily, using the spot rate for that date. The difference between the expense accrued in the functional currency and the related FC accrued expense balance translated into the functional currency at the valuation date spot rate is un-

realized FC gain or loss. When the expense is paid, the unrealized FC gain or loss should be reclassified as realized FC gain or loss.

## Receivables and Payables

.28 All receivables and payables that are denominated in an FC and that may relate to income or expense, or to securities sold or purchased, should be translated into the functional currency each valuation date at the spot rate on that date. The difference between that amount and the functional currency amount that was recorded at various spot rates for income and expense items, and at the trade date spot rate in the case of sales and purchases of securities, is unrealized FC gain or loss. Upon liquidation of the receivable or payable balance in an FC, the difference should be reclassified as realized FC gain or loss.

## Cash

.29 FC cash balances and movements should be accounted for in the same way that FC-denominated securities are. Every receipt of an FC should be treated as a purchase of a security and recorded in the functional currency at the spot rate on the cash receipt date. Similarly, every disbursement of an FC should be treated as a sale of a security and the appropriate functional currency cost should be released, depending on whether a specific identified cost, the first-in, first-out (FIFO) method, or an average cost is used.

.30 The acquisition of an FC does not result in any FC gain or loss. However, the disbursement of an FC results in a realized FC gain or loss that is the difference between the functional currency equivalent of the FC when it was acquired and the FC disbursement translated at the spot rate on the disbursement date. Also, as is the case with all other assets and liabilities denominated in an FC, FC cash balances should be translated on each valuation date at the spot rate on that date, resulting in unrealized FC gain or loss.

## Forward Exchange Contracts

.31 A forward exchange contract is an agreement between two parties to exchange different currencies at a specified exchange rate at an agreed-upon future date. A forward exchange contract can be for either hedging or speculation purposes. Funds usually enter into such contracts for hedging purposes only.

.32 If a fund enters into a forward exchange contract, the forward contract should be recorded on the inception date at the forward rate and marked to market daily.

.33 The unrealized FC gain or loss on such a contract is the difference between the FC amount valued at the forward rate (on the valuation date) and the original contracted value of the forward contract (the amount to be received or paid at expiration or settlement date). On the expiration or settlement date, the unrealized FC gain or loss should be reclassified as realized FC gain or loss. If the forward contract is meant to hedge the payable for the purchase of a security denominated in an FC, the cost of the investment purchased and the related payable that has been hedged by the forward contract should still be recorded at the spot rate on the trade date, and the payable should be translated into the functional currency daily.

Financial Statement Presentation

.34 The current practice of not separately disclosing that portion of unrealized and realized gains and losses on investments that results from FC changes continues to be permitted. All other FC gains or losses should be reported under the realized and unrealized gain or loss on investments and foreign currency section in the statement of operations. For example, realized FC gain or loss on interest and dividends should be included in the realized FC gain or loss component of net realized gain or loss. All unrealized FC gain or loss, other than those on investments, should be reported as unrealized appreciation or depreciation on translation of assets and liabilities in foreign currencies. The statement of changes in net assets and the statement of assets and liabilities should reflect the same realized and unrealized gain and loss components. However, it is permissible (a) to combine the net realized gains or losses from investments with net realized gains or losses from foreign currency transactions and (b) to combine the net unrealized appreciation (depreciation) on investments with the net unrealized appreciation (depreciation) on translation of assets and liabilities in foreign currencies and to report them as single components in those statements.

.35 If separate reporting of the unrealized and realized FC gains or losses on investments is chosen, such gains and losses should be aggregated with all other FC gains and losses and reported as described above. Notes to the financial statements should state an entity's practice of either including or excluding that portion of realized and unrealized gains and losses on investments that results from foreign currency changes with or from other foreign currency gains and losses.

.36 Taxes withheld that are not reclaimable, if any, on foreign source income should be deducted from the relevant income item and be shown either parenthetically or as a separate contra item in the income section of the statement of operations. Taxes levied on the aggregate income or capital gains of the investment company itself should be presented in a manner that is similar to that used for income taxes. The normal withholding taxes should be presented as follows:

Interest or dividend income (net of withholding taxes of \$ X)	\$XXX
or	
Interest or dividend income	\$XXX
Less withholding tax	(XXX)

Other Matters

.37 In addition to the FC risk associated with investing in foreign securities, such investments present additional risks that need to be assessed continuously by management and considered for financial statement disclosure:

- *Liquidity.* Since certain foreign markets are illiquid, market prices may not necessarily represent realizable value.
- *Size.* When market capitalization is low, a fund's share in the entire market (particularly when single-country funds are involved) or in specific securities may be proportionately very large, and the market price would not necessarily reflect the realizable value.

- **Valuation.** Because of liquidity and size problems as well as other factors, such as securities that are unlisted or securities that are thinly traded, funds would have to adopt specific fair valuation procedures for determining the values of such securities. Doing so may be difficult in a foreign environment; while others may perform the research and provide supporting documentation for fair values, the ultimate responsibility for determining the fair values of securities rests with the directors.

The disclosures suggested above are no different from those that might be required for domestic securities with the same attributes.

.38 The preceding risks may need to be disclosed in the notes to the financial statements if such factors exist in the markets in which the fund has material investments. It would also be incumbent on management to make sure that the prices provided by local sources (such as the last sale price, bid or ask, mean of bid and ask, closing price, and so on) do represent the market value of the securities. This is especially important for open-end funds or closed-end funds that allow limited redemption.

## Effective Date and Transition

.39 This SOP is effective for financial statements for fiscal years beginning after December 15, 1993, and interim periods within such years. This SOP may, but need not be, applied to financial statements for fiscal years ending before its effective date that, for comparative purposes, are provided with financial statements for fiscal years ending after its effective date. Earlier application of this SOP is encouraged.

.40

## Appendix A

### Illustrations for Separately Calculating and Disclosing the Foreign Currency Element of Realized and Unrealized Gains and Losses

Illustrations A and B apply if separate disclosures of the FC elements of unrealized and realized gains and losses on investments are chosen by the reporting entity.

#### A. Purchases and Sales

ABC Fund uses US\$ as its functional currency.

ABC buys 1,000 shares of XYZ £15.00 with a spot exchange rate of \$1.75 = £1.00.

Foreign currency (FC) cost basis = £15.00 × 1,000 = £15,000

Functional currency cost basis = £15,000 × 1.75 = \$26,250

Market gain/loss = (FC sale proceeds – FC cost) × foreign exchange (FX) rate on day of sale

Currency gain/loss = FC cost × (FX rate day of sale – FX rate day of purchase)

Assume a sale of 1,000 XYZ £12.00 and \$1.50 = £1.00:

FC proceeds	= £12.00 × 1,000	= £12,000
Functional currency proceeds	= £12,000 × 1.50	= \$18,000
Market loss	= (£12,000 – £15,000) × 1.50	= (\$ 4,500)
Currency loss	= (£15,000 × 1.50 – 1.75)	= (\$ 3,750)
Total loss		<u>(\$ 8,250)</u>

#### Proof

Functional currency proceeds	\$18,000
Functional currency cost	<u>(\$26,250)</u>
	<u>(\$ 8,250)</u>

#### B. Securities—Mark to Market

**DAY 1:** 1,000 XYZ marked to market £16.00; spot rate: \$1.85 = £1.00.

Market gain/loss = (FC current market value – FC cost) × current FX rate

Currency gain/loss = FC cost × (current FX rate – FX rate on day of purchase)

Market gain	= (£16,000 – £15,000) × 1.85	= \$1,850
Currency gain	= £15,000 × (1.85 – 1.75)	= <u>\$1,500</u>
Total gain in functional currency		= <u>\$3,350</u>

Total gain – (£16,000 × 1.85) – (£15,000 × 1.75) = \$29,600 – \$26,250 = \$3,350

Mark-to-Market Journal Entries

[Average rates may be used if fluctuations in exchange rates aren't significant]

**DAY 2:** 1,000 XYZ marked to market £17.00; spot rate: \$1.80 = £1.00.

Market gain	= (£17,000 – £15,000) × 1.80	=	\$3,600
Currency gain	= £15,000 × (1.80 – 1.75)	=	\$ 750
Total functional currency gain			<u>\$4,350</u>

Daily Journal Entries

Market gain/loss	= \$3,600 – \$1,850	=	\$1,750
Currency gain/loss	= \$750 – \$1,500	=	(\$ 750)
Day 2 gain (\$4,350 – \$3,350)		=	<u>\$1,000</u>

**C. Other Assets/Liabilities—FX Mark to Market**

Sale of 1,000 XYZ £12.00 = £12,000 receivable \$1.50 = £1.00 = \$18,000

**DAY 1:** Spot rate moves to \$1.55 = £1.00.

Currency gain	= £12,000 × (1.55 – 1.50) .05	=	\$ 600
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**DAY 2:** Spot rate moves to \$1.58 = £1.00.

Currency gain	= £12,000 × (1.58 – 1.50) .08	=	\$ 960
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Currency gain	<u>Day 1</u>	<u>Day 2</u>
<u>Daily Journal Entry</u>	\$600	\$360

**D. Changes Between Trade and Settlement Dates**Trade Date

Purchase 1,000 XYZ £15.00; exchange rate: \$1.75 = .00.

Cost basis: \$26,250 or £15,000

DR: sterling securities at cost	\$26,250	
CR: payables for securities purchased		\$26,250

Settlement Date

Spot rate: \$1.80 = £1.00; £15,000 is purchased at the spot rate for \$27,000.

DR: payables for securities purchased	\$26,250	
DR: realized currency gain/loss	\$ 750	
CR: cash		\$27,000

**E. Settlement Against Foreign Currency Cash Balances**

£20,000 balance is available in London.

Lot a: £10,000 purchased \$1.65 per £1.00  
\$US cost basis: \$16,500

Lot b: £10,000 purchased \$1.85 per £1.00  
\$US cost basis: \$18,500

Assume lot b will be liquidated first at \$1.80 per £1.00.

Lot b

DR: cash	\$18,000	
DR: realized currency gain/loss	\$ 500	
CR: sterling cash at cost		\$18,500
Assume one half of lot a will be liquidated at \$1.80 per £1.00.		

Lot a

DR: cash	\$ 9,000	
CR: sterling cash at cost		\$ 8,250
CR: realized currency gain/loss	\$ 750	

Realized FX gain on payable remains the same.

Between Purchase Settlement and Sale Trade Dates

Mark the holding to market, based on both local market price and daily spot rate.

**F. Sale of XYZ—Trade Date**

Sell 1,000 XYZ £18.00; exchange rate: \$1.90 = £1.00

Total proceeds: \$34,200 or £18,000

FX gain is recognized on the sale trade date based on the holding period.  
Receivable is booked at the spot rate on sale trade date.

DR: receivable for securities sold	\$34,200	
CR: sterling securities at cost ( $£15,000 \times 1.75$ )		= \$26,250
CR: realized market gain/loss ( $£18,000 - £15,000) \times 1.90$		= \$ 5,700*
CR: realized currency gain/loss ( $£15,000 \times 1.90) - 26,250$		= \$ 2,250*

Maintain local currency basis (£18,000) on the receivable record.

Between Sale Trade Date and Settlement Date

Mark the receivable to market based on the prevailing spot rate.

Sale Settlement Date

Spot rate: \$1.85 = £1.00

£18,000 is converted at the spot rate to \$33,300.

FX loss is recognized upon the receipt (settlement) of the receivable.

DR: cash	\$33,300	
DR: realized currency gain/loss	\$ 900	
CR: receivables from securities sold		\$34,200

If foreign currency cash received is to be kept as local currency:

Purchase: £18,000 \$1.85 = £1.00

Cost basis: \$33,300

DR: sterling cash at cost	\$33,300	
CR: cash		\$33,300

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\* If separate disclosures of the FC elements of unrealized and realized gains and losses on investments are chosen by the entity.



## Appendix B

### Sample Financial Statements

**The ABC Fund  
Statement of Operations  
Year Ended December 31, 19X1**

Investment income	
Interest (net of withholding taxes of \$XXXX)	\$XXXX
Dividends (net of withholding taxes of \$XXXX)	<u>XXXX</u>
	<u>XXXX</u>
Expenses	
Investment advisory fee	XXXX
Interest	XXXX
Professional fees	XXXX
Custodian and transfer agent fees	XXXX
Distribution expenses	<u>XXXX</u>
Total expenses	<u>XXXX</u>
Net investment income	<u>XXXX</u>
Realized and unrealized gain (loss) from investments and foreign currency	
Net realized gain (loss) from:	
Investments	XXXX
Foreign currency transactions*	XXXX
Net increase (decrease) in unrealized appreciation or (depreciation) on:	
Investments	XXXX
Translation of assets and liabilities in foreign currencies*	<u>XXXX</u>
Net realized and unrealized gain (loss) from investments and foreign currency	<u>XXXX</u>
Net increase (decrease) in net assets resulting from operations	<u><u>\$XXXX</u></u>

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\* If separate reporting is adopted, these captions would also include foreign currency effects of realized and unrealized gains and losses on investments. If separate reporting is not adopted, such foreign currency effects would be included in the investments captions.

See accompanying notes to financial statements.

The ABC Fund  
Statement of Changes in Net Assets  
Year Ended December 31, 19X1

From operations:	
Net investment income	\$XXXX
Net realized gains (losses) from investments *	XXXX
Net realized gains (losses) from foreign currency transactions *†	XXXX
Net increase (decrease) in unrealized appreciation (depreciation) on investments†	XXXX
Net increase (decrease) in unrealized appreciation (depreciation) on translation of assets and liabilities in foreign currencies†‡	<u>XXXX</u>
Net increase (decrease) in net assets resulting from operations	<u>XXXX</u>
Dividends and distributions:	
From net investment income	(XXXX)
From net realized gains on investments and foreign currency transactions	(XXXX)
	<u>(XXXX)</u>
From share transactions:	
Net proceeds from sale of shares	XXXX
Cost of shares repurchased	XXXX
Dividends reinvested	<u>XXXX</u>
Net increase in net assets derived from share transactions	<u>XXXX</u>
Net increase (decrease) in net assets	<u>XXXX</u>
Net assets	
Beginning of period	<u>XXXX</u>
End of period (including undistributed net investment income of \$XXXX)	<u><u>XXXXX</u></u>

\* It is also acceptable to combine these lines and present them as a single item: Net realized gains (losses) from investments and foreign currency transactions.

† If separate reporting is adopted, these captions would also include foreign currency effects of realized and unrealized gains and losses on investments. If separate reporting is not adopted, such foreign currency effects would be included in the investments captions.

‡ It is also acceptable to combine these lines and present them as a single item: Net increase (decrease) in unrealized appreciation (depreciation) on investments and translation of assets and liabilities in foreign currencies.

See accompanying notes to financial statements.

**The ABC Fund**  
**Statement of Assets and Liabilities\***  
**Year Ended December 31, 19X1**

Assets

Investments in securities, at value (cost – \$XXXX)	\$XXXX
Cash denominated in foreign currencies (cost – \$XXXX)	XXXX
Cash	XXXX
Receivable for investments sold	XXXX
Dividends and interest receivable	XXXX
Receivable for shares of beneficial interest sold	XXXX
Deferred organizational expense	XXXX
Other assets	XXXX
Total assets	<u>XXXXX</u>

Liabilities

Payable for investments purchased	XXXX
Payable for shares repurchased	XXXX
Payable to affiliates	XXXX
Other liabilities	XXXX
Total liabilities	<u>XXXXX</u>

Net assets

Beneficial interest—XXXX shares of \$XXXX par value outstanding (unlimited amount authorized)	\$XXXX
Undistributed net investment income	XXXX
Undistributed net realized gains from investments **	XXXX
Undistributed net realized gains (losses) from foreign currency transactions *†	XXXX
Net unrealized appreciation (depreciation) of investments†	XXXX
Net unrealized appreciation (depreciation) on translation of assets and liabilities in foreign currencies††	XXXX
Net assets applicable to shares outstanding	<u>XXXXX</u>
Net asset value per share	<u>XXXXX</u>

\* This SOP has been amended by SOP 98-5, *Reporting on the Costs of Start-Up Activities*. Changes to reflect the issuance of SOP 98-5 will be made closer to the SOP's effective date. See section 10,750.

\*\* It is also acceptable to combine these lines and present them as a single item: Undistributed net realized gains (losses) from investments and foreign currency transactions.

† If separate reporting is adopted, these captions would also include foreign currency effects of realized and unrealized gains and losses on investments. If separate reporting is not adopted, such foreign currency effects would be included in the investments captions.

† It is also acceptable to combine these lines and present them as a single item: Net unrealized appreciation (depreciation) on investments and translation of assets and liabilities in foreign currencies.

See accompanying notes to financial statements.

**The ABC Fund**  
**(A Single Country Fund)**  
**Selected Notes to Financial Statements**

1. *Foreign Currency.* Amounts denominated in or expected to settle in foreign currencies (FC) are translated into United States dollars (US\$) at rates reported by a major New York City bank on the following basis:

- a. Market value of investment securities, other assets and liabilities—  
at the closing rate of exchange at the balance sheet date.
- b. Purchases and sales of investment securities, income and expenses—  
at the rate of exchange prevailing on the respective dates of such transactions (or at an average rate if significant rate fluctuations have not occurred).

*[The following paragraphs illustrate disclosures depending upon whether the fund chooses (i) to report or (ii) not to report the FC elements of realized and unrealized gains and losses on investments.]*

c(i). The Fund isolates that portion of the results of operations resulting from changes in foreign exchange rates on investments from the fluctuations arising from changes in market prices of securities held.

Reported net realized foreign exchange gains or losses arise from sales of portfolio securities, sales and maturities of short-term securities, sales of FCs, currency gains or losses realized between the trade and settlement dates on securities transactions, the difference between the amounts of dividends, interest, and foreign withholding taxes recorded on the Fund's books, and the U.S. dollar equivalent of the amounts actually received or paid. Net unrealized foreign exchange gains and losses arise from changes in the value of assets and liabilities including investments in securities at fiscal year end, resulting from changes in the exchange rate.

c(ii). The Fund does not isolate that portion of the results of operations resulting from changes in foreign exchange rates on investments from the fluctuations arising from changes in market prices of securities held. Such fluctuations are included with the net realized and unrealized gain or loss from investments.

Reported net realized foreign exchange gains or losses arise from sales and maturities of short-term securities, sales of FCs, currency gains or losses realized between the trade and settlement dates on securities transactions, the difference between the amounts of dividends, interest, and foreign withholding taxes recorded on the Fund's books, and the U.S. dollar equivalent of the amounts actually received or paid. Net unrealized foreign exchange gains and losses arise from changes in the value of assets and liabilities other than investments in securities at fiscal year end, resulting from changes in the exchange rate.

2.\* The Fund has obtained the approval of the Central Bank for the registration and conversion into FC of all proceeds of the offering to be invested in the ABC country securities markets, which by its terms ensures repatriation of such investment and the remittance of profits and dividends accruing on the investment. Notwithstanding the foregoing, the right of the Fund to repatriate its investments in ABC country securities and to receive profits, capital gains, and dividends in foreign exchange is subject to the power of the Central Bank,

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\* Should be considered, if applicable to the respective fund.

with the approval of the President of the ABC country, to restrict the availability of foreign exchange in the imminence of, or during, an exchange crisis or in times of national emergency.

There are nationality restrictions on the ownership of certain equity securities of the ABC country companies. Based on confirmations that the Fund received from the ABC country's governmental authorities, the Fund believes that it is permitted to make certain investments through the ABC country's Trust that are otherwise available only to the ABC country.

The Fund has significant investments in the equity securities of companies located in the ABC country. Future economic and political developments in the country could adversely affect the liquidity or value, or both, of the ABC country securities in which the Fund is invested.

## Appendix C

### Bifurcation of Changes in Value of Foreign Securities

FASB Statement No. 8, *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements*, appendix D, paragraphs 219 and 220, specifically states that the FASB did not intend to require investment companies to disclose separately the portion of the change in market value that results from foreign currency rate changes. Even though that exception is not specifically mentioned in FASB Statement No. 52, *Foreign Currency Translation*, practice has continued to follow this approach. This practice continues to be allowed by this SOP for the foreign exchange components of realized and unrealized gains or losses on securities.

On June 5, 1992, the AICPA issued a proposed SOP for comment that required, among other things, that investment companies report foreign exchange effects on realized and unrealized gains and losses separately from changes in market prices. Most commentators objected to that requirement and, accordingly, the Investment Companies Committee and AcSEC decided to make the practice voluntary and study the matter further.

The Investment Companies Committee intends to form a task force to solicit comments from preparers, auditors, regulators, and users of investment companies financial statements to address concerns of the costs to implement bifurcation of changes in value of foreign securities, to evaluate the relevance of the information provided by bifurcation, and to explore other approaches to reporting information if deemed necessary to help users assess foreign currency effects. After the task force submits its recommendations to the committee, the committee may decide to do one of the following:

- Draft an SOP to make bifurcation described in the current SOP mandatory
- Draft an SOP to modify the reporting in the current SOP and make it mandatory
- Not change the current guidance

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[The next page is 19,741.]





## Section 10,580

# **Statement of Position 93-6 Employers' Accounting for Employee Stock Ownership Plans**

November 22, 1993

### **NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## **Scope**

.01 This statement of position (SOP) provides guidance on employers' accounting for employee stock ownership plans (ESOPs). It applies to all employers with ESOPs, both leveraged and nonleveraged. It does not address financial reporting by ESOPs.<sup>1</sup>

.02 An ESOP is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock.

.03 This SOP supersedes American Institute of Certified Public Accountants (AICPA) SOP 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans* [section 10,130], and affects certain Emerging Issues Task Force (EITF) consensuses. A list of the documents affected is provided in appendix D [paragraph .102] of this SOP.

## **Background**

.04 SOP 76-3 [section 10,130] was issued in December 1976, primarily to deal with accounting and reporting issues relevant to employers with leveraged ESOPs, and it has been the primary source of guidance on the subject.

.05 Since the issuance of SOP 76-3 [section 10,130], Congress has revised laws concerning ESOPs several times and the Internal Revenue Service (IRS) and the U.S. Department of Labor have issued many regulations covering the

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<sup>1</sup> Financial reporting by ESOPs is discussed in the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*.

operation of plans, which actions have resulted in changes in the way ESOPs may operate and the reasons they are established by companies. Those changes, the most significant of which are described in appendix C [paragraph .101], were factors in the growth in the number of plans from fewer than 2,500 plans in 1976 to nearly 10,000 at the end of 1990.<sup>2</sup>

.06 The increase in the number of ESOPs since the issuance of SOP 76-3 [section 10,130] was matched by an increase in their complexity. It is no longer possible to describe a typical ESOP. ESOPs are used for many purposes in addition to furthering employee ownership, some of which were not contemplated when SOP 76-3 [section 10,130] was issued. These include the following:

- To fund a matching program for a sponsor's 401(k) saving plan, formula-based profit-sharing plan, and other employee benefits
- To raise new capital or to create a marketplace for the existing stock
- To replace lost benefits from the termination of other retirement plans or provide benefits under postretirement benefit plans, particularly medical benefits
- To be part of the financing package in leveraged buy-outs
- To provide a tax-advantaged means for owners to terminate their ownership
- To be part of a long-term program to restructure the equity section of a plan sponsor's balance sheet
- To defend the company against hostile takeovers

.07 The borrowing arrangements used by leveraged ESOPs have also become more diverse. When SOP 76-3 [section 10,130] was issued, most leveraged ESOPs borrowed from outside lenders, and the loan terms were relatively simple. Since then, internally leveraged ESOPs (ESOPs that borrow from the sponsor) have become more common. Furthermore, some ESOP loans are now structured so that a large portion of the debt service will be paid with dividends on shares held by the ESOP rather than with employer contributions.

.08 Employers' accounting for ESOP transactions, particularly the measurement of compensation cost and the treatment of dividends on shares held by an ESOP, has been a source of accounting controversy for many years. Even when SOP 76-3 [section 10,130] was issued, there was disagreement about some ESOP issues.<sup>3</sup> Changes in laws and regulations that apply to ESOPs and the increased diversity in the structure and purpose of ESOPs have called new attention to the limitations of SOP 76-3 [section 10,130]. Furthermore, SOP 76-3 [section 10,130] does not address some of the accounting issues presented by the new ESOPs. Although the EITF has addressed a number of ESOP issues, it has done so on an ad hoc basis.

.09 Therefore, the Accounting Standards Executive Committee (AcSEC) undertook this project to reconsider SOP 76-3 [section 10,130] and to consider current ESOP issues that are not specifically addressed in the accounting liter-

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<sup>2</sup> Statistics from an unpublished study completed in 1991 by the National Center for Employee Ownership, Oakland, Calif.

<sup>3</sup> Paragraph 13 of SOP 76-3 [section 10,130.13] presents a minority view that disagrees with that SOP's recommendations on reporting dividends paid and earnings per share.

ature. AcSEC's objective in issuing this SOP is to enhance the relevance and representational faithfulness of financial statements of employers that sponsor ESOPs.

.10 There are two basic forms of ESOP: nonleveraged and leveraged. This SOP addresses the financial reporting for each separately.

## Conclusions

.11 The following conclusions should be read in conjunction with the "Discussion of Conclusions" beginning with paragraph .59 of this SOP. That section explains considerations that were deemed significant by members of AcSEC in reaching the conclusions.

### Leveraged ESOPs

.12 Unlike other kinds of employee benefit plans, an ESOP is permitted by ERISA to borrow from a related party or with the assistance of a related party. A leveraged ESOP borrows money to acquire shares of the employer company. The debt usually is collateralized by the employer's shares. The shares initially held by the ESOP in a suspense account are called *suspense shares*.<sup>4</sup> The debt is generally repaid by the ESOP from employer contributions and dividends on the employer's stock. As the debt is repaid, suspense shares are released from the suspense account, and the released shares must be allocated to individual accounts as of the end of the ESOP's fiscal year. The money can be borrowed by the ESOP from the sponsor, with or without a related outside loan, or directly from an outside lender. Outside loans to the ESOP are generally guaranteed by the sponsor.

### Reporting the Purchase of Shares by ESOPs

.13 An employer should report the issuance of shares or the sale of treasury shares to an ESOP when they occur and should report a corresponding charge to unearned ESOP shares, a contra-equity account. That account should be presented as a separate item in the balance sheet. Furthermore, even if a leveraged ESOP buys outstanding shares of employer stock on the market rather than from the employer, the employer should charge unearned ESOP shares and credit either cash or debt, depending on whether the ESOP is internally or externally leveraged (see paragraph .24).

### Reporting the Release of ESOP Shares

.14 ESOP shares are released for different purposes: to compensate employees directly, to settle employer liabilities for other employee benefits, and to replace dividends on *allocated shares* that are used for debt service. As ESOP shares are committed to be released, unearned ESOP shares should be credited and, depending on the purpose for which the shares are released, either (a) compensation cost, (b) dividends payable, or (c) compensation liabilities should be charged. Regardless of the account charged, the amount of the charge should be based on fair values<sup>5</sup> of *committed-to-be-released shares*.

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<sup>4</sup> Terms defined in the glossary [paragraph .103] are in italicized type the first time they appear in this SOP.

<sup>5</sup> Paragraph .20 of this SOP contains guidance on fair value.

.15 Under this SOP, when shares are committed to be released, rather than when shares are legally released, is significant for accounting purposes. That refinement was made in recognition of the fact that ESOP shares are legally released from an ESOP's suspense account (and from serving as collateral for ESOP debt) when debt payments are made, but the employee service to which the shares released relates is continuous. Accordingly, for purposes of reporting compensation cost and satisfaction of liabilities under this SOP, accounting recognition should occur when shares are committed to be released, which may occur before the shares are legally released. Shares that have not been legally released, but that relate to employee services rendered during an accounting period (interim or annual) ending before the related debt service payment is made, should be considered committed to be released. The periods of employee service to which shares relate is generally specified in the ESOP documents.

.16 Some employers establish ESOPs that are not linked to any other employee benefit or compensation promise; therefore, the ESOP shares directly compensate the employees. For ESOP shares committed to be released to compensate employees directly, the employer should recognize compensation cost equal to the fair value of the shares committed to be released. The shares generally should be deemed to be committed to be released ratably during an accounting period as the employees perform services, and, accordingly, average fair values should be used to determine the amount of compensation cost to recognize each reporting period (interim or annual). The amount of compensation cost recognized in previous interim periods should not be adjusted for subsequent changes in the fair value of shares.

.17 Some employers agree to provide a specified or determinable benefit, such as a contribution to a 401(k) plan or to a formula profit-sharing plan, to employees and use the ESOP to partially or fully fund the benefit. Employers should recognize compensation cost and liabilities associated with providing such benefits to employees in the same manner they would had an ESOP not been used to fund the benefit. For ESOP shares committed to be released to settle liabilities for such benefits, employers should report satisfaction of the liabilities when the shares are committed to be released to settle the liability. The number of shares released to settle the liability is based on the fair value of shares as of dates specified by the employers, which are usually specified in the ESOP documents.

.18 The IRC allows employers to use dividends on ESOP shares that have been allocated to participants for debt service if participants are allocated shares of employer stock with a fair value no less than the amount of the dividends used for debt service. If shares released will include shares designated to replace *dividends on previously allocated shares used for debt service*, employers should report the settlement of the dividend payable when the shares are committed to be released to replace the dividends on shares used for debt service. (See paragraphs .21 and .22; only dividends on allocated shares should be charged to retained earnings.) The number of shares committed to be released to replace the dividends on allocated shares used for debt service is based on the fair value of shares as of dates specified by the employer, which are usually specified in the ESOP documents based on the employer's interpretation of current IRS regulations.

.19 Unearned ESOP shares should be credited as shares are committed to be released based on the cost of the shares to the ESOP. Employers should charge or credit the difference between the fair value of shares committed to

be released and the cost of those shares to the ESOP to shareholders' equity in the same manner as gains and losses on sales of treasury stock (generally to additional paid-in capital).

### ***Fair Value***

.20 The fair value of ESOP shares is needed to apply certain provisions of this SOP. The fair value of an ESOP share is the amount the seller could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than a forced or liquidation sale. For shares that are traded, the price in the most active market should be used to measure fair value. If there is no market price, the employer's best estimate of fair value should be used. The use of independent experts may be necessary to estimate fair value. For example, the amount determined in a recent (within twelve months of the employer's year-end) independent stock valuation report may aid in determining the best estimate of fair value.

### ***Reporting Dividends on ESOP Shares***

.21 Because employers control the use of dividends on unallocated shares, dividends on unallocated shares are not considered dividends for financial reporting purposes. Dividends on unallocated shares used to pay debt service should be reported as a reduction of debt or of accrued interest payable. Dividends on unallocated shares paid to participants or added to participant accounts should be reported as compensation cost.

.22 Dividends on allocated shares should be charged to retained earnings. The dividends payable may be satisfied either by contributing cash to the participant accounts, by contributing additional shares to participant accounts, or by releasing shares from the ESOP's suspense account to participant accounts (see paragraph .18).

### ***Reporting Redemptions of ESOP Shares***

.23 Regardless of whether an ESOP is leveraged or nonleveraged, employers are required to give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires employers to repurchase the shares at fair value. Furthermore, public company sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts. Employers should report the satisfaction of such option exercises as purchases of treasury stock.

### ***Reporting of Debt and of Interest***

.24 For purposes of applying this SOP, ESOP debt is characterized as follows:

- *Direct loan*—A loan made by a lender other than the employer to the ESOP. Such loans often include some formal guarantee or commitment by the employer.
- *Indirect loan*—A loan made by the employer to the ESOP, with a related outside loan to the employer.
- *Employer loan*—A loan made by the employer to the ESOP, with no related outside loan.

ESOPs with indirect loans and employer loans are often referred to as internally leveraged.

**.25** Employers that sponsor an ESOP with a direct loan should report the obligations of the ESOP to the outside lender as liabilities. Furthermore, employers should accrue interest cost on the debt and should report cash payments to the ESOP that are used by the ESOP to service debt, regardless of whether the source of cash is employer contributions or dividends, as reductions of the debt and accrued interest payable when the ESOP makes the payments to the outside lender.

**.26** Employers that sponsor an ESOP with an indirect loan should report outside loans as liabilities. Employers should not report a loan receivable from the ESOP as an asset and should, therefore, not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Contributions to the ESOP and the concurrent payments from the ESOP to the employer for debt service would not be recognized in the employer's financial statements.

**.27** Employers that sponsor an ESOP with an employer loan should not report the ESOP's note payable and the employer's note receivable in the employer's balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.

### ***Earnings per Share***

**.28** For purposes of computing basic and diluted earnings per share (EPS), ESOP shares that have been committed to be released should be considered outstanding. ESOP shares that have not been committed to be released should not be considered outstanding. [Paragraph revised to reflect the conforming changes necessary due to the issuance of FASB Statement No. 128, November 1998.]

**.29** Employers with ESOPs that hold convertible preferred stock may encounter unique EPS issues for diluted EPS calculations. The remainder of this section provides guidance on how to deal with some of those issues, particularly the following:

- How to determine the number of shares assumed to be outstanding in the if-converted EPS computations
- How earnings applicable to common stock in if-converted EPS computations should be adjusted for dividends on allocated shares used for debt service
- Whether prior periods' EPS should be restated for changes in conversion rates

This SOP does not provide a step-by-step discussion of how to apply the if-converted method to compute diluted EPS and does not address all possible EPS questions that may arise. FASB Statement No. 128, *Earnings per Share*, and illustrations 4 and 5 in appendix A [paragraph .99] of this SOP provide additional guidance. [Paragraph revised to reflect the conforming changes necessary due to the issuance of FASB Statement No. 128, November 1998.]

**[.30]** [Paragraph deleted to reflect the conforming changes necessary due to the issuance of FASB Statement No. 128, November 1998.]

**.31** *Number of Shares Outstanding.* Under this SOP, ESOP shares are not considered outstanding until they are committed to be released. The num-

ber of common shares that would be issued on conversion of the convertible shares held by an ESOP that have been committed to be released should be deemed outstanding in the if-converted EPS computations for diluted EPS if the effect is dilutive. Convertible preferred shares held by the ESOP that have not been committed to be released should not be considered outstanding and, accordingly, would be excluded from the if-converted computations for diluted EPS. [Paragraph revised to reflect the conforming changes necessary due to the issuance of FASB Statement No. 128, November 1998.]

**.32** When participants withdraw account balances containing convertible preferred shares from an ESOP, they may be entitled to receive common shares or cash with a value equal to either the fair value of the convertible preferred shares or a stated minimum value per share. Accordingly, if the value of the common stock issuable is less than the stated minimum value or the fair value of the preferred, participants may receive common shares or cash with a value greater than the value of the common shares issuable at the stated conversion rate. In determining EPS, the employer should presume that such a shortfall will be made up with shares of common stock. However, that presumption may be overcome if past experience or a stated policy provides a reasonable basis to believe that the shortfall will be paid in cash.<sup>[6]</sup> In applying the if-converted method, the number of common shares issuable on assumed conversion, which should be included in the denominator of the EPS calculation, should be the greater of (a) the shares issuable at the stated conversion rate and (b) the shares issuable if the participants were to withdraw the shares from their accounts. Shares issuable on assumed withdrawal should be computed based on the ratio of (a) the average fair value of the convertible stock or, if greater, its stated minimum value, to (b) the average fair value of the common stock. [Paragraph revised to reflect the conforming changes necessary due to the issuance of FASB Statement No. 128, November 1998.]

**.33** *Adjustments to Earnings.* Employers that use dividends on allocated ESOP shares to pay debt service should adjust earnings applicable to common shares in the if-converted computation for the difference (net of income taxes) between the amount of compensation cost reported and the amount of compensation cost that would have been reported if the allocated shares had been converted to common stock at the beginning of the period.

**.34** *Changes in Conversion Rates.* Prior period EPS should not be restated for changes in the conversion rates. [Paragraph revised to reflect the conforming changes necessary due to the issuance of FASB Statement No. 128, November 1998.]

### **Accounting for Terminations**

**.35** Upon termination of a leveraged ESOP, either in whole or in part, all outstanding debt related to the shares being terminated must be repaid or refinanced. An ESOP may repay the debt using an employer contribution to the plan, dividends on ESOP shares, the proceeds from selling suspense shares to the employer or to another party, or some combination of these. The law limits the shares employers may reacquire to the number of shares with a fair value equal to the applicable unpaid debt and requires that the remaining shares, if any, be allocated to participants.

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<sup>[6]</sup> [Footnote deleted to reflect the conforming changes necessary due to the issuance of FASB Statement No. 128, November 1998.]

**.36** If the employer makes a contribution to the ESOP or pays dividends on unallocated shares that are used by the ESOP to repay the debt, the employer should charge the debt and accrued interest payable when the ESOP makes the payment to the outside lender. Similarly, an employer sponsoring an ESOP with an indirect loan should report loan repayments as reductions of the debt and accrued interest payable.

**.37** If the ESOP sells the suspense shares and uses the proceeds to repay the debt, the employer should report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt, and accrued interest payable, and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, paragraph 20 of APB Opinion No. 26, *Early Extinguishment of Debt*, as amended by FASB Statement of Financial Accounting Standards No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, requires that difference to be included in the employer's income when the debt is extinguished.

**.38** If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock transaction. The treasury stock should be reported at the fair value of the shares at the reacquisition date. Unearned ESOP shares should be credited for the cost of the shares, and the difference should be recognized in additional paid-in capital.

**.39** If the fair value of the suspense shares on the termination date is more than the unpaid debt balance, the release of the remaining suspense shares to participants should be charged to compensation in accordance with paragraphs .14 to .18 of this SOP. That is, compensation cost should equal the fair value of the shares at the date the ESOP debt is extinguished, because that is when the shares are committed to be released.

## **Nonleveraged ESOPs**

**.40** An employer with a nonleveraged ESOP periodically contributes its shares or cash to its ESOP on behalf of employees. The shares contributed or acquired with the cash contributed, which may be outstanding shares, treasury shares, or newly issued shares, are allocated to participant accounts and held by the ESOP until distributed to the employees at a future date, such as on the date of termination or retirement. The shares of employer stock obtained by the nonleveraged ESOP must be allocated to individual participant accounts as of the end of the ESOP's fiscal year.

### ***Reporting Purchase of Shares by ESOPs***

**.41** Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan. Compensation cost should be measured as the fair value of the shares contributed to or committed to be contributed to the ESOP or as the cash contributed to or committed to be contributed to the ESOP, as appropriate under the terms of the plan.

### ***Reporting Dividends on ESOP Shares***

**.42** Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to retained earnings, except that dividends on suspense account shares of a pension reversion ESOP should be accounted for the same way as dividends on suspense account shares of leveraged ESOPs.



## ***Reporting Redemptions of ESOP Shares***

.43 Regardless of whether an ESOP is leveraged or nonleveraged, employers are required to give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires the employer to repurchase the shares at fair value. Furthermore, public company sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts, which on exercise requires the employer to repurchase the shares at fair value. Employers should report the satisfaction of such option exercises as purchases of treasury stock.

### ***Earnings per Share***

.44 All shares held by a nonleveraged ESOP should be treated as outstanding in computing the employer's EPS, except the suspense account shares of a pension reversion ESOP, which should not be treated as outstanding until they are committed to be released for allocation to participant accounts. If a nonleveraged ESOP holds convertible preferred stock, the guidance in paragraphs .29 to .34 of this SOP for leveraged ESOPs should be considered.

## ***Pension Reversion ESOPs***

.45 An employer that terminates a defined benefit pension plan may avoid part of the excise tax on an asset reversion by transferring the assets to an existing or newly created ESOP, which could be either leveraged or nonleveraged. The reverted assets may be used either to purchase shares of the employer stock or to retire existing ESOP debt.

.46 If the assets from the pension plan are used by the ESOP to purchase employer shares, the employer should report the share issuance the same way as other share issuances to an ESOP. The issuance of shares or the sale of treasury shares to the ESOP should be recognized when it occurs, and a corresponding charge to unearned ESOP shares, a contra-equity account, should be reported. If the shares are purchased on the market, the employer should similarly charge unearned ESOP shares. (The credit would be to cash.)

.47 Because the number of shares the ESOP acquires in a pension plan reversion is usually more than the IRS permits to be allocated to participant accounts in a single year, some of the shares are held in a suspense account until they are committed to be released in future years for allocation to participant accounts. The guidance in this SOP, for shares held by leveraged ESOPs, should be applied to suspense account shares.

.48 If the assets from the pension plan reversion are used to repay the debt of an existing ESOP, ESOP shares are committed to be released from suspense. In such situations, the guidance for leveraged ESOPs in this SOP should be followed. The employer should reduce the debt as it is repaid and reduce unearned ESOP shares as shares are committed to be released. How the committed-to-be-released shares are used determines what accounts are charged upon release of shares (see paragraphs .14 to .18).

## ***Issues Related to Accounting for Income Taxes***

### ***Leveraged ESOPs***

.49 For employers with leveraged ESOPs, the amount of ESOP-related expense reported under this SOP for a period may differ from the amount of

the ESOP-related income tax deduction (prescribed by income tax rules and regulations) for that period. Differences result if (a) the fair value of shares committed to be released differs from the cost of those shares to the ESOP and (b) the timing of expense recognition is different for income tax and financial reporting purposes. Such differences should be reported in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. Similar differences arise from employee stock options. Paragraph 36e of Statement No. 109 requires that the tax effects of expenses for employee stock options recognized differently for financial reporting and tax purposes be recognized in the related component of shareholders' equity.

.50 In accordance with paragraph 36e of Statement No. 109, if the cost of shares committed to be released is greater than their fair value, the employer should credit the tax effect of the amount by which the deductible expense exceeds the book expense to shareholders' equity. Conversely, if the cost of shares committed to be released is less than their fair value, the employer should charge the tax effect of the amount by which the book expense exceeds the deductible expense to shareholders' equity to the extent of previous credits to shareholders' equity related to cost exceeding fair value of ESOP shares committed to be released in previous periods.

.51 Furthermore, the tax benefit of tax-deductible dividends on allocated ESOP shares should be recorded as a reduction of income tax expense allocated to continuing operations. Under paragraph 36f of FASB Statement No. 109, the tax benefit of tax-deductible dividends on unallocated ESOP shares that are charged to retained earnings should be credited to shareholders' equity. However, because dividends on unallocated shares would not be charged to retained earnings under this SOP, paragraph 36f of Statement No. 109 would not apply to ESOP shares accounted for under this SOP.

### ***Nonleveraged ESOPs***

.52 Employers with nonleveraged ESOPs may accrue compensation cost for financial reporting purposes earlier than the cost is deductible for income tax purposes. Accruing the compensation cost earlier for financial reporting purposes creates a temporary difference under Statement No. 109.

### **Disclosures**

.53 An employer sponsoring an ESOP should disclose the following information about the plan, if applicable:

- a. A description of the plan, the basis for determining contributions, including the employee groups covered, and the nature and effect of significant matters affecting comparability of information for all periods presented. For leveraged ESOPs and pension reversion ESOPs, the description should include the basis for releasing shares and how dividends on allocated and unallocated shares are used.
- b. A description of the accounting policies followed for ESOP transactions, including the method of measuring compensation, the classification of dividends on ESOP shares, and the treatment of ESOP shares for EPS computations. If the employer has both old ESOP shares for which it does not adopt the guidance in this SOP and new ESOP shares for which the guidance in this SOP is required (see paragraphs .54 and .55), the accounting policies for both blocks of shares shall be described.

- c. The amount of compensation cost recognized during the period.
- d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the ESOP at the balance-sheet date. This disclosure should be made separately for shares accounted for under this SOP and for grandfathered ESOP shares (see paragraphs .54 and .55).
- e. The fair value of unearned ESOP shares at the balance-sheet date for shares accounted for under this SOP. (Future tax deductions will be allowed only for the ESOP's cost of unearned ESOP shares.) This disclosure need not be made for old ESOP shares for which the employer does not apply the guidance in this SOP (see paragraphs .55 and .56).
- f. The existence and nature of any repurchase obligation, including disclosure of the fair value<sup>7</sup> of the shares allocated as of the balance-sheet date, which are subject to a repurchase obligation.

## Effective Date and Transition

**.54** This SOP is effective for fiscal years beginning after December 15, 1993. The SOP should be adopted in the first interim period of an employer's fiscal year. Early application is permitted. Prospective application of the guidance in the SOP is required for shares acquired by ESOPs after December 31, 1992 (new ESOP shares) but not yet committed to be released as of the beginning of the year in which the SOP is adopted. No cumulative effect adjustment should be reported under this approach. Restatement of previously issued annual financial statements is not permitted.

**.55** Application of all of the guidance in this SOP may be elected, and is encouraged, for shares acquired by ESOPs on or before December 31, 1992 (old ESOP shares). (Selective adoption of the guidance in this SOP is not permitted.) However, employers with ESOPs that do not adopt this SOP for shares held by ESOPs on December 31, 1992, should make all of the applicable disclosures required by paragraph .53. Employers electing to adopt this SOP for old ESOP shares in the first fiscal year beginning after December 15, 1993, or in the preceding year should apply the SOP prospectively to the old ESOP shares that have not yet been committed to be released as follows:

- Employers that applied the shares allocated method described in EITF Issue No. 89-8<sup>8</sup> should apply this SOP prospectively to those shares that have not yet been committed to be released as of the beginning of the year in which the SOP is adopted. No cumulative effect adjustment should be reported under this approach.
- Employers that did not apply the shares allocated method described in EITF Issue No. 89-8 should recognize as an expense in the period of adoption the difference between (a) the cumulative ESOP expense

<sup>7</sup> See paragraph .20 for guidance on fair value.

<sup>8</sup> In EITF Issue No. 89-8, *Expense Recognition for Employee Stock Ownership Plans*, the EITF reached a consensus that ESOP shares purchased after December 15, 1989, should be accounted for under the shares allocated method, which is described in that consensus. However, the consensus allows employers with shares purchased before December 15, 1989, to account for such shares under their current methods in certain circumstances.

recognized prior to the period of adoption of this SOP and (b) the cumulative expense that would have been recognized prior to the period of adoption of this SOP under the shares allocated method ([total shares committed to be released multiplied by cost of the shares to the ESOP] less cumulative dividends on ESOP shares). That difference should be reported as the cumulative effect of a change in accounting principle in accordance with APB Opinion No. 20, *Accounting Changes*, by including the cumulative effect of the change in income and crediting unearned ESOP shares in the period the SOP is first applied. However, pro forma disclosures are not required.

Restatement of previously issued annual financial statements is not permitted.

.56 Employers electing to adopt this SOP for old ESOP shares in a fiscal year later than the first fiscal year beginning after December 15, 1993, should apply the SOP retroactively through restatement of previously issued financial statements for all years beginning after December 15, 1993. The restatement of the financial statements for the first year beginning after December 15, 1993 (the earliest year restated) should be performed in accordance with paragraph .55. If the earliest year restated is not presented in the financial statements, the beginning balance of retained earnings (and, if necessary, additional paid-in capital) for the earliest year presented should be adjusted for the effect of the restatement as of that date.

.57 For employers that adopt this SOP in a period other than the period the ESOP shares were purchased, certain shares considered outstanding for EPS computations in prior years will no longer be considered outstanding for EPS purposes in the year of adoption. As noted above, restatement is not permitted, however, such employers should disclose the number of shares considered outstanding for EPS purposes in prior periods that are no longer considered outstanding in the current period.

.58 An employer may have both (1) old ESOP shares for which it does not adopt the guidance in this SOP and (2) new ESOP shares for which the guidance in this SOP is required. The measure of compensation cost for the old and new shares in this circumstance will differ. The identification of the shares released each year for financial reporting purposes should be the same as the identification of the shares released for ERISA purposes.

## Discussion of Conclusions

.59 This section discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

## Leveraged ESOPs

.60 AcSEC believes that all of the specific conclusions about employers' accounting for leveraged ESOP transactions follow from AcSEC's fundamental conclusion that the accounting for an ESOP's debt (financing element) should be separate from the accounting for an ESOP's shares (defined contribution element). Although the financing and defined contribution elements of leveraged ESOPs are related, each should be analyzed and reported separately,

and the principles for reporting one element should not affect the principles for reporting the other. Under this SOP, each element is reported in accordance with its substance as it would be reported if it occurred as a separate transaction.

### ***Accounting for Debt and Shares at the Inception of the ESOP***

.61 When a leveraged ESOP is established, it borrows money and buys employer shares for cash. However, because the employer is the ultimate source of the cash to repay the debt and is the beneficiary of the financing, AcSEC believes that the substance of the transaction is that the cash is not a consideration to the employer for the shares but rather proceeds from a borrowing. The consideration to be received by the employer for placing the shares in the ESOP trust is future employee services. In fact, the ESOP acquires the shares before the employees have performed the services for which the shares are to compensate them.

.62 AcSEC believes that because the shares transferred from the employer to the ESOP when the ESOP is established are not exchanged for a receipt of assets or services, or for a reduction of liabilities, total shareholders' equity should remain unchanged. The transaction should be reported only as a change within equity until the shares are committed to be released for allocation to participant accounts for services provided. Furthermore, AcSEC believes that even if a leveraged ESOP buys shares on the market rather than from the employer and, therefore, the employer has no direct capital stock transaction and no direct cash inflow when establishing a leveraged ESOP, the employer should treat it as a leveraged ESOP. Such a situation is analogous to an employer selling newly acquired treasury stock to its ESOP. Therefore, shareholders' equity should be reduced by reporting the amount of the stock the ESOP acquires as unearned ESOP shares. Either cash or debt would be credited, depending on whether the ESOP is internally or externally leveraged.

.63 For employers with internally leveraged ESOPs (indirect and employer loans), AcSEC notes that the ESOP's note payable does not represent an obligation of the employer to transfer resources to the ESOP and that the employer's note receivable does not represent a claim by the employer on the ESOP's resources. Therefore, AcSEC concluded they should not be reported by the employer as a liability and as an asset, respectively.

### ***Recognition and Measurement of Release of Shares***

.64 AcSEC believes its conclusions on recognition and measurement follow from its conclusions that the debt and shares related to ESOP transactions should be accounted for separately. The substance of an employer's cash contribution to an ESOP is that the cash contribution is used for the payment of debt service on the employer's debt. It is the release of shares, not the employer's cash contribution, that represents the compensation of participants in connection with the defined contribution plan. AcSEC's objective is that the accounting reflect the terms of the exchange transactions that take place between an employer that provides compensation and the employees who render services in exchange for that compensation. To do that, AcSEC considered how the ESOP shares are used.

.65 A key concept introduced in this SOP is that employers may use ESOP shares for different purposes: to compensate employees directly, which was the

primary use when SOP 76-3 [section 10,130] was issued; to settle liabilities for employee benefits, such as an employer's match under a 401(k) plan, that arise outside of the ESOP; or to replace dividends on allocated ESOP shares that are used for debt service. The accounting in each of those situations is discussed below.

**.66 *Shares Used to Directly Compensate Employees.*** For ESOP shares used to compensate employees directly, AcSEC addressed two issues: (a) when to record compensation and (b) when to measure compensation. AcSEC concluded that employers should record compensation when the shares are committed to be released, because AcSEC believes that is when the exchange between the employer and the employees of employer stock for services rendered occurs. Furthermore, AcSEC believes that the release of shares in a leveraged ESOP is analogous to the employer's contribution to a nonleveraged ESOP.

**.67** In reaching its conclusion on when to record compensation, AcSEC also considered whether either the point at which ESOP shares are allocated or at which employees become vested in ESOP shares is significant for accounting purposes, but rejected both of those recognition dates.

**.68** AcSEC notes that allocation is merely a mechanical process of assigning the released shares to individual participant accounts within the ESOP trust based on a known formula involving compensation, seniority, or both. AcSEC, therefore, believes that the allocation of shares is not significant for accounting purposes in recognizing compensation cost.

**.69** Furthermore, AcSEC believes that vesting provisions, which determine *vested shares*, are not the most meaningful way for employers with ESOPs to relate compensation cost to services performed. ESOPs are defined contribution plans in which participants receive regular periodic awards subject to vesting provisions. AcSEC believes that, in plans such as ESOPs in which employees receive regular, periodic awards, the shares released each period are earned by providing that period's service even though the shares may not vest until later.<sup>9</sup> Furthermore, FASB Statement No. 87, *Employers' Accounting for Pensions*, states that for defined contribution plans, the pension cost should equal the contribution called for in the period. Vesting is not a factor in recognizing compensation costs for defined contribution pension plans.

**.70** One of the most significant issues addressed in this SOP is the date on which compensation cost should be measured. Under current practice, compensation cost is measured at the date the ESOP purchases the shares, based on the ESOP's purchase price. AcSEC believes that compensation cost should be measured at the dates shares are committed to be released based on their current fair value, for the following reasons:

- APB Opinion 25, *Accounting for Stock Issued to Employees*, states that the measurement date for compensation is the first date on which the number of shares that an individual employee is entitled to receive is

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<sup>9</sup> Allocated shares that have not vested may be forfeited by certain participants and reallocated to others. Under this SOP, the reallocation of forfeited shares does not result in a cost in the period the shares are reallocated. In fact, the increase or decrease in the fair value of such shares between the date the shares were originally released and the date they are reallocated may affect the number of shares needed to satisfy the employer's obligation to employees. Nevertheless, AcSEC believes that the costs associated with maintaining the records necessary to determine the effects of forfeitures on the employer's obligations and costs would exceed the benefits derived.

known. For ESOPs, the number of shares individual employees will receive is not determinable until the shares are committed to be released. Furthermore, paragraph 11e specifically notes that transferring shares to a trustee does not establish a measurement date for measuring compensation, even if the transfer is irrevocable, unless the identity of the recipient is known. (The general definition of measurement date in APB Opinion 25 supports the allocation date as the measurement date for a leveraged ESOP. However, AcSEC believes the special situations described in paragraphs 11a and 11c of APB Opinion 25 support measurement of compensation at the date shares are committed to be released. The total number of shares committed to be released for the current year's employee service is known prior to allocation and the shares must be allocated to individual employees' accounts as of the end of the ESOP's fiscal year.) Although APB Opinion 25 was issued before SOP 76-3 [section 10,130], AcSEC believes that, because of the significant changes in ESOPs since SOP 76-3 [section 10,130] was issued, the accounting in that SOP contrary to APB Opinion 25 is no longer appropriate.

- Using the fair value of the shares when the shares are committed to be released more accurately reflects the value of the services received by the employer. AcSEC believes an employer that sponsors a leveraged ESOP has entered into a transaction similar to an employer that borrows funds to buy treasury stock and later exchanges those shares with employees for services. Neither transaction should fix the employer's cost of providing employee benefits in the future.
- The risks and rewards of ownership of the shares rests with the employer until the shares are committed to be released, because of the large degree of control employers have (a) over how the ESOP debt will be repaid (for example, in some situations, an employer may prepay or refinance debt to achieve certain compensation goals) and (b) over an employee's compensation (for example, in some situations, an employer has the ability to change other parts of an employee's compensation package in reaction to changes in the value of the shares being released to maintain an overall competitive level of compensation).
- Measuring compensation based on current fair value conforms the accounting for leveraged and nonleveraged ESOPs. Instead of forming a leveraged ESOP, an employer could borrow and use the funds to buy treasury stock. Then, as the debt is repaid, the employer could contribute the treasury shares to a nonleveraged ESOP. Compensation cost would be measured and recognized based on the fair value of the shares when they are contributed or committed to be contributed to the nonleveraged ESOP. AcSEC believes that a leveraged ESOP and the transaction described in this paragraph have more similarities than differences, and that compensation should be measured in the same way for both.

**.71 Shares Used to Fund Liabilities for Other Employee Benefits.** AcSEC believes the employer's cost and liabilities for employee benefits that are funded with ESOP shares should be measured and recognized in the same way as if some other means of funding were used. The shares committed to be released represent funding or settlement of the employer's obligation for the benefits. To illustrate, assume the following facts about an employer with a leveraged ESOP:

- The ESOP shares are used to fund an employer match under its 401(k) savings plan equal to 50 percent of employee contributions.
- The market value of ESOP shares on the release date is used to determine (a) how many shares are allocated to particular participants and (b) whether the employer must provide cash or additional shares to fund the difference between the market value of the shares committed to be released and the employer's obligation under the savings plan.
- In period 1, employees contribute \$1,000 to their 401(k) accounts and, accordingly, the employer must match \$500.
- The market value of shares committed to be released to those employee accounts is \$450; the cost of the shares committed to be released is \$425.
- The employer issues additional shares with a fair value of \$50 to the ESOP (*top-up shares*).

Under current practice for ESOPs, the employer would report compensation cost of \$475 (\$425 cost of shares plus \$50 top-up), although its obligation to employees is \$500 (50 percent of the employee contribution). Under this SOP, the employer would report compensation cost of \$500, which is the amount AcSEC believes more accurately reflects the substance of the transaction.

**.72 *Shares Used to Replace Dividends.*** Similarly, AcSEC believes that for ESOP shares used to replace dividends on allocated shares that were used for debt service, the dividend payable is measured and recognized in the same way as if it were paid in cash. The shares committed to be released represent funding or settlement of the dividend payable.

### ***Dividends***

**.73** Legally, dividends on allocated shares belong to ESOP participants and are not controlled by employers. Although employers may use those dividends to pay debt service, they must allocate shares to participant accounts to replace such dividends. AcSEC believes that dividends on allocated shares have the attributes of dividends, because employers have a liability to pay such dividends to an identifiable outside party in proportion to shares of ownership. Therefore, AcSEC believes that dividends on allocated shares should be charged to retained earnings.

**.74** Although legally the dividends on unallocated ESOP shares belong to the ESOP, employers control the use of such dividends, the shares have not been exchanged for employee services, and are not considered outstanding for EPS purposes. The use of dividends on unallocated shares is usually determined by the employer when the ESOP is established. The employer may decide to use such dividends to compensate participants by adding the value of the dividends to participant accounts. Or, more commonly, the employer decides to use such dividends to pay debt service on the ESOP's debt, which the employer has reported as a liability. In all those situations, the employer controls, and benefits from, the use of the dividends on unallocated shares.

**.75** If the employer decides to pay the dividends to participants or add the value of the dividends to participant accounts, no linkage exists within the ESOP trust between the ownership of the shares and the amount of dividends



paid to participants.<sup>10</sup> AcSEC concluded that such dividends lack the normal attributes of dividends and that the employers are providing additional compensation to participants. Accordingly, such dividends should be charged to compensation cost.

.76 If the employer decides to use the dividends to pay debt service, there is no requirement that the employer replace those dividends or allocate additional shares to participants. Therefore, from the employer's perspective, the only economic event that has occurred when the employer uses dividends on ESOP suspense shares to pay debt service is that cash is transferred to a creditor of the employer (indirect or direct loans) for debt service or is retained by the employer (employer loans); no distribution to shareholders has occurred. AcSEC concluded that such dividends lack the normal attributes of dividends and should be reported as reductions of debt and interest payable.

.77 Under this SOP, dividends on committed-to-be-released-but-unallocated shares are not charged to retained earnings although, for financial reporting purposes, such shares have been exchanged for employee service and are considered outstanding for EPS computations. However, because employers do not relinquish control over the use of the dividends on ESOP shares until the shares are allocated, AcSEC believes that dividends on committed-to-be-released-but-unallocated shares should be treated the same way as dividends on other unallocated shares. AcSEC also notes that the treatment of dividends in other situations does not necessarily correspond with whether the shares are outstanding for EPS purposes. For example, in practice, dividends on restricted shares issued in conjunction with a restricted stock compensation plan are charged to retained earnings although the shares may be only partially outstanding for EPS purposes under the treasury stock method.

### ***Unearned ESOP Shares***

.78 AcSEC considered whether the contra-equity account representing unearned ESOP shares should be adjusted to fair value at each reporting date with a corresponding entry to paid-in-capital. However, because the fair value of unearned ESOP shares must be disclosed and there would be no effect on equity, AcSEC decided against such a requirement.

### ***Redemption of Shares***

.79 AcSEC believes that employer redemptions of ESOP shares from participants are purchases of treasury stock, even if there is a put option on the shares, and therefore believes that compensation cost should not be adjusted as the value of allocated shares changes. Employers whose shares are not readily tradable are required to give participants a put option, often called a liquidity put. AcSEC notes that such put options are given and shares are purchased from participants to comply with legal requirements and to make a market for the employer's shares. For employers whose shares are readily tradable, AcSEC views the cash redemption options primarily as a convenience to participants, to save them the brokerage commissions involved in the sale of what often may be small holdings and odd lots. Furthermore, ESOPs are nondiscriminatory benefit plans for substantially all employees, and participants may redeem their shares only at times permitted by law, typically on

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<sup>10</sup> Under the IRC, if employers choose to pay dividends on suspense account shares to participants or to add those dividends to participant accounts, the allocation of the dividends must be nondiscriminatory among plan participants.

termination, hardship, or retirement. Accordingly, AcSEC believes that the existence of such options does not change the nature of an ESOP to that of a cash plan as described in paragraph 11g of APB Opinion 25.

### ***Earnings per Share***

.80 AcSEC believes that ESOP shares committed to be released and, accordingly, exchanged for employee services, are the same as other outstanding shares and should be treated as outstanding for EPS purposes. By contrast, AcSEC believes that ESOP shares that have not been committed to be released and, accordingly, not exchanged for employee services, should not be treated as outstanding for EPS purposes. AcSEC believes that this conclusion is consistent with its conclusion on reporting the release of shares in that the shares are not treated as issued until they are committed to be released.

.81 AcSEC believes that ESOP shares that have not been committed to be released are analogous to unpaid stock subscriptions, and the related consideration the employer will receive is future employee services rather than cash proceeds. Accordingly, AcSEC also considered whether the treasury stock method should be used to determine EPS similar to the way it is applied to unpaid stock subscriptions. However, AcSEC rejected the treasury stock method in favor of the released shares outstanding method, because the number of shares outstanding would be the same under either method and the released shares outstanding method is simpler to understand and apply.

### ***ESOPs That Hold Convertible Preferred Stock***

[.82] [Paragraph deleted to reflect the conforming changes necessary due to the issuance of FASB Statement No. 128, November 1998.]

.83 *Computation of Shares Issuable on Assumed Conversion.* If participants withdrawing shares from their accounts are entitled to additional common shares because the fair value or the stated minimum value of the convertible preferred shares exceeds the fair value of the common shares issuable upon conversion, AcSEC believes that the additional shares should be assumed issued in the if-converted EPS computations. Some believe that because employers may have the ability to pay cash to the ESOP trustee (who would then buy employer common stock on the market for those participants who choose common stock) instead of issuing common stock to participants directly, the additional shares should be excluded from the EPS computations. However, AcSEC believes that any issuer of convertible securities has the ability to buy shares on the market to satisfy conversion requirements and that such ability does not change the requirement to reflect the potential dilution from the convertible securities in EPS computations.

.84 ESOP convertible preferred stock has unique attributes, which AcSEC believes make it similar to convertible securities with variable conversion rates. AcSEC's recommendations in this section are based on that analogy. Because the varying conversion rates are purely a function of changes in fair values, which are unknown before they occur, AcSEC concluded that the additional shares issuable should be computed based on current period fair values for diluted EPS computations. [Paragraph revised to reflect the conforming changes necessary due to the issuance of FASB Statement No. 128, November 1998.]

**.85 *Adjustment of Earnings Applicable to Common Stock.*** When dividends on allocated ESOP shares are used to pay debt service, participants receive their dividends in shares rather than in cash. In the normal situation, if the preferred stock were converted to common stock, the common stock dividend would be less than the preferred stock dividend, the proportion of committed-to-be-released shares needed to replace dividends on allocated shares would be smaller after the assumed conversion, and the proportion of committed-to-be-released shares used to compensate participants for services would be greater after the assumed conversion. AcSEC believes the availability of a greater proportion of released shares to compensate participants is a nondiscretionary adjustment, as described in paragraph 26 of FASB Statement No. 128. Accordingly, earnings applicable to common stock in the if-converted computations should reflect the additional compensation cost that would arise from the assumed conversion. (Illustrations 4 and 5 of appendix A [paragraph .99] include this calculation.) [Paragraph revised to reflect the conforming changes necessary due to the issuance of FASB Statement No. 128, November 1998.]

**.86** AcSEC believes that cash dividends on allocated ESOP shares paid to participants or added to participant accounts should be treated the same way as dividends on non-ESOP convertible preferred stock, and, accordingly, concluded that adjustment of compensation cost for EPS computation purposes is unnecessary.

**.87** Dividends on unallocated ESOP shares used to pay debt service are not treated as dividends for accounting purposes and, therefore, do not affect the if-converted EPS computations.

**.88** Dividends on unallocated ESOP shares paid to participants or added to participant accounts are treated as compensation cost. That use of dividends and, consequently, the compensation provided to participants, is discretionary when the ESOP is established. Accordingly, AcSEC believes that the compensation cost arising from those dividends should not be adjusted in the if-converted EPS computations.

### ***Terminations***

**.89** Although IRS and ERISA rules make it difficult, and often uneconomical, to terminate leveraged ESOPs and generally require a valid business reason—such as significant shrinkage in the work force or bankruptcy—for doing so, terminations and curtailments of ESOP plans occasionally occur. AcSEC believes that the conclusion that terminations or curtailments involving an ESOP's suspense shares should be accounted for as treasury stock transactions is consistent with the basic premise of this SOP—that the shares and debt should be accounted for separately. Another important consideration was that suspense shares are not considered outstanding for EPS computations.

**.90** The accounting for terminations recommended in this SOP would result in a debit to paid-in capital when the fair value of the shares at the termination date is less than the cost of the shares to the ESOP and a credit to paid-in capital when the fair value of the shares at the termination date is more than the cost of the shares to the ESOP. AcSEC believes those debits or credits to equity are analogous to losses and gains on the employer's own stock, which should be excluded from income. Under this SOP, differences between the fair value and cost of ESOP shares used to settle employer liabilities are debited

and credited to shareholders' equity. An ESOP termination is effectively the use of ESOP shares to settle the employer's liability for ESOP debt. Even if an employer has an internally leveraged ESOP with no related outside debt, AcSEC believes the reacquisition of the ESOP shares should be treated as a purchase of treasury stock because, under this SOP, the employer does not report the ESOP's note payable and does not report a note receivable from the ESOP, and the suspense shares have neither been considered outstanding for EPS nor exchanged for employee services.

.91 AcSEC provides the following example to illustrate the point. An ESOP borrows \$1,000 and acquires 100 shares of employer stock for \$10 per share (market price on the date acquired). The market price subsequently drops to \$6 per share, and the employer decides to terminate its ESOP when there are 80 shares in suspense and an \$800 debt balance. Accordingly, the employer would have to contribute an additional \$320 (\$800 less \$6 multiplied by 80 shares) to retire the ESOP debt. AcSEC believes that the additional contribution is a result of a change in the value of the employer's shares, not of a change in the debt obligation. Therefore, the \$320 should be charged to paid-in capital, not to income as an extinguishment loss or compensation expense. AcSEC believes the accounting treatment recommended for terminations is analogous to any company borrowing cash to buy shares of its own stock and later selling those shares to obtain cash to repay the debt. If the proceeds from the sale of the shares is insufficient to repay the debt because the fair value of the shares declined between the purchase and sale dates, the company will have to use additional cash to repay the debt. Such a transaction would have no impact on the company's income.

### Nonleveraged ESOPs

.92 Although this SOP would not change how employers with nonleveraged ESOPs account for ESOP transactions, AcSEC believes it is helpful to include a discussion of nonleveraged ESOPs. The accounting described in this SOP for employers with nonleveraged ESOPs is based on the fact that nonleveraged ESOPs are defined contribution pension plans covered by FASB Statement No. 87. Therefore, the compensation cost for the period should generally equal the contribution called for in the period. The shares or cash that an employer contributes or commits to contribute to a nonleveraged ESOP for a period is consideration for employee services rendered during that period.

### Pension Reversion ESOPs

.93 If the excess assets from a pension reversion are used to purchase ESOP shares, the shares in excess of the amount that may be allocated to participants in the year of the reversion are held in a suspense account and allocated in future years. The suspense account shares arising from a pension reversion do not collateralize a borrowing, and the release of such shares is not based on debt service payments. However, in most other respects, such suspense account shares are the same as the suspense account shares in a leveraged ESOP, and, accordingly, AcSEC concluded that they should be accounted for in the same way as suspense account shares of leveraged ESOPs.

### Income Taxes

.94 Although FASB Statement No. 109, *Accounting for Income Taxes*, does not explicitly address how to treat differences between the fair value and

the cost of ESOP shares committed to be released, it does address expenses for employee stock options recognized differently for financial reporting and tax purposes, which AcSEC believes is analogous to ESOPs. The FASB decided to make no changes to paragraph 17 of APB Opinion 25, which prohibits reporting the related tax effect of such differences as a part of income and requires that they be reported as charges or credits directly to related components of shareholders' equity.

## Disclosures

.95 AcSEC notes that the disclosures in paragraph .53f related to repurchase obligations are a minimum requirement. AcSEC recognizes that employers may wish to disclose additional information about the obligation, particularly information about the timing of payments.

## Transition

.96 AcSEC believes that transition, to a significant extent, is a practical matter. A major objective of transition is to minimize implementation costs and to mitigate disruption to the extent possible without unduly compromising the objectives of the accounting guidance in this SOP and consistency among reporting entities.

.97 In deciding to grandfather shares held by ESOPs as of December 31, 1992, AcSEC was most influenced by its perception that it would be unfair to employers with existing ESOPs to change their accounting for ESOPs currently in place. The decision to establish an ESOP is complex and involves the consideration of many factors, such as IRS and ERISA regulations, employee compensation matters, and possible other uses of debt proceeds, as well as how the ESOP will affect earnings during its term. ESOPs are long-term undertakings, they are costly to establish, and they cannot be undone easily. For many employers, the accounting treatment, which was covered in SOP 76-3 [section 10,130], was an important consideration in establishing their ESOPs.

## Minority View

.98 Four AcSEC members dissent to the issuance of this SOP, because they believe that fair value of shares released should not be used to measure compensation cost of certain ESOPs. The dissenters believe there are two types of ESOPs, as follows:

- *Type I*—Shares are released to compensate employees directly. Such ESOPs are not used to fund other employee benefits and the fair value of the shares released is not a factor in determining the number of shares to be allocated to employees. These ESOPs are typical of the ESOPs that commonly existed at the time SOP 76-3 [section 10,130] was issued.
- *Type II*—Shares are released to settle or fund liabilities for other specified or determinable employee benefits, such as an employer's match of a 401(k) plan. The fair value of shares released is used to determine how many shares are needed to satisfy an obligation that arose outside the ESOP.

The dissenters believe that Type I ESOPs should be excluded from the scope of the SOP because the current accounting guidance for Type I ESOPs continues

to be relevant and the costs of applying the SOP to Type I ESOPs are not justified. They believe this SOP on employers' accounting for ESOP transactions should cover only the ESOPs for which there is concern that the current accounting is inappropriate. The dissenters believe that the measurement date to recognize compensation expense for Type I ESOPs should continue to be the date the shares are purchased by the ESOP, because that is when the risks and rewards associated with the value of the ESOP shares are transferred from the employer to employees. In contrast, the dissenters agree with the accounting in this SOP for Type II ESOPs.

## Appendix A

### Illustrations

This appendix contains illustrations of the requirements of this SOP for employers with the following kinds of ESOPs:

- *Illustration 1*—A common-stock leveraged ESOP with a direct loan
- *Illustration 2*—A common-stock leveraged ESOP used to fund the employer's match of a 401(k) savings plan with an indirect loan
- *Illustration 3*—A common-stock nonleveraged ESOP
- *Illustration 4*—A convertible-preferred-stock leveraged ESOP with a direct loan [Illustration revised to reflect the conforming changes necessary due to the issuance of FASB Statement No. 128, November 1998.]
- *Illustration 5*—A convertible, preferred-stock, leveraged ESOP used to fund a 401(k) savings plan with an employer loan [Illustration revised to reflect the conforming changes necessary due to the issuance of FASB Statement No. 128, November 1998.]

The illustrations do not address all possible circumstances that may arise in applying the SOP. The illustrations are for annual reporting periods and, accordingly, do not demonstrate the application of the SOP to interim financial statements. However, depending on the circumstances, many of the journal entries illustrated would be made for interim financial statements.

Illustration 1

Common Stock Leveraged ESOP With a Direct Loan

Assumptions

On January 1, Year 1, Company A establishes a leveraged ESOP as follows:

- The ESOP borrows \$1,000,000 from an outside lender at 10 percent for five years and uses the proceeds to buy 100,000 shares of newly issued common stock of the sponsor for \$10 per share, which is the market price of those shares on the date of issuance.
- Debt service is funded by cash contributions and dividends on employer stock held by the ESOP.
- Dividends on all shares held by the ESOP are used for debt service.
- Cash contributions are made at the end of each year.
- The year-end and average market values of a share of common stock follow:

Table 1-a

<i>Year</i>	<i>Year-end</i>	<i>Average</i>
1	\$11.50	\$10.75
2	9.00	10.25
3	10.00	9.50
4	12.00	11.00
5	14.40	13.20

- The common stock pays normal dividends at the end of each quarter of 12.5 cents per share (\$50,000 for the ESOP's shares each year). Accordingly, in this illustration, the average fair value of shares is used to determine the number of shares used to satisfy the employers' obligation to replace dividends on allocated shares used for debt service.
- Principal and interest are payable in equal annual installments at the end of each year. Debt service is as follows:

Table 1-b

<i>Year</i>	<i>Principal</i>	<i>Interest</i>	<i>Total Debt Service</i>
1	\$ 163,800	\$100,000	\$ 263,800
2	180,200	83,600	263,800
3	198,200	65,600	263,800
4	218,000	45,800	263,800
5	239,800	24,000	263,800
	<u>\$1,000,000</u>	<u>\$319,000</u>	<u>\$1,319,000</u>

- The number of shares released each year is as follows:



Table 1-c

<i>Year</i>	<i>Dividends</i>	<i>Compensation</i>	<i>Total</i>
1	0	20,000	20,000
2	976	19,024	20,000
3	2,105	17,895	20,000
4	2,727	17,273	20,000
5	3,030	16,970	20,000

The number of shares released for dividends is determined by dividing the amount of dividends on allocated shares by the average fair value of a share of common stock (for year 2: \$10,000 divided by \$10.25 equals 976 shares). In this illustration, the remaining shares are released for compensation (for year 2: 20,000 less 976 equals 19,024 shares).

- Shares are released from the suspense account for allocation to participants' accounts based on a principal-plus-interest formula. The released shares are allocated to participant accounts the following year. Shares released and allocated follow:

Table 1-d

<i>Year</i>	<i>Cumulative Number of Shares</i>		<i>Average Shares</i>	<i>Year-End Suspense</i>
	<i>Released</i>	<i>Allocated</i>	<i>Released</i>	<i>Shares</i>
1	20,000	0	10,000	80,000
2	40,000	20,000	30,000	60,000
3	60,000	40,000	50,000	40,000
4	80,000	60,000	70,000	20,000
5	100,000	80,000	90,000	0

- Income before ESOP-related charges is as follows:

Table 1-e

<i>Year</i>	<i>Income</i>
1	\$1,800,000
2	1,900,000
3	2,000,000
4	2,100,000
5	2,200,000

- All interest cost and compensation cost are charged to expense each year.
- Excluding ESOP shares, 1,000,000 shares are outstanding on average each year.
- Company A follows FASB Statement No. 109.
- Company A's combined statutory tax rate is 40 percent each year.
- Company A's only book/tax differences are those associated with its ESOP.

- No valuation allowance is necessary for deferred tax assets.

Results of Applying SOP

The following table sets forth Company A's ESOP-related information. All amounts represent changes (credits in parentheses) in account balances.

Year	Principal	Unearned ESOP Shares	Paid-In Capital	Dividends	Interest Expense	Compensation Expense	Cash
Notes	(1)	(2)	(3)	(4)	(1)	(5)	(6)
1	\$ 163,800	\$ (200,000)	\$(15,000)	\$ 0	\$100,000	\$215,000	\$ (263,800)
2	180,200	(200,000)	(5,000)	10,000	83,600	195,000	(263,800)
3	198,200	(200,000)	10,000	20,000	65,600	170,000	(263,800)
4	218,000	(200,000)	(20,000)	30,000	45,800	190,000	(263,800)
5	239,800	(200,000)	(64,000)	40,000	24,000	224,000	(263,800)
Total	<u>\$1,000,000</u>	<u>\$(1,000,000)</u>	<u>\$(94,000)</u>	<u>\$100,000</u>	<u>\$319,000</u>	<u>\$994,000</u>	<u>\$(1,319,000)</u>

Notes:

- (1) See table 1-b.
- (2) Total number of shares released for year (20,000) multiplied by the cost per share to ESOP (\$10).
- (3) Total number of shares released for year (20,000) multiplied by the difference between average fair value per share (see table 1-a) and cost per share to ESOP (\$10). [Year 1: 20,000 shares multiplied by (\$10.75-\$10.00)]
- (4) Cumulative number of allocated shares (see table 1-d) multiplied by the dividend per share. [Year 2: 20,000 shares multiplied by \$.50]
- (5) Number of shares released for compensation (see table 1-c) multiplied by the average fair value per share for the period (see table 1-a). The amounts in this column have been rounded.
- (6) The cash disbursed each year is comprised of \$213,800 contribution and \$50,000 in dividends.

Journal Entries

Company A would record journal entries from inception through year 5 as follows:

January 1, Year 1 (inception)

Cash	1,000,000	
Debt		1,000,000
[To record the ESOP's loan]		
Unearned ESOP shares (equity)	1,000,000	
Common stock and paid-in capital		1,000,000
[To record the issuance of 100,000 shares to the ESOP at \$10 per share]		

Year 1

Interest expense	100,000	
Accrued interest payable		100,000
[To record interest expense]		

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Accrued interest payable	100,000	
Debt	163,800	
Cash		263,800
[To record debt payment (The cash disbursement of \$263,800 consists of \$50,000 in dividends, none of which is charged to retained earnings in year 1, and \$213,800 supplemental cash contribution to the ESOP)]		
Compensation expense	215,000	
Paid-in capital		15,000
Unearned ESOP shares		200,000
[To record release of 20,000 shares at an average fair value of \$10.75 per share (shares cost ESOP \$10)]		
Deferred tax asset	14,480	
Provision for income taxes	600,000	
Income taxes payable		614,480
[To record income taxes for year 1 (See tax computations following journal entries)]		

## Year 2

Interest expense	83,600	
Accrued interest payable		83,600
[To record interest expense]		
Accrued interest payable	83,600	
Debt	180,200	
Cash		263,800
[To record debt payment (The cash disbursement of \$263,800 consists of \$50,000 in dividends, \$10,000 of which is charged to retained earnings in year 2, and \$213,800 supplemental cash contribution to the ESOP)]		
Retained earnings	10,000	
Dividends payable		10,000
[To record declaration of \$.50 per share dividend on the 20,000 allocated shares]		
Compensation expense	195,000	
Dividends payable	10,000	
Paid-in capital		5,000
Unearned ESOP shares		200,000
[To record release of 20,000 shares (19,024 for compensation and 976 for dividends) at an average fair value of \$10.25 per share (shares cost ESOP \$10 per share)]		
Deferred tax asset	7,920	
Provision for income taxes	646,560	
Income taxes payable		654,480
[To record income taxes for year 2 (See tax computations following journal entries)]		

## Year 3

Interest expense	65,600	
Accrued interest payable		65,600
[To record interest expense]		

Accrued interest payable	65,600	
Debt	198,200	
Cash		263,800
[To record debt payment]		
Retained earnings	20,000	
Dividends payable		20,000
[To record declaration of \$.50 per share dividend on the 40,000 allocated shares]		
Compensation expense	170,000	
Dividends payable	20,000	
Paid-in capital	10,000	
Unearned ESOP shares		200,000
[To record release of 20,000 shares (17,895 for compensation and 2,105 for dividends) at an average fair value of \$9.50 per share (shares cost ESOP \$10 per share)]		
Deferred tax asset	720	
Provision for income taxes	697,760	
Paid-in capital		4,000
Income taxes payable		694,480
[To record income taxes for year 3 (See tax computations following journal entries)]		

**Year 4**

Interest expense	45,800	
Accrued interest payable		45,800
[To record interest expense]		
Accrued interest payable	45,800	
Debt	218,000	
Cash		263,800
[To record debt payment]		
Retained earnings	30,000	
Dividends payable		30,000
[To record declaration of \$.50 per share dividend on the 60,000 allocated shares]		
Compensation expense	190,000	
Dividends payable	30,000	
Paid-in capital		20,000
Unearned ESOP shares		200,000
[To record release of 20,000 shares (17,273 for compensation and 2,727 for dividends) at an average fair value of \$11.00 per share (shares cost ESOP \$10 per share)]		
Provision for income taxes	737,680	
Paid-in capital	4,000	
Deferred tax asset		7,200
Income taxes payable		734,480
[To record income taxes for year 4, see tax computations following journal entries]		

**Year 5**

Interest expense	24,000	
Accrued interest payable		24,000
[To record interest expense]		
Accrued interest payable	24,000	
Debt	239,800	
Cash		263,800
[To record debt payment]		
Retained earnings	40,000	
Dividends payable		40,000
[To record declaration of \$.50 per share dividend on the 80,000 allocated shares]		
Compensation expense	224,000	
Dividends payable	40,000	
Paid-in capital		64,000
Unearned ESOP shares		200,000
[To record release of 20,000 shares (16,970 for compensation and 3,030 for dividends) at an average fair value of \$13.20 per share (shares cost ESOP \$10 per share)]		
Provision for income taxes	790,400	
Deferred tax asset		15,920
Income taxes payable		774,480
[To record income taxes for year 5, see tax computations following journal entries]		

**Illustration of Termination**

Assuming Company A terminates its ESOP at the end of year 2 (when the fair value of the suspense shares is \$540,000 [60,000 shares multiplied by \$9 per share], the unearned compensation balance is \$600,000, and the unpaid debt balance is \$656,000), and assuming the suspense shares are sold to pay down the debt, Company A would make the following journal entry:

Debt	656,000	
Additional paid-in capital	60,000	
Unearned ESOP shares		600,000
Cash		116,000
[To record repayment of the ESOP's loan and termination of the plan]		

## Tax and EPS Computations

The following tables set forth Company A's tax (assuming no termination) and EPS computations:

	Year				
	1	2	3	4	5
Income before ESOP	\$1,800,000	\$1,900,000	\$2,000,000	\$2,100,000	\$2,200,000
Interest expense	(100,000)	(83,600)	(65,600)	(45,800)	(24,000)
Compensation expense	(215,000)	(195,000)	(170,000)	(190,000)	(224,000)
Pretax income	<u>1,485,000</u>	<u>1,621,400</u>	<u>1,764,400</u>	<u>1,864,200</u>	<u>1,952,000</u>
Provision for income tax					
Currently payable	614,480	654,480	694,480	734,480	774,480
Deferred	(14,480)	(7,920)	(720)	7,200	15,920
Shareholders' equity	-0-	-0-	4,000*	(4000)*	-0-
Total	<u>600,000</u>	<u>646,560</u>	<u>697,760</u>	<u>737,680</u>	<u>790,400</u>
Net income	<u>\$ 885,000</u>	<u>\$ 974,840</u>	<u>\$1,066,640</u>	<u>\$1,126,520</u>	<u>\$1,161,600</u>
Average shares outstanding	1,010,000	1,030,000	1,050,000	1,070,000	1,090,000
Earnings per share	<u>\$ .88</u>	<u>\$ .95</u>	<u>\$ 1.02</u>	<u>\$ 1.05</u>	<u>\$ 1.07</u>

## Tax Computations

	Year				
	1	2	3	4	5
Current provision:					
Income before ESOP	\$1,800,000	\$1,900,000	\$2,000,000	\$2,100,000	\$2,200,000
ESOP contribution	(213,800)	(213,800)	(213,800)	(213,800)	(213,800)
ESOP dividends	(50,000)	(50,000)	(50,000)	(50,000)	(50,000)
Taxable income	<u>1,536,200</u>	<u>1,636,200</u>	<u>1,736,200</u>	<u>1,836,200</u>	<u>1,936,200</u>
Multiplied by 40 percent	<u>\$ 614,480</u>	<u>\$ 654,480</u>	<u>\$ 694,480</u>	<u>\$ 734,480</u>	<u>\$ 774,480</u>
Deferred provision:					
Reduction in unearned ESOP shares for financial reporting	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000
Related tax deduction**	163,800	180,200	198,200	218,800	239,800
Difference	<u>(36,200)</u>	<u>(19,800)</u>	<u>(1,800)</u>	<u>18,000</u>	<u>39,800</u>
Tax rate	40%	40%	40%	40%	40%
Deferred tax expense/(benefit)	<u>\$ (14,480)</u>	<u>\$ (7,920)</u>	<u>\$ (720)</u>	<u>7,200</u>	<u>15,920</u>

\* See paragraph .50. In year 3, the amount is calculated as follows: 20,000 shares released multiplied by \$.50 excess cost over average fair value per share multiplied by 40 percent tax rate.

\*\* This amount is the principal repayment.

**Reconciliation of Effective Tax Rate to Provision for Income Taxes**

	<i>Year</i>				
	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
Pretax income	\$1,485,000	\$1,621,400	\$1,764,400	\$1,864,200	\$1,952,000
Tax at 40 percent (statutory rate)	594,000	648,560	705,760	745,680	780,800
Benefit of ESOP dividends	-0-	(4,000)	(8,000)	(12,000)	(16,000)
Effect of difference between average fair value and cost of released shares	6,000	2,000	-0-	4,000	25,600
Provision as reported	<u>\$ 600,000</u>	<u>\$ 646,560</u>	<u>\$ 697,760</u>	<u>\$ 737,680</u>	<u>\$ 790,400</u>

**Illustrative Disclosure for End of Year 3**

The company sponsors a leveraged employee stock ownership plan (ESOP) that covers all U.S. employees who work twenty or more hours per week. The company makes annual contributions to the ESOP equal to the ESOP's debt service less dividends received by the ESOP. All dividends received by the ESOP are used to pay debt service. The ESOP shares initially were pledged as collateral for its debt. As the debt is repaid, shares are released from collateral and allocated to active employees, based on the proportion of debt service paid in the year. The company accounts for its ESOP in accordance with Statement of Position 93-6. Accordingly, the debt of the ESOP is recorded as debt and the shares pledged as collateral are reported as unearned ESOP shares in the statement of financial position. As shares are released from collateral, the company reports compensation expense equal to the current market price of the shares, and the shares become outstanding for earnings-per-share (EPS) computations. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings; dividends on unallocated ESOP shares are recorded as a reduction of debt and accrued interest. ESOP compensation expense was \$170,000, \$195,000, and \$215,000 for years 3, 2, and 1, respectively. The ESOP shares as of December 31 were as follows:

	<i>Year 3</i>	<i>Year 2</i>
Allocated shares	40,000	20,000
Shares released for allocation	20,000	20,000
Unreleased shares	40,000	60,000
Total ESOP shares	<u>100,000</u>	<u>100,000</u>
Fair value of unreleased shares at December 31	<u>\$400,000</u>	<u>540,000</u>

Illustration 2

Common Stock Leveraged ESOP Used to Fund the Employer's Match of a 401(k) Savings Plan With an Indirect Loan

Assumptions

On January 1, Year 1, Company B established an ESOP to fund the employer's match of its savings plan as follows:

- All of the assumptions are the same as those for Company A, except as follows.
- Company B loaned its ESOP \$1,000,000 and concurrently obtained a related loan. The terms of both lending arrangements are the same as for Company A's outside loan.
- Company B uses shares released by the ESOP to satisfy its matching obligation of 50 percent of voluntary employee contributions to the savings plan. The average fair value of the shares for each year is used to determine the number of shares necessary to satisfy the matching obligation.
- If the fair value of the shares released is less than Company B's matching obligation, Company B contributes additional newly issued shares to the ESOP to satisfy the remaining obligation.
- Shares used to replace dividends on allocated shares used to service debt do not count toward the employer's match.
- The employee contributions, required employer match, and the number of shares needed to fund the employee match follow:

Table 2-a

<i>Year</i>	<i>Employee Contributions</i>	<i>Employer Match</i>	<i>Number of Shares</i>
1	\$400,000	\$200,000	18,605
2	410,000	205,000	20,000
3	420,000	210,000	22,105
4	430,000	215,000	19,545
5	440,000	220,000	16,667

*Note:* The number of shares needed to satisfy the employer's matching obligation is determined by dividing the matching obligation by the average fair value of a share of common stock [for year 1: \$200,000 divided by \$10.75 (See table 1-a for average fair values) equals 18,605 shares].



- The 20,000 shares released each year based on debt service payments follow:

**Table 2-b**

<i>Year</i>	<i>Number of Shares Needed to Settle 401(k) Liability</i>	<i>Total ESOP Shares Released</i>	<i>ESOP Shares Used for Dividends</i>	<i>ESOP Shares Available to Settle 401(k) Liability</i>	<i>Compensation (Additional Shares)</i>	<i>Top-Up (Additional Shares)</i>
<i>Notes</i>	<i>(1)</i>	<i>(2)</i>	<i>(3)</i>	<i>(4)</i>	<i>(5)</i>	<i>(6)</i>
1	18,605	20,000	-0-	20,000	1,395	-0-
2	20,000	20,000	976	19,024	-0-	976
3	22,105	20,000	2,105	17,895	-0-	4,210
4	19,545	20,000	2,727	17,273	-0-	2,272
5	16,667	20,000	3,030	16,970	303	0

**Notes:**

- (1) See table 2-a.
  - (2) See assumptions.
  - (3) See table 1-c.
  - (4) Total ESOP shares released minus ESOP shares used for dividends.
  - (5) If the ESOP shares needed to settle the 401(k) liability (column 1) are less than the ESOP shares available to settle the liability (column 4), then the remaining shares are considered compensation (this is the case in years 1 and 5).
  - (6) If the ESOP shares needed to settle the 401(k) liability (column 1) are greater than the ESOP shares available to settle the liability (column 4), then the shortfall must be made up by the employer in the form of top-up shares (this is the case in years 2, 3, and 4).
- Cumulative share amounts follow:

**Table 2-c**

<i>Year</i>	<i>Cumulative Number of Shares</i>		<i>Total Suspense Shares</i>
	<i>Released</i>	<i>Allocated</i>	
1	20,000	-0-	80,000
2	40,976	20,000	60,000
3	65,186	40,976	40,000
4	87,458	65,186	20,000
5	107,458	87,458	-0-

*Note:* Dividends on top-up shares are paid in cash. Cumulative shares released include top-up shares.

## Results of Applying SOP

The following table sets forth Company B's ESOP-related information. All amounts represent changes (credits in parentheses) in account balances.

Year	Principal	Unearned ESOP Shares	Paid-In Capital	Dividends	Interest Expense	Com- pensation Expense ESOP	Com- pensation Expense Top-Up	Cash
Notes	(1)	(2)	(3)	(4)	(1)	(5)	(6)	(7)
1	\$ 163,800	\$ (200,000)	\$ (15,000)	\$ -0-	\$100,000	\$215,000	\$ -0-	\$ (263,800)
2	180,200	(200,000)	(15,000)	10,000	83,600	195,000	10,000	(263,800)
3	198,200	(200,000)	(30,000)	20,500	65,600	170,000	40,000	(264,300)
4	218,000	(200,000)	(45,000)	32,600	45,800	190,000	25,000	(266,400)
5	239,800	(200,000)	(64,000)	43,700	24,000	224,000	-0-	(267,500)
Total	<u>\$1,000,000</u>	<u>\$(1,000,000)</u>	<u>\$(169,000)</u>	<u>\$106,800</u>	<u>\$319,000</u>	<u>\$994,000</u>	<u>\$75,000</u>	<u>\$(1,325,800)</u>

Notes:

- (1) See table 1-b.
- (2) Number of shares released during the year (20,000) multiplied by the cost per share to ESOP (\$10).
- (3) Number of shares released during the year (20,000) multiplied by the difference between average fair value per share (see table 1-a) and cost per share to the ESOP (\$10) plus the additional paid-in capital that arises from the top-up shares contributed, which equals the compensation expense related to the top-up.
- (4) Cumulative shares allocated (see table 2-c) multiplied by the dividend per share (\$.50).
- (5) Number of ESOP shares released for direct compensation plus number of shares released related to employer's match of 401(k) (see table 2-b) multiplied by the average fair value per share (see table 1-a).
- (6) Additional shares contributed (top-up) to satisfy the 401(k) obligation (see table 2-b) multiplied by the fair value of shares contributed.
- (7) The cash disbursed to the ESOP each year is composed of \$213,800 contribution; \$50,000 in dividends on original ESOP shares; and dividends on top-up shares of \$500 in year 3, \$2,600 in year 4, and \$3,700 in year 5.

Journal Entries

Company B would record journal entries from inception through year 2 as follows:

January 1, Year 1 (inception)

Cash	1,000,000	
Debt		1,000,000
[To record loan]		
Unearned ESOP shares (equity)	1,000,000	
Common stock and additional paid-in capital		1,000,000
[To record the issuance of 100,000 shares to the ESOP at \$10 per share]		

Year 1

Interest expense	100,000	
Accrued interest payable		100,000
[To record interest expense]		

Accrued interest payable	100,000	
Debt	163,800	
Cash		263,800

[To record debt payment (The cash disbursement of \$263,800 consists of \$50,000 in dividends, none of which was charged to retained earnings in year 1, and \$213,800 supplemental cash contribution to the ESOP)]

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

[To record cost and liability related to employer's 401(k) match, which represents 50 percent of employee contributions]

401(k) liability	200,000	
Compensation expense	15,000	
Unearned ESOP shares		200,000
Paid-in capital		15,000

[To record release of 20,000 shares at an average fair value of \$10.75 per share, 18,605 shares are used to satisfy 401(k) liability and the remaining 1,395 are used to compensate participants directly (shares cost ESOP \$10 per share)]

Deferred tax asset	14,480	
Provision for income taxes	600,000	
Income taxes payable		614,480

[To record income taxes for year 1 (See illustration 1 for detailed tax computation)]

## **Year 2**

Interest expense	83,600	
Accrued interest payable		83,600

[To record interest expense]

Accrued interest payable	83,600	
Debt	180,200	
Cash		263,800

[To record debt payment (The cash disbursement of \$263,800 consists of \$50,000 in dividends, \$10,000 of which was charged to retained earnings in year 2, and \$213,800 supplemental cash contribution to the ESOP)]

Compensation expense	205,000	
401(k) liability		205,000

[To record cost and liability related to employer's 401(k) match, which represents 50 percent of employee contributions]

Retained earnings	10,000	
Dividends payable		10,000

[To record declaration of \$.50 per share dividend on the 20,000 allocated shares]

401(k) liability	205,000	
Dividends payable	10,000	
Unearned ESOP shares		200,000
Common stock/paid-in capital		15,000

[To record release of 20,000 shares plus contribution of an additional 976 shares to the ESOP at an average fair value of \$10.25 per share, 20,000 shares are used to satisfy 401(k) liability and the remaining 976 shares are used to replace dividends on allocated shares used for debt service (shares cost ESOP \$10 per share)]

Deferred tax asset	7,920	
Provision for income taxes	642,560	
Income taxes payable		650,480

[To record income taxes for year 2 (See illustration 1 for detailed tax computation)]

*Note:* Journal entry differs from Illustration 1 because Company B receives an additional \$10,000 deduction (\$4,000 tax benefit) for the 976 top-up shares.

Illustration of Termination

Assuming Company B terminated its ESOP at the end of year 4 (when the fair value of the suspense shares is \$240,000, the unearned ESOP shares balance is \$200,000, and the unpaid debt balance is \$239,800), and assuming the employer buys back the suspense shares in an amount equal to the debt balance, there will be seventeen suspense shares left, which must be allocated to participants. (In this illustration the shares are used to partially satisfy the employer's 401(k) matching obligation.) Company B would make the following journal entry:

Treasury stock	39,800	
401(k) liability	204	
Additional paid-in-capital		40,004
Unearned ESOP shares		200,000

[To record repurchase of ESOP suspense shares and termination of the plan]

Debt	239,800	
Cash		239,800

[To record repayment of the ESOP's loan]

Tax and EPS Computations

Company B's taxes would be computed the same way as Company A's. For Company B the average number of ESOP shares outstanding would be as follows:

<i>Year</i>	<i>ESOP Shares Outstanding</i>
1	10,000
2	30,488
3	53,081
4	76,322
5	97,458

This represents the cumulative numbers of shares released at the beginning of the year plus the end of the year (see table 2-c) divided by 2.

### **Illustrative Disclosure for End of Year 3**

The company sponsors a 401(k) savings plan under which eligible U.S. employees may choose to save up to 6 percent of salary income on a pre-tax basis, subject to certain IRS limits. The company matches 50 percent of employee contributions with company common stock. The shares for this purpose are provided principally by the company's employee stock ownership plan (ESOP), supplemented as needed by newly issued shares. The company makes annual contributions to the ESOP equal to the ESOP's debt service less dividends received by the ESOP. All dividends received by the ESOP are used to pay debt service. The ESOP shares initially were pledged as collateral for its debt. As the debt is repaid, shares are released from collateral and allocated to employees who made 401(k) contributions that year, based on the proportion of debt service paid in the year. The company accounts for its ESOP in accordance with Statement of Position 93-6. Accordingly, the shares pledged as collateral are reported as unearned ESOP shares in the statement of financial position. As shares are released from collateral, the company reports compensation expense equal to the current market price of the shares, and the shares become outstanding for EPS computations. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings; dividends on unallocated ESOP shares are recorded as a reduction of debt and accrued interest.

Compensation expense for the 401(k) match and the ESOP was \$210,000, \$205,000, and \$215,000 for years 3, 2, and 1, respectively. The ESOP shares as of December 31 were as follows:

	<u>Year 3</u>	<u>Year 2</u>
Allocated shares	40,976	20,000
Shares released for allocation	24,210	20,976
Unreleased shares	40,000	60,000
Total ESOP shares	<u>105,186</u>	<u>100,976</u>
Fair value of unreleased shares at December 31	<u>\$400,000</u>	<u>\$540,000</u>

Illustration 3

Common Stock Nonleveraged ESOP

Assumptions

On January 1, Year 1, Company C established a nonleveraged ESOP as follows:

- Company C contributed 10 percent of pretax profit before ESOP-related charges to the ESOP at the end of each of years 1 through 5; the ESOP bought newly issued employer stock with the contribution.
- The number of shares, earnings, tax, and other relevant assumptions are the same as those for Company A.

Results of Applying SOP

The following chart sets forth Company C's ESOP-related information:

Year	Compensation Expense	Dividends	Number of ESOP Shares Purchased	Cumulative ESOP Shares
1	\$180,000	\$ -0-	15,652	15,652
2	190,000	7,830	21,111	36,763
3	200,000	18,380	20,000	56,763
4	210,000	28,380	17,500	74,263
5	220,000	37,130	15,278	89,541

The year-end market value is used in this illustration to determine the number of ESOP shares purchased. [Year 1: \$180,000 divided by \$11.50 (See table 1-a) equals 15,652]

Journal Entries

Company C would record journal entries for years 1 and 2 as follows:

Year 1

Compensation expense	180,000	
Common stock/paid-in capital		180,000
[To record contribution, sale of shares, and compensation expense]		
Provision for income taxes	648,000	
Income taxes payable		648,000
[To record income taxes at 40 percent for year 1 on earnings of \$1,620,000 (\$1,800,000 pre-ESOP income less ESOP compensation of \$180,000)]		

Year 2

Compensation expense	190,000	
Retained earnings	7,830	
Common stock/paid-in capital		190,000
Dividends payable		7,830
[To record contribution, sale of shares, declaration of dividends, and compensation expense]		

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Dividends payable	7,830	
Cash		7,830
[To record payment of dividends]		
Provision for income taxes	684,000	
Income taxes payable		684,000
[To record income taxes at 40 percent for year 2 on earnings of \$1,710,000 (\$1,900,000 pre-ESOP income less ESOP compensation of \$190,000)]		

Illustration 4

Convertible Preferred Stock Leveraged  
ESOP With a Direct Loan

Assumptions

On January 1, Year 1, Company D established an ESOP with convertible preferred stock as follows:

- The borrowing, debt service, earnings, and tax assumptions are the same as those for Company A.
- On January 1, Year 1, the ESOP used the proceeds of the debt to buy 80,000 shares of newly issued convertible preferred stock of Company D for \$12.50 per share.
- The preferred stock pays dividends quarterly at an annual rate of \$1.25 per share (\$100,000 each year for the ESOP's shares). Accordingly, in this illustration the average fair value of the shares is used to determine the number of shares used to satisfy the employer's obligation to replace dividends on allocated shares used for debt service.
- All dividends on ESOP shares are used for debt service.
- The preferred stock is convertible into common stock at 1:1 ratio.
- Participants may not withdraw the convertible preferred stock from the ESOP. When participants become eligible to withdraw shares from their account, they must either convert to common stock or redeem the preferred shares.
- The preferred stock has a guaranteed minimum redemption value of \$12.50 per share, to be paid in shares of common stock.
- The preferred stock is callable at \$13.00 per share.
- There is one vote per preferred share.
- The year-end and average fair values of a share of preferred stock (fair value is assumed to be greater than or equal to minimum value) follow:

Table 4-a

<i>Year</i>	<i>Year-end</i>	<i>Average</i>
1	\$12.50	\$12.50
2	12.50	12.50
3	12.50	12.50
4	12.50	12.50
5	14.40	13.20



- The shares released each year follow:

Table 4-b

Year	Dividends	Compensation	Total Released	Total Allocated
1	0	16,000	16,000	-0-
2	1,600	14,400	16,000	16,000
3	3,200	12,800	16,000	16,000
4	4,800	11,200	16,000	16,000
5	6,061	9,939	16,000	16,000

*Note:* The number of shares released for dividends is determined by dividing the amount of dividends on allocated shares (16,000 multiplied by \$1.25 in year 2; 32,000 multiplied by \$1.25 in year 3; etc.) by the average fair value of a share of preferred stock (\$12.50 in years 2 and 3). In this illustration the remaining shares are released for compensation (16,000 less 1,600 in year 2, 16,000 less 3,200 in year 3, etc.).

- Additional share information follows:

Table 4-c

Year	Cumulative Number of Shares		Year-End Suspense Shares
	Released	Allocated	
1	16,000	-0-	64,000
2	32,000	16,000	48,000
3	48,000	32,000	32,000
4	64,000	48,000	16,000
5	80,000	64,000	-0-

## Results of Applying SOP

The following chart sets forth Company D's ESOP-related information. All amounts represent changes (credits in parentheses) in account balances.

Year	Principal	Unearned ESOP Shares	Paid-In Capital	Dividends	Interest Expense	Compensation Expense	Cash
Notes	(1)	(2)	(3)	(4)	(1)	(5)	(6)
1	\$ 163,800	\$ (200,000)	\$ -0-	\$ -0-	\$100,000	\$200,000	\$ (263,800)
2	180,200	(200,000)	-0-	20,000	83,600	180,000	(263,800)
3	198,200	(200,000)	-0-	40,000	65,600	160,000	(263,800)
4	218,000	(200,000)	-0-	60,000	45,800	140,000	(263,800)
5	239,800	(200,000)	(11,200)	80,000	24,000	131,200	(263,800)
Total	<u>\$1,000,000</u>	<u>\$(1,000,000)</u>	<u>\$(11,200)</u>	<u>\$200,000</u>	<u>\$319,000</u>	<u>\$881,200</u>	<u>\$(1,319,000)</u>

### Notes:

- (1) See table 1-b.

- (2) Total number of shares released during the year (16,000) multiplied by the cost per share to ESOP (\$12.50).
- (3) Total number of shares released during the year (16,000) multiplied by the difference between average fair value per share at the release date (see table 4-a) and cost-per-share to the ESOP (\$12.50).
- (4) Cumulative shares allocated (see table 4-c) multiplied by the dividend per share (\$1.25).
- (5) Total number of ESOP shares released for compensation (see table 4-b) multiplied by the average fair value per share to ESOP (see table 4-a).
- (6) The cash disbursed each year is composed of \$163,800 in contributions and \$100,000 in dividends.

Journal Entries

The journal entries to reflect the accounting for Company D's ESOP from inception through year 2 are as follows:

January 1, Year 1 (inception)

Cash	1,000,000	
Debt		1,000,000
[To record the ESOP's loan]		
Unearned ESOP shares (equity)	1,000,000	
Preferred stock		1,000,000
[To record the issuance of shares to the ESOP]		

Year 1

Interest expense	100,000	
Accrued interest payable		100,000
[To record interest expense]		
Accrued interest payable	100,000	
Debt	163,800	
Cash		263,800
[To record debt payment (The cash disbursement of \$263,800 consists of \$100,000 in dividends, none of which was charged to retained earnings in year 1, and \$163,800 supplemental cash contribution to the ESOP)]		
Compensation expense	200,000	
Unearned ESOP shares		200,000
[To record release of 16,000 shares at an average fair value of \$12.50 per share (shares cost ESOP \$12.50 per share)]		
Deferred tax asset	14,480	
Provision for income taxes	600,000	
Income taxes payable		614,480
[To record income taxes for year (See tax computations following journal entries)]		

**Year 2**

Interest expense	83,600	
Accrued interest payable		83,600
[To record interest expense]		
Accrued interest payable	83,600	
Debt	180,200	
Cash		263,800
[To record debt payment (The cash disbursement of \$263,800 is made up of \$100,000 in dividends, \$20,000 of which was charged to retained earnings in year 2, and \$163,800 supplemental cash contribution to the ESOP)]		
Retained earnings	20,000	
Dividends payable		20,000
[To record declaration of \$1.25 per share dividend on the 16,000 allocated shares]		
Compensation expense	180,000	
Dividends payable	20,000	
Unearned ESOP shares		200,000
[To record release of 16,000 shares at an average fair value of 12.50 per share (shares cost ESOP \$12.50 per share)]		
Deferred tax asset	7,920	
Provision for income taxes	646,560	
Income taxes payable		654,480
[To record income taxes for year (See tax computations following journal entries)]		

**Tax and EPS Computations**

The tax and EPS calculations for Company D follow:

	<i>Year</i>				
	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
Income before ESOP	\$ 1,800,000	\$ 1,900,000	\$ 2,000,000	\$ 2,100,000	\$ 2,200,000
Interest expense	(100,000)	(83,600)	(65,600)	(45,800)	(24,000)
Compensation expense	(200,000)	(180,000)	(160,000)	(140,000)	(131,200)
Pretax income	1,500,000	1,636,400	1,774,400	1,914,200	2,044,800
Provision for income tax					
Currently payable	614,480	654,480	694,480	734,480	774,480
Deferred	(14,480)	(7,920)	(720)	7,200	15,920
Total	<u>\$ 600,000</u>	<u>\$ 646,560</u>	<u>\$ 693,760</u>	<u>\$ 741,680</u>	<u>\$ 790,400</u>
Net income	\$ 900,000	\$ 989,840	\$ 1,080,640	\$ 1,172,520	\$ 1,254,400
Preferred stock dividends	-0-	\$ 20,000	40,000	60,000	80,000
Earnings applicable to common stock	<u>\$ 900,000</u>	<u>\$ 969,840</u>	<u>\$ 1,040,640</u>	<u>\$ 1,112,520</u>	<u>\$ 1,174,400</u>
Common shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Basic EPS without conversion	<u>\$ .90</u>	<u>\$ .97</u>	<u>\$ 1.04</u>	<u>\$ 1.11</u>	<u>\$ 1.17</u>
Diluted EPS if converted	<u>\$ .89</u>	<u>\$ .95</u>	<u>\$ 1.01</u>	<u>\$ 1.07</u>	<u>\$ 1.13</u>

## Statements of Position

## If-converted computation:

	Year				
	1	2	3	4	5
Earnings applicable to common stock	\$ 900,000	\$ 969,840	\$ 1,040,640	\$ 1,112,520	\$ 1,174,400
Add—					
Preferred dividends net of tax	-0-	12,000	24,000	36,000	48,000
Tax benefit on "as if" converted common dividend (1)	-0-	3,902	8,421	10,909	12,800
Less—					
Additional compensation (2)	-0-	(6,146)	(11,368)	(19,636)	(28,800)
Adjusted earnings	<u>\$ 900,000</u>	<u>\$ 979,596</u>	<u>\$ 1,061,693</u>	<u>\$ 1,139,793</u>	<u>\$ 1,206,400</u>
Shares outstanding					
Non-ESOP	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
ESOP as if converted (3)	9,302	29,268	52,632	63,636	72,000
Total	<u>1,009,302</u>	<u>1,029,268</u>	<u>1,052,632</u>	<u>1,063,636</u>	<u>1,072,000</u>
If-converted diluted EPS	<u>\$ .89</u>	<u>\$ .95</u>	<u>\$ 1.01</u>	<u>\$ 1.07</u>	<u>\$ 1.13</u>

## Computations for (1), (2), and (3) follow:

	Year				
	1	2	3	4	5
(1) Allocated preferred shares	-0-	16,000	32,000	48,000	64,000
Conversion ratio	1:1	1:1	1:1	1:1	1:1
Redemption ratio	12.50/10.75	12.50/10.25	12.50/9.50	12.50/11.00	1:1
If converted allocated common shares	-0-	19,512	42,105	54,545	64,000
Dividends at \$.50 per common share	\$ -0-	\$ 9,756	\$ 21,053	\$ 27,273	\$ 32,000
Tax benefit on common dividends	\$ -0-	\$ 3,902	\$ 8,421	\$ 10,909	\$ 12,800
(2) Preferred dividends at \$1.25 per share	\$ -0-	\$ 20,000	\$ 40,000	\$ 60,000	\$ 80,000
Dividends at \$.50 per common share	\$ -0-	(9,756)	(21,053)	(27,273)	(32,000)
Additional compensation gross	\$ -0-	\$ 10,244	\$ 18,947	\$ 32,727	\$ 48,000
Net of tax	\$ -0-	\$ 6,146	\$ 11,368	\$ 19,636	\$ 28,800
(3) Computation					
Average preferred shares released	8,000	24,000	40,000	56,000	72,000
Conversion ratio	1:1	1:1	1:1	1:1	1:1
Redemption ratio	12.50/10.75	12.50/10.25	12.50/9.50	12.50/11.00	1:1
If converted average released common shares	9,302	29,268	52,632	63,636	72,000

**Reconciliation of Effective Tax Rate to Provision for Income Taxes**

	<i>Year</i>				
	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
Pretax income	\$1,500,000	\$1,636,400	\$1,774,400	\$1,914,200	\$2,044,800
Tax at 40 percent (Statutory rate)	\$ 600,000	\$ 654,560	\$ 709,760	\$ 765,680	\$ 817,920
Benefit of ESOP dividends	-0-	(8,000)	(16,000)	(24,000)	(32,000)
Effect of difference between fair value and cost of released shares	-0-	-0-	-0-	-0-	4,480
Provision as reported	<u>\$ 600,000</u>	<u>\$ 646,560</u>	<u>\$ 693,760</u>	<u>\$ 741,680</u>	<u>\$ 790,400</u>

Illustration 5

Convertible Preferred Stock Leveraged ESOP Used to Fund a 401(k) Savings Plan With an Employer Loan

Assumptions

On January 1, Year 1, Company E established a leveraged ESOP with convertible preferred stock as follows:

- The ESOP borrowed \$1,000,000 from the employer at 10 percent for five years and used the proceeds to buy 80,000 shares of newly issued convertible preferred stock of Company E for \$12.50 per share.
- Debt service is funded by cash contributions and dividends on employer stock held by the ESOP.
- Dividends on all of the original 80,000 shares held by the ESOP are used for debt service.
- Cash contributions are made at the end of each year.
- The preferred stock pays dividends quarterly at an annual rate of \$1.25 per share (\$100,000 each year for the ESOP's shares). Accordingly, in this illustration, the average fair value of the shares is used to determine the number of shares used to satisfy the employer's obligation to replace dividends on allocated shares used for debt service.
- The preferred stock is convertible at a 1:1 ratio into common stock.
- Participants may not withdraw the convertible preferred stock from the ESOP. When participants become eligible to withdraw shares from their account, they must either convert to common stock or redeem the preferred shares.
- The preferred stock has a guaranteed minimum redemption value of \$12.50 per share, to be paid in shares of common stock.
- The preferred stock is callable at \$13.00 per share.
- There is one vote per preferred share.
- The year-end and average fair values of a share of preferred stock (fair value is assumed to be greater than or equal to minimum value) follow:

Table 5-a

<i>Year</i>	<i>Year-end</i>	<i>Average</i>
1	\$12.50	\$12.50
2	12.50	12.50
3	12.50	12.50
4	12.50	12.50
5	14.40	13.20

- Company E uses shares released by the ESOP to satisfy its matching obligation of 50 percent of voluntary employee contributions to the savings plan. The fair value of the shares at the end of each month is

used to determine the number of shares necessary to satisfy the matching obligation. (Accordingly, in this illustration, average fair values are used to determine the number of shares needed to satisfy the employer's liabilities.)

- If the fair value of the shares released is less than Company E's matching obligation, Company E contributes additional newly issued shares (top-up shares) to the ESOP to satisfy the remaining obligation. The top-up shares are issued at the end of the year. Dividends on the top-up shares are paid in cash.
- Shares that replace dividends on allocated shares used to service debt do not count toward the employer's match.
- The employee contributions, required employer match, and the number of shares needed to fund the employee match follow:

**Table 5-b**

<i>Year</i>	<i>Employee Contributions</i>	<i>Employer Match</i>	<i>Number of Shares</i>
1	\$400,000	\$200,000	16,000
2	410,000	205,000	16,400
3	420,000	210,000	16,800
4	430,000	215,000	17,200
5	440,000	220,000	16,667

*Note:* The number of shares needed to satisfy the employer's matching obligation is determined by dividing the matching obligation by the average fair value of a share of common stock (for year 1: \$200,000 divided by \$12.50 equals 16,000 shares).

- Principal and interest are payable in annual installments at the end of each year. Debt service is as follows:

**Table 5-c**

<i>Year</i>	<i>Principal</i>	<i>Interest</i>	<i>Total Debt Service</i>
1	\$ 110,000	\$100,000	\$ 210,000
2	150,000	89,000	239,000
3	200,000	74,000	274,000
4	250,000	54,000	304,000
5	290,000	29,000	319,000
Total	<u>\$1,000,000</u>	<u>\$346,000</u>	<u>\$1,346,000</u>

- Shares are released from the suspense account for allocation to participants' accounts based on a principal-plus-interest formula. The released shares are allocated to participants' accounts at the beginning of the following year. Shares are assumed to be released ratably throughout the year.
- The shares released each year follow:

Table 5-d

Year	Number of Shares Needed to Satisfy 401(k) Liability	Total Released	Shares Released for Dividends	ESOP Shares Available to Satisfy 401(k) Liability	Additional Shares (Top-Up)
1	16,000	12,481	-0-	12,481	3,519
2	16,400	14,205	1,248	12,957	3,443
3	16,800	16,286	2,669	13,617	3,183
4	17,200	18,068	4,297	13,771	3,429
5	16,667	18,960	5,780	13,180	3,487

*Note:* The number of shares released for dividends is determined by dividing the amount of dividends on allocated shares (12,481 multiplied by \$1.25 in year 2; 26,686 multiplied by \$1.25 in year 3, etc.) by the average fair value of a share of preferred stock (\$12.50 in years 2 and 3). In this illustration, the remaining shares are released for compensation (14,205 less 1,248 in year 2; 16,286 less 2,669 in year 3, etc.).

- Additional share information follows:

Table 5-e

Year	<u>Initial ESOP Shares</u> <u>Cumulative Shares</u>		<u>Top-Up Shares</u> <u>Cumulative Shares</u>		Average Shares Released / Issuable	Total Shares Allocated	Year- end Suspense Shares
	Released	Allocated	Issuable	Issued			
1	12,481	0	3,519	0	8,000	0	67,519
2	26,686	12,481	6,962	3,519	24,824	16,000	53,314
3	42,972	26,686	10,145	6,962	43,383	33,648	37,028
4	61,040	42,972	13,574	10,145	63,866	53,117	18,960
5	80,000	61,040	17,061	13,574	85,838	74,614	0

- The pre-ESOP income, shares outstanding, and income tax assumptions are the same as for illustrations 1 through 4.

Results of Applying SOP

The following chart sets forth Company E's ESOP-related information. All amounts represent changes (credits are in parentheses) in account balances.

Year	Unearned ESOP Shares	Paid-In Capital	Dividends— Original Shares	Dividends Top-Up Shares	Compensation Expense ESOP	Compensation Expense Top-Up
Notes	(1)	(2)	(3)	(4)	(5)	(6)
1	\$ (156,000)	\$ (44,000)	\$ -0-	\$ -0-	156,000	\$ 44,000
2	(177,600)	(43,000)	15,600	4,400	162,000	43,000
3	(203,600)	(39,800)	33,400	8,700	170,200	39,800
4	(225,800)	(42,900)	53,700	12,700	172,100	42,900
5	(237,000)	(59,300)	76,300	17,000	174,000	46,000
Total	<u>\$ (1,000,000)</u>	<u>\$ (229,000)</u>	<u>\$ 179,000</u>	<u>\$ 42,800</u>	<u>\$ 834,300</u>	<u>\$ 215,700</u>



Notes:

- (1) Total number of shares released during the year multiplied by the cost per share to ESOP (\$12.50).
- (2) Total number of shares released during the year multiplied by the difference between average fair value per share at the release date (see table 5-a) and cost per share to the ESOP (\$12.50) plus the additional paid-in capital that arises from the top-up shares contributed, which equals the compensation expense related to the ESOP.
- (3) Cumulative shares allocated from original 80,000 shares (see table 5-e) multiplied by the dividend per share (\$1.25).
- (4) Cumulative top-up shares issued (see table 5-e) multiplied by the dividend per share (\$1.25).
- (5) Total number of ESOP shares released for compensation (see table 5-d) multiplied by the average fair value per share (see table 5-a).
- (6) Top-up shares (see table 5-d) multiplied by the average fair value per share (see table 5-a).

**Journal Entries**

The journal entries to reflect the accounting for Company E's ESOP from inception through year 2 are as follows:

**January 1, Year 1 (inception)**

Unearned ESOP shares (equity)	1,000,000	
Preferred stock		1,000,000

[To record the issuance of shares to the ESOP]

**Year 1**

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

[To record cost and liability related to 401(k) match]

401(k) liability	200,000	
Preferred stock		44,000
Unearned ESOP shares		156,000

[To record release of 12,481 shares at an average fair value of \$12.50 per share (shares cost ESOP \$12.50 per share) and issuance of 3,519 additional shares at \$12.50 per share for top-up]

Deferred tax asset	18,400	
Provision for income taxes	600,000	
Income tax payable		618,400

[To record income taxes for year 1 (See tax computations following journal entries)]

**Year 2**

Retained earnings	15,600	
Dividends payable		15,600

[To record declaration of \$1.25 per share dividend on the 12,481 allocated shares]

Retained earnings	4,400	
Cash		4,400

[To record declaration and payment of \$1.25 per share dividend on the 3,519 issued top-up shares]

Compensation expense	205,000	
401(k) liability		205,000

[To record cost and liability related to 401(k) match]

401(k) liability	205,000	
Dividends payable	15,600	
Unearned ESOP shares		177,600
Preferred stock		43,000

[To record release of 14,205 shares at an average fair value of \$12.50 per share (shares cost ESOP \$12.50 per share) and issuance of 3,443 additional shares at \$12.50 per share for top-up]

Deferred tax asset	11,040	
Provision for income taxes	636,160	
Income tax payable		647,200

[To record income taxes for year 2 (See tax computations following journal entries)]

Tax and EPS Computations

The tax and EPS computations for Company E follow:

	Year				
	1	2	3	4	5
Income before ESOP	\$1,800,000	\$1,900,000	\$2,000,000	\$2,100,000	\$2,200,000
Interest expense	100,000	89,000	74,000	54,000	29,000
Compensation—ESOP	156,000	162,000	170,200	172,100	174,000
Compensation—top-up	44,000	43,000	39,800	42,900	46,000
Pretax income	1,500,000	1,606,000	1,716,000	1,831,000	1,951,000
Provision for income tax					
Currently payable	618,400	647,200	674,480	701,240	734,000
Deferred	(18,400)	(11,040)	(1,440)	9,680	21,200
Total	600,000	636,160	673,040	710,000	755,200
Net income	900,000	969,840	1,042,960	1,120,080	1,195,800
Preferred stock dividends	0	20,000	42,100	66,400	93,300
Earnings applicable to common stock	\$ 900,000	\$ 949,840	\$1,000,860	\$1,053,680	\$1,102,500
Common shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Basic EPS without conversion	\$ .90	\$ .95	\$ 1.00	\$ 1.05	\$ 1.10
Diluted EPS if converted	\$ .89	\$ .93	\$ .97	\$ 1.01	\$ 1.06

**If-Converted EPS Computation**

	Year				
	1	2	3	4	5
Earnings applicable to common shares	\$ 900,000	\$ 949,840	\$1,000,860	\$1,053,680	\$1,102,500
Add—					
Preferred dividends net of tax	0	12,000	25,260	39,840	55,980
Tax benefit on "as if" converted common dividend (1)	0	3,902	8,855	12,072	14,923
Less—					
Additional compensation (2)	0	4,795	9,481	17,579	27,468
Adjusted earnings	<u>\$ 900,000</u>	<u>\$ 960,947</u>	<u>\$1,025,494</u>	<u>\$1,088,013</u>	<u>\$1,145,935</u>
Shares outstanding Non-ESOP	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
ESOP as if converted (3)	9,302	30,273	57,083	72,575	85,838
Total	<u>1,009,302</u>	<u>1,030,273</u>	<u>1,057,083</u>	<u>1,072,575</u>	<u>1,085,838</u>
If-converted diluted EPS	<u>\$ .89</u>	<u>\$ .93</u>	<u>\$ .97</u>	<u>\$ 1.01</u>	<u>\$ 1.06</u>

	Year				
	1	2	3	4	5
<b>Calculation 1:</b>					
Allocated and issued preferred shares	0	16,000	33,648	53,117	74,614
Conversion ratio	1:1	1:1	1:1	1:1	1:1
Redemption ratio	12.50/10.75	12.50/10.25	12.50/9.50	12.50/11.00	1:1
If-converted allocated and issued common shares	0	19,512	44,274	60,360	74,614
Dividends at \$.50 per common share	\$0	\$ 9,756	\$22,137	\$30,180	\$ 37,307
Tax benefit on common dividends	\$0	\$ 3,902	\$ 8,855	\$12,072	\$ 14,923

<b>Calculation 2:</b>					
Allocated preferred shares (excluding top-up shares)	0	12,481	26,686	42,972	61,040
Preferred dividends at \$1.25 per share	\$0	\$15,601	\$33,358	\$53,715	\$76,300
If-converted allocated common shares (excluding top-up shares)	0	15,221	35,113	\$48,832	\$61,040
Dividends at \$.50 per common share	<u>\$0</u>	<u>\$ 7,610</u>	<u>\$17,557</u>	<u>\$24,416</u>	<u>\$30,520</u>
Additional compensation					
Gross	\$0	\$ 7,991	\$15,801	\$29,299	\$45,780
Net of tax	\$0	\$ 4,795	\$ 9,481	\$17,579	\$27,468

Statements of Position

	Year				
	1	2	3	4	5
<b>Calculation 3:</b>					
Average preferred shares released and issuable	8,000	24,824	43,383	63,866	85,838
If-converted average re-leased and issuable common shares	9,302	30,273	57,083	72,575	85,838

Tax Computation

	Year				
	1	2	3	4	5
Current provision:					
Income before ESOP	\$1,800,000	\$1,900,000	\$2,000,000	\$2,100,000	\$2,200,000
ESOP contribution	110,000	139,000	174,000	204,000	219,000
ESOP dividends	100,000	100,000	100,000	100,000	100,000
Top-up contribution	44,000	43,000	39,800	42,900	46,000
Taxable income	1,546,000	1,618,000	1,686,200	1,753,100	1,835,000
Tax rate	40%	40%	40%	40%	40%
	618,400	647,200	674,480	701,240	734,000
Deferred provision:					
Reduction in unearned ESOP shares	156,000	177,600	203,600	225,800	237,000
Related tax deduction	110,000	150,000	200,000	250,000	290,000
Difference	(46,000)	(27,600)	(3,600)	24,200	53,000
Tax rate	40%	40%	40%	40%	40%
Deferred tax expense/ (benefit)	(18,400)	(11,040)	(1,440)	9,680	21,200
Total provision	\$ 600,000	\$ 636,160	\$ 673,040	\$ 710,920	\$ 755,200

Reconciliation of Effective Tax Rate to Provision for Income Taxes

	Year				
	1	2	3	4	5
Pretax income	\$1,500,000	\$1,606,000	\$1,716,000	\$1,831,000	\$1,951,000
Tax at 40 percent	600,000	642,400	686,400	732,400	780,400
Benefit of ESOP dividends	0	(6,240)	(13,360)	(21,480)	(30,520)
Effect of difference between fair value and cost of released shares	0	0	0	0	5,320
Provision as reported	\$ 600,000	\$ 636,160	\$ 673,040	\$ 710,920	\$ 755,200

## Appendix B

### Discussion of Comments Received on Exposure Draft

An exposure draft of a proposed statement of position, "Employers' Accounting for Employee Stock Ownership Plans," was issued for public comment in December 1992 and distributed to a variety of interested parties to encourage comment by those that would be affected by the proposal. Sixty-five comment letters were received on the exposure draft.

The most significant and pervasive comments received were in three areas: (a) measurement of compensation cost, (b) pro forma disclosures, and (c) effective date.

#### Measurement of Compensation Cost

A majority of respondents asked AcSEC to reconsider, for some or all ESOPs, the requirement in the SOP that the fair value of shares committed to be released be used to measure compensation cost. Many of them supported the minority view in this SOP. Three primary objections were raised in the comment letters.

The most frequent reason stated in comment letters for objecting to the proposed measurement of compensation was that debt payments or contributions, that is the cash payments, are a better measure of the value of employees' services than the fair value of shares released.

The second most frequent reason for objecting was disagreement with the argument in the proposed SOP that the risks and rewards of ownership of the shares rest with the employer, not the employees, until the shares are committed to be released. Some respondents disagreed with that statement in general. Other respondents disagreed with a related notion that employers have control over the employees' total compensation package and can make changes in other parts of compensation in response to unanticipated changes in the value of the unreleased shares. Most of those making those arguments support the minority view—that is, they believe that the risks and rewards remain with the employer for type II ESOPs, but believe that is not the case for type I ESOPs.

AcSEC had considered such arguments during the process leading up to the exposure draft, and continues to believe that the reasons for measuring compensation cost based on the fair value of the shares when committed to be released as stated in paragraph .70 of the SOP support its conclusion. Furthermore, AcSEC notes that the conclusion on measurement of compensation cost is consistent with AcSEC's fundamental conclusion that the debt and shares related to ESOP transactions should be accounted for separately. AcSEC believes that the fact that employers may, and often do, establish internally leveraged ESOPs that involve no net cash flows by the employer to the ESOP (the financing element is eliminated), supports its view that the fair value of shares when released is a more relevant measure of the employee's services than the value of the shares when they are placed in an ESOP trust. From the employer's perspective, the economic substance of such transactions is that shares are placed in a trust and released to employees over time; no net cash is ever disbursed or received.

AcSEC continues to believe that the risks and rewards of ownership of the unreleased shares remain with the employer, even when there is no explicit use of the fair value of the shares in determining whether the employer has

satisfied an obligation. Though many commentators said that employers do not adjust other compensation to reflect unanticipated changes in the fair value of employer shares, AcSEC has seen ESOP transactions in which the employer effectively controls compensation through its ability to control the debt terms and the rate at which shares are released. Further, AcSEC notes that many employers maintain control over the number of ESOP shares released through the ESOP loans with flexible terms, which allow for no or minimal principal payments before maturity and no prepayment penalties.

The third most frequent reason for objecting was that using the fair value of shares released penalizes companies whose share values increase and rewards companies whose share values decrease. AcSEC believes that the important issue is whether the measure of compensation cost is appropriate, not whether the amount is more or less than it would be under a different method.

### **Pro Forma Disclosures**

The proposed SOP would have required public companies that under the grandfathering provisions elected not to adopt the provisions of the SOP to disclose pro forma income before extraordinary items, net income, and EPS as if the employer had adopted the provisions of the SOP. Many respondents objected to those pro forma disclosures. The reasons most often cited for not requiring such disclosures follow:

- Such disclosures would add unnecessary complexity to the financial statements and would confuse rather than inform users.
- Such disclosures generally have not been required in the past for other accounting pronouncements with grandfathering provisions and would set a precedent for such disclosures in the future.
- Such disclosures are inconsistent with the grandfathering provisions and would discredit the amounts reported in the financial statements.
- The costs of making such disclosures would outweigh the benefits.
- It is unfair to require such disclosures only for public companies.

AcSEC found those arguments persuasive and deleted the disclosure requirement.

### **Effective Date**

In the exposure draft the grandfathering cutoff date was September 23, 1992, the date the FASB cleared the proposed SOP for exposure. Many respondents noted that a later date connected with a year end would be more appropriate. In response to those comments the cutoff date was changed to December 31, 1992.

Many respondents considered the effective date for years ending on or before December 15, 1993, in the exposure draft unreasonable. AcSEC agreed and extended the effective date by one year.

## Appendix C

### Law Changes

The following is a list of the most significant revisions to laws concerning ESOPs since 1976.

- The tax deduction limits were expanded from 15 percent of pay to 25 percent of pay, plus interest in certain cases.<sup>1</sup> This change prompted more small companies to use ESOPs and larger companies to increase the portion of employee benefits covered by ESOPs.
- ESOP sponsors were permitted to deduct dividends paid on ESOP shares from taxable income if the dividends were applied to debt service or distributed to plan participants.<sup>2</sup> This change increased the economic appeal of leveraged ESOPs. For example, it increased the amount of debt that could be covered for employers whose compensation base was too low to amortize the ESOP debt under the contribution limits of the Internal Revenue Code (IRC).
- Under certain circumstances, a person who sold stock to an ESOP was permitted to defer income tax on any resulting gain by reinvesting the sales proceeds in other corporate securities.<sup>3</sup> This change contributed to the substantial increase in the number of ESOPs sponsored by nontraded companies.
- Commercial lenders were permitted to exclude from taxable income 50 percent of the interest they earned on certain ESOP securities acquisition loans.<sup>4</sup> This change resulted in a reduced financing rate on such loans, as lenders frequently passed a portion of the savings on to their customers. Many new ESOP loans were made as a result of this change. (Although 1989 legislation significantly limited this benefit, all of the prior loans were allowed to retain their tax advantages.)
- The regulatory requirement that if ESOPs buy outstanding shares, the purchase must be tested under the corporate redemption rules was eliminated.<sup>5</sup> The significance of this development was that the IRC recognized the independence of ESOPs from their sponsors if certain controls are in place. Thus, it increased the usefulness of ESOPs in transfers of ownership of closely held companies.

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<sup>1</sup> IRC Sections 404(a)(9) and 415 (c)(6).

<sup>2</sup> IRC Section 404(k).

<sup>3</sup> IRC Section 1042.

<sup>4</sup> IRC Section 133.

<sup>5</sup> Rev. Proc. 87-22, which superseded Rev. Procs. 77-30, 78-18, and 78-23.

## Appendix D

### Impact of SOP on Current ESOP Guidance

#### Current Guidance

FASB Statement No. 87, *Employers' Accounting for Pensions*

AICPA SOP 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans* [section 10,130]

EITF Issue No. 85-11, *Use of an Employee Stock Ownership Plan in a Leveraged Buyout*

EITF Issue No. 86-4, *Income Statement Treatment of Income Tax Benefit for Employee Stock Ownership Plan Dividends*

EITF Issue No. 86-27, *Measurement of Excess Contributions to a Defined Contribution Plan or Employee Stock Ownership Plan*

EITF Issue No. 87-23, *Book Value Stock Purchase Plans*

#### Impact of SOP

The SOP includes accounting guidance on nonleveraged ESOPs that is consistent with the guidance for defined contribution plans in Statement No. 87.

The SOP supersedes SOP 76-3 [section 10,130]. However, under the transition provisions in the proposed SOP, employers may continue their current accounting practices for ESOP shares purchased before December 31, 1992.

No consensus was reached on this issue by the EITF. However, for ESOP shares accounted for under the SOP, the issue is moot, because compensation cost is measured based on the fair value of shares when committed to be released.

FASB Statement No. 109, *Accounting for Income Statement Income Taxes* nullified this consensus. The SOP deals with issues related to accounting for income taxes.

The SOP supersedes this consensus. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased in a pension reversion occurring before December 31, 1992.

This EITF topic includes three issues; only the third one relates to ESOPs. The SOP, which is consistent with the consensus, supersedes this consensus on the third issue. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased before December 31, 1992. This consensus applies to employers making that election.



Current Guidance

EITF Issue No. 88-27, *Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations*

EITF Issue No. 89-8, *Expense Recognition for Employee Stock Ownership Plans*

EITF Issue No. 89-10, *Sponsor's Recognition of Employee Stock Ownership Plan Debt*

EITF Issue No. 89-11, *Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan*

EITF Issue No. 89-12, *Earnings-per-Share Issues Related to Convertible Preferred Stock Held by an Employee Stock Ownership Plan*

EITF Issue No. 90-4, *Earnings-per-Share Treatment of Tax Benefits for Dividends of Stock Held by an Employee Stock Ownership Plan*

EITF Issue No. 92-3, *Earnings-per-Share Treatment of Tax Benefits for Dividends on Unallocated Stock Held by an Employee Stock Ownership Plan*

EITF Issue No. 93-2, *Effect of Acquisition of Employer Shares for/by an Employee Benefit Trust on Accounting for Business Combinations*

Impact of SOP

The SOP does not deal with this issue and accordingly does not supersede the consensus. The consensus is reprinted in this appendix.

The SOP supersedes this consensus. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased before December 31, 1992. This consensus applies to employers making that election.

The SOP, which is consistent with this consensus, supersedes the consensus.

The SOP does not deal with this issue and accordingly does not supersede the consensus. The consensus is reprinted in this appendix.

The SOP supersedes these consensus. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased before December 31, 1992. This consensus applies to employers making that election.

FASB Statement No. 109, *Accounting for Income Taxes*, nullified this consensus.

Under this SOP, dividends paid on unallocated shares are not charged to retained earnings. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased before December 31, 1992. This consensus would apply to employers making that election.

The SOP does not deal with this issue and accordingly does not supersede this consensus. The consensus is reproduced in this appendix.

**EITF Abstracts****Issue No. 88-27**

**Title:** Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations

**Date Discussed:** January 12-13, 1989

**References:** APB Opinion No. 16, *Business Combinations*  
AICPA Accounting Interpretation 20, *Treasury Stock Allowed with Pooling*, of APB Opinion No. 16  
AICPA Statement of Position 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans*  
SEC Accounting Series Release No. 146, *Effect of Treasury Stock Transactions on Accounting for Business Combinations*  
SEC Accounting Series Release No. 146A, *Statement of Policy and Interpretations in Regard to Accounting Series Release No. 146*

**ISSUE**

Employee stock ownership plans (ESOPs) may hold shares of the sponsoring entity that are not allocated to the participants in the plan. Those unallocated shares may be allocated later or, under certain limited circumstances, may be sold or disposed of otherwise by the ESOP. Unlike allocated shares that must be reallocated to remaining plan participants if a participant leaves the plan before the shares become vested, the unallocated sponsoring entity shares held by the ESOP are not required to remain within the ESOP or with its participants. Further, to the extent the ESOP acquires unallocated shares as a result of a pension plan termination, Issue No. 86-27, "Measurement of Excess Contributions to a Defined Contribution Plan or Employee Stock Ownership Plan," requires unallocated shares held by the ESOP to be reported as treasury shares by the sponsoring entity.

The issue is under what circumstances, if any, unallocated sponsoring entity shares held by an ESOP should be considered tainted treasury shares for purposes of determining whether the pooling-of-interests method of accounting is appropriate for a business combination.

**EITF DISCUSSION**

The Task Force reached a consensus that unallocated shares held by an ESOP should not be considered tainted for purposes of determining whether the pooling-of-interests method of accounting is appropriate unless (1) there is more than a remote possibility that such shares could revert to the sponsoring entity, (2) there exists an agreement or intent, either written or implicit, whereby the sponsoring entity will repurchase or reacquire shares from the ESOP or from an employee that receives shares in a distribution (except if required by law to provide liquidity to the plan participant), or (3) the shares were acquired to circumvent the requirements of Opinion 16.

The Task Force considered comments by a tax partner of an accounting firm that generally, for unallocated shares in an ESOP, the possibility of those shares reverting to the sponsoring entity is remote. Some Task Force members

noted that the relevant attributes of unallocated shares differ for purposes of determining whether the shares are treasury shares, as addressed in Issue 86-27, compared with whether those treasury shares are tainted, as addressed in this Issue.

**STATUS**

No further EITF discussion is planned.

5/18/89

**EITF Abstracts****Issue No. 89-11**

**Title:** Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan

**Dates Discussed:** September 21, 1989; December 14, 1989

**References:** APB Opinion No. 25, *Accounting for Stock Issued to Employees*  
SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"*

**ISSUE**

Under federal income tax regulations, employer securities (such as convertible preferred stock) that are held by participants in an employee stock ownership plan (ESOP) and that are not readily tradeable on an established market must include a put option. The put option is a right to demand that the sponsor redeem shares of employer stock held by the participant for which there is no market for an established cash price. The employer may have the option to issue marketable securities for all or a portion of that option rather than to pay cash. The provisions of the ESOP may permit the ESOP to substitute for the sponsor as buyer of the employer stock; however, in no case can the sponsor require the ESOP to assume the obligation for the put option.

The issue is, in a leveraged ESOP, if securities subject to a put option are classified outside of permanent equity, whether any of the debit in the equity section of the sponsor's balance sheet (sometimes described as *loan to ESOP* or *deferred compensation*) should be similarly classified.

**EITF DISCUSSION**

The Task Force reached a consensus that when ASR 268 (as presented in Section 211 of the "Codification of Financial Reporting Policies") requires some or all of the value of the securities to be classified outside of permanent equity, a proportional amount of the debit in the equity section of the sponsor's balance sheet (sometimes described as *loan to ESOP* or *deferred compensation*), if any, should be similarly classified.

The SEC Observer indicated that ASR 268 requires that to the extent that there are conditions (regardless of their probability of occurrence) whereby holders of equity securities may demand cash in exchange for their securities, the sponsor must reflect the maximum possible cash obligation related to those securities outside of permanent equity. Thus, securities held by an ESOP (whether or not allocated) must be reported outside of permanent equity if by their terms they can be put to the sponsor for cash. With respect to ESOP securities where the cash obligation relates only to market value guarantee features, the SEC staff would not object to registrants only classifying outside of permanent equity an amount that represents the maximum cash obligation of the sponsor based on market prices of the underlying security as of the reporting date; accordingly, reclassifications of equity amounts would be required based on the market values of the underlying security. Alternatively, the SEC staff would not object to classifying the entire guaranteed value amount outside of permanent equity due to the uncertainty of the ultimate cash obligation because of a possible market value decline in the underlying security.

**STATUS**

No further EITF discussion is planned.

12/14/89

## ***EITF Abstracts***

### **Issue No. 93-2**

**Title:** Effect of Acquisition of Employer Shares for/by an Employee Benefit Trust on Accounting for Business Combinations

**Date Discussed:** January 21, 1993

**References:** APB Opinion No. 16, *Business Combinations*  
 AICPA Accounting Interpretation 20, *Treasury Stock Allowed with Pooling*, of APB Opinion No. 16  
 AICPA Statement of Position 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans*  
 AICPA Proposed Statement of Position, *Employers' Accounting for Employee Stock Ownership Plans*, dated December 21, 1992  
 SEC Accounting Series Release No. 146, *Effect of Treasury Stock Transactions on Accounting for Business Combinations*  
 SEC Accounting Series Release No. 146A, *Statement of Policy and Interpretations in Regard to Accounting Series Release No. 146*

### **ISSUE**

An employer (Company) establishes an irrevocable grantor trust (Trust) to prefund certain employee benefits. The Company sells shares of its stock to the Trust in return for a note payable and, at or about the same time, reacquires treasury shares. Alternatively, the Trust may acquire Company shares in the marketplace using funds borrowed from the Company. The shares will be released from the Trust in future periods as debt is repaid or forgiven and will be used to meet obligations of the Company to various employee benefit plans.

The issue is whether Company shares reacquired coincident with the establishment of the Trust, either by the Company or by the Trust, should be considered tainted shares for purposes of pooling-of-interests accounting under Opinion 16.

### **EITF DISCUSSION**

The SEC Observer stated that it is the SEC staff's position that Issue No. 88-27, "Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations," and Topic No. D-19, "Impact on Pooling-of-Interests Accounting of Treasury Shares Acquired to Satisfy Conversions in a Leveraged Preferred Stock ESOP," in *EITF Abstracts* Appendix D, addressed ESOPs that are defined contribution employee benefit plans, as contemplated by SOP 76-3.<sup>1</sup> An ESOP that funds other employee benefit plans was not contemplated by either Issue 88-27 or Topic D-19.<sup>2</sup>

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<sup>1</sup> This type of ESOP arrangement has been characterized as a Type I ESOP in the proposed Statement of Position on employers' accounting for employee stock ownership plans:

*Type I*—shares are released to compensate employees directly. Such ESOPs are not used to fund other employee benefits and the fair value of the shares at the time of release is not a factor at the time of release. These ESOPs are the typical ESOPs that existed at the time SOP 76-3 was issued.

<sup>2</sup> This type of ESOP arrangement has been characterized as a Type II ESOP in the proposed Statement of Position:

*Type II*—shares are released to settle or fund liabilities for other specified or determinable employee benefits, such as an employer's match of a 401(k) plan. The fair value of shares released is used to determine how many shares are needed to satisfy an obligation that arose outside the ESOP.

The SEC staff believes that the application of the consensus in Issue 88-27 and the statements made in Topic D-19 should be limited to "Type I" ESOPs. However, the SEC staff will not object to the application of the consensus in Issue 88-27 and Topic D-19 for shares held by a "Type II" ESOP as of January 21, 1993, provided the respective criteria are satisfied. Shares purchased by a Type II ESOP subsequent to January 21, 1993 would be considered treasury stock directly acquired by the employer and presumed to be tainted shares for the purpose of applying the provisions of paragraph 47(d) of Opinion 16.

The SEC Observer also stated that the trust arrangement described in this Issue is neither a Type I nor a Type II ESOP. Therefore, the SEC staff's position is that shares acquired in the past or in the future and placed in trust to fund future corporate obligations, such as the trust vehicle described in this Issue, are treasury stock directly acquired by the employer and presumed to be tainted shares for the purpose of applying the provisions of paragraph 47(d) of Opinion 16.

Because of the SEC staff's position, the Task Force did not discuss this Issue.

#### **STATUS**

No further EITF discussion is planned.

5/20/93

## Glossary

This glossary contains definitions of certain terms used in employers' accounting for ESOP transactions.

**Allocated shares.** The shares in an ESOP trust that have been assigned to individual participant accounts based on a known formula. IRS rules require allocations to be nondiscriminatory generally based on compensation, length of service, or a combination of both. For any particular participant such shares may be vested, unvested, or partially vested.

**Committed-to-be-released shares.** The shares that, although not legally released, will be released by a future scheduled and committed debt service payment and will be allocated to employees for service rendered in the current accounting period. The period of employee service to which shares relate is generally defined in the ESOP documents. Shares are legally released from suspense and from serving as collateral for ESOP debt as a result of payment of debt service. Those shares are required to be allocated to participant accounts as of the end of the ESOP's fiscal year. Formulas used to determine the number of shares released can be based on either (a) the ratio of the current principal amount to the total original principal amount (in which case unearned ESOP shares and debt balance will move in tandem) or (b) the ratio of the current principal plus interest amount to the total original principal plus interest to be paid. Shares are released more rapidly under the second method than under the first. Tax law permits the first method only if the ESOP debt meets certain criteria.

**Dividends on previously allocated shares used for debt service.** The allocation of shares to participant accounts that replaces the cash dividends on allocated shares that were or will be used for debt service. Under the IRC, dividends on shares held by an ESOP that have been allocated to participant accounts cannot be used for debt service unless the employers allocate shares to those participants whose dollar value is no less than the dollar value of the dividends that were used for debt service. (The IRS has not issued guidance on what employers would be required to do to make up the difference between the value of any dividends withdrawn and the shares allocated. In practice, plan sponsors apply a wide variety of techniques to satisfy the Code requirements.)

**Suspense shares.** Shares that have not been released, committed to be released, or allocated to participant accounts. Suspense shares generally collateralize ESOP debt.

**Top-up shares.** The shares or cash that an employer contributes to an ESOP because the fair value of the shares released is less than the employer's liability for a particular benefit, such as a savings plan match.

**Vested shares.** Allocated shares for which a participant's right to receive the shares or redeem the shares for cash is no longer contingent on remaining in the service of the employer. Allocated shares that have not been vested may be forfeited if a participant terminates his or her employment and reallocated to other participants. Whether the shares in a participant's ESOP account are vested depends on the length of that employee's service and the vesting provisions of the ESOP. The Code specifies minimum vesting requirements for benefits attributable to employer contributions. Currently, the Code permits two minimum vesting approaches:



- a.* Graded vesting, under which employees vest 20 percent after three years of service and 20 percent for each additional year of service until they become 100 percent vested.
- b.* Cliff vesting, under which employees vest 100 percent after five years of service.

Accordingly, the shares allocated to participants at any date will include shares that are fully vested, shares that are not vested, and (if graded vesting is used) shares that are partially vested.

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## Section 10,590

# **Statement of Position 93-7 Reporting on Advertising Costs**

December 29, 1993

### **NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## **Introduction**

.01 The Accounting Standards Executive Committee (AcSEC) has on its agenda a project on reporting the costs of activities—such as advertising, preopening, start-up, training, customer acquisition, and similar activities—that are undertaken to create future economic benefits through the development of intangible assets. The project was undertaken to provide guidance that would aid in resolving issues concerning financial reporting for the costs of such activities.

.02 Because of the difficulty of developing sound financial reporting guidance that could be applied broadly to the costs of all activities, AcSEC decided that this statement of position (SOP) should be issued as a first step and be used to develop guidance for reporting costs of other kinds of activities undertaken to create such benefits although AcSEC has not begun deliberations to develop such guidance. The guidance in this SOP therefore is not intended to be used to account for the costs of other kinds of activities undertaken to create future economic benefits through the development of intangible assets.

.03 Some entities report the costs of all advertising as expenses when the costs are incurred. However, other entities report the costs of future economic benefits that they expect will result from some or all advertising as assets when the costs are incurred and amortize the costs to expense in the current and subsequent periods.

.04 The authoritative financial reporting literature provides no broad guidance on reporting the costs of advertising, although it does provide guid-

ance for certain specific transactions and industries and on reporting the costs of activities similar to advertising. The lack of broad guidance and the inconsistency of existing guidance has led to diversity in practice.

.05 This SOP provides guidance for annual financial statements on the following:

- Reporting the costs of advertising, which should be expensed either as incurred or the first time the advertising takes place, except for direct-response advertising (a) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (b) that results in probable future economic benefits
- For direct-response advertising that may result in reported assets—
  - How such assets should be measured initially
  - How the amounts ascribed to such assets should be amortized
  - How the realizability of such assets should be assessed
- The financial statement disclosures that should be made about advertising
- Amendments to other accounting literature affected by this SOP
- Transition rules for applying this SOP

## Scope

.06 This SOP provides financial reporting guidance for the annual financial statements of all entities and all advertising other than that for which pronouncements included in category (a) in paragraph 10 of Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, provide such guidance.<sup>1</sup> This SOP does not apply to financial statements for interim periods. Paragraphs 15 and 16 of Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting*, which are discussed in the appendix of this SOP [paragraph .81], provide guidance for accounting for advertising in interim periods. This SOP amends the following AICPA SOPs<sup>2</sup>:

- a. SOP 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications*, paragraph 22 [section 10,430.22]
- b. SOP 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services*, paragraph 54
- c. SOP 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities*, paragraph 15

.07 This SOP does not amend FASB Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*.

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<sup>1</sup> Category (a) in paragraph 10 of SAS No. 69 consists of Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards and Interpretations, Accounting Principles Board (APB) Opinions, and AICPA Accounting Research Bulletins. Advertising that is covered by pronouncements in category (a) of paragraph 10 of SAS No. 69 should be accounted for in conformity with that guidance regardless of the guidance in this SOP.

<sup>2</sup> The appendix [paragraph .81] discusses the guidance concerning advertising in these SOPs. Paragraphs .51 to .53 of this SOP discuss the amendments to these SOPs.

.08 This SOP applies to not-for-profit organizations.

.09 Reporting on the costs of advertising conducted for others under contractual arrangements is part of reporting on contracts in general and is not covered by this SOP. Indirect costs that are specifically reimbursable under the terms of a contract also are excluded from this SOP.

## Background

.10 FASB Statement No. 2, *Accounting for Research and Development Costs*, issued in 1974, requires all research and development costs to be reported as expenses when incurred. Therefore, FASB Statement No. 2 in effect prohibits reporting the research and development costs incurred in anticipation of probable future benefits as assets. Although activities similar to research and development were included in the discussion memorandum that initiated the FASB's project, paragraph 22 of appendix A of Statement No. 2 states that the FASB concluded, following the public hearing on the Discussion Memorandum, that the "initial Statement of Financial Accounting Standards resulting from the project should address solely accounting for research and development costs."

.11 Since issuing the discussion memorandum, the FASB has developed its conceptual framework, which provides conceptual criteria for asset recognition, and there has been periodic interest in how the costs of activities similar to research and development are reported on. The Securities and Exchange Commission (SEC) has issued some accounting and auditing enforcement releases on activities similar to research and development, and the SEC staff has expressed concern about the accounting for these activities.

.12 Costs incurred in anticipation of the probable future economic benefits of advertising generally have been expensed for the following reasons:

- Financial statement preparers generally presumed that the benefit period is short.
- The periods during which the future economic benefits probably would be received and the amounts of such benefits could not be measured and determined easily and objectively.
- The advertising costs for some entities were not material.

.13 Advertising is undertaken to provide or increase future economic benefits. FASB Statement on Financial Accounting Concepts (Concepts Statement) No. 6, *Elements of Financial Statements*, paragraph 178, states, "An entity commonly incurs costs to obtain future economic benefits, either to acquire assets from other entities in exchange transactions or to add value through operations to assets it already has . . . ." New technology, sources of information, and measurement techniques have given some entities the ability to better estimate the future economic benefits that could result from certain kinds of advertising.

.14 If future economic benefits do result from advertising, they generally would be in the form of revenue.

## Authoritative Pronouncements

.15 FASB Concepts Statement No. 6, paragraph 25, defines assets as "probable future economic benefits obtained or controlled by a particular entity

as a result of past transactions or events.”<sup>3</sup> Footnote 18 to Concepts Statement No. 6 states that “*probable* is used with its usual general meaning, rather than in a specific accounting or technical sense, . . . and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved . . . .” Paragraph 26 states:

An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred.

.16 Appendix B of Concepts Statement No. 6 discusses in paragraphs 175 and 176 the characteristics of assets and the concept of probable future economic benefits, including those that may arise from activities such as advertising:

Uncertainty about business and economic outcomes often clouds whether . . . particular items that might be assets have the capacity to provide future economic benefits to the entity, . . . sometimes precluding their recognition as assets. The kinds of items that may be recognized as expenses or losses rather than as assets because of uncertainty are some in which management’s intent in taking certain steps or initiating certain transactions is clearly to acquire or enhance future economic benefits available to the entity. For example, business enterprises . . . advertise, develop markets . . . and spend significant funds to do so. The uncertainty is not about the intent to increase future economic benefits but about whether and, if so, to what extent they succeeded in doing so. Certain expenditures for . . . advertising . . . are examples of the kinds of items for which assessments of future economic benefits may be especially uncertain . . . .

If . . . advertising results in an entity’s acquiring or increasing future economic benefit, that future economic benefit qualifies as an asset as much as do the future benefits from prepaid insurance or prepaid rent. The practical problem is whether future economic benefit is actually present and, if so, how much—an assessment that is greatly complicated by the feature that the benefits may be realized far in the future, if at all.

.17 Paragraphs 247 to 250 discuss deferred costs and acknowledge that advertising may provide future economic benefits, but they note that such benefits may not be reported as assets for practical reasons stemming from considerations of uncertainty or measurement. Paragraph 248 states, in part:

The question that needs to be answered to apply the definition of assets is whether the economic benefit received by incurring those costs was used up at the time the costs were incurred or shortly thereafter or future economic benefit remains at the time the definition is applied. Costs such as . . . advertising services do not *by themselves* qualify as assets under the definition in paragraph 25 any more than do spoiled units, dry holes, or legal costs. The reason for considering the possibility that they might be accounted for as if they were assets stems from their possible relationship to future economic benefits.

.18 FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 63, sets forth the following criteria that should be met to report an item in the financial statements:

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<sup>3</sup> Because assets should be understood to represent current conditions, the term *probable future economic benefits* in this SOP means that current prospects indicate that the reporting entity probably will receive economic benefits in the future.

**Definitions**—The item meets the definition of an element of financial statements.

**Measurability**—It has a relevant attribute measurable with sufficient reliability.

**Relevance**—The information about it is capable of making a difference in user decisions.

**Reliability**—The information is representationally faithful, verifiable, and neutral.

**.19** No authoritative pronouncement provides broad guidance on financial reporting on advertising. However, aspects of the following documents, discussed in the appendix [paragraph .81], provide guidance on reporting on advertising in connection with specific items or industries.

- a. FASB Statement No. 13, *Accounting for Leases*, as amended by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- b. FASB Statement No. 51, *Financial Reporting By Cable Television Companies*
- c. FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*
- d. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*
- e. FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- f. The AICPA Industry Audit Guide *Audits of Airlines*, as amended by SOP 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications* [section 10,430]
- g. The AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*
- h. SOP 89-5, *Financial Accounting and Reporting by Providers of Pre-paid Health Care Services*
- i. FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*

**.20** Aspects of the following documents, also discussed in the appendix [paragraph .81], provide further guidance on reporting on activities similar to research and development:

- a. APB Opinion 17, *Intangible Assets*
- b. APB Opinion 28, *Interim Financial Reporting*
- c. FASB Statement No. 2, *Accounting for Research and Development Costs*
- d. FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*
- e. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*

- f. FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*
- g. The AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*
- h. SOP 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities*

.21 The guidance in the pronouncements listed in the two preceding paragraphs is not consistent. Some believe that pronouncements permitting capitalization of advertising do so because a clearly demonstrable cause-and-effect relationship exists between the assets acquired and costs incurred. Also, some believe that pronouncements prohibiting capitalization of advertising do so because (a) no such demonstrable causal relationship exists, (b) the amounts capitalized would be immaterial, or (c) the costs of obtaining the information would not be justified by the benefits of reporting it. The conclusions reached in this SOP are based on the guidance in the FASB Concepts Statements.

## Description of Advertising

.22 Advertising is the promotion of an industry, an entity, a brand, a product name, or specific products or services so as to create or stimulate a positive entity image or to create or stimulate a desire to buy the entity's products or services.<sup>4</sup>

.23 Advertising is one kind of customer acquisition activity. Financial reporting of other kinds of customer acquisition activities is outside the scope of this SOP.<sup>5</sup>

.24 Advertising generally uses a form of media—such as mail, television, radio, telephone, facsimile machine, newspaper, magazine, coupon, or billboard—to communicate with potential customers. Examples of kinds of advertising include the following:

- Directory and buyer's guide advertising
- Business and industrial publications
- Reprints of advertisements
- Television advertising
- Direct-mail advertising
- Consumer publications
- Radio advertisements
- Billboard advertisements
- Company and product catalogues
- Cooperative advertising

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<sup>4</sup> Fund-raising by not-for-profit organizations is not considered advertising and is not within the scope of this SOP. However, this SOP does apply to advertising activities of not-for-profit organizations.

<sup>5</sup> The costs of premiums, contest prizes, gifts, and similar promotions, as well as discounts or rebates, including those resulting from the redemption of coupons, are not considered advertising costs for purposes of applying the guidance in this SOP. (Other costs of coupons and similar items, such as costs of newspaper advertising space, are considered advertising costs.)



- Booklets for sales promotion
- Newspaper advertising
- Point-of-sale material
- Sponsorship of public events

## Conclusions

**.25** The following conclusions should be read in conjunction with “Discussion of Conclusions and Implementation Guidance,” beginning with paragraph .55 of this SOP, which explains the basis for the conclusions and provides guidance for implementing them.

## Expensing or Capitalizing Advertising Costs

**.26** The costs of advertising should be expensed either as incurred or the first time the advertising takes place (paragraphs .42 to .44 elaborate on component costs of advertising),<sup>6</sup> except for—

- a. Direct-response advertising (1) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (2) that results in probable future economic benefits (future benefits). (Paragraph .37 discusses the conditions that must be met in order to conclude that direct-response advertising results in probable future benefits.) Examples of the first time advertising takes place include the first public showing of a television commercial for its intended purpose and the first appearance of a magazine advertisement for its intended purpose.
- b. Expenditures for advertising costs that are made subsequent to recognizing revenues related to those costs, as discussed in paragraph .27.

**.27** Expenditures for some advertising costs are made subsequent to recognizing revenues related to those costs. For example, some entities assume an obligation to reimburse their customers for some or all of the customers’ advertising costs (cooperative advertising). Generally, revenues related to the transactions creating those obligations are earned and recognized before the expenditures are made. For purposes of applying this SOP, those obligations should be accrued and the advertising costs expensed when the related revenues are recognized.

**.28** The costs of direct-response advertising (a) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (b) that results in probable future benefits should be reported as assets net of accumulated amortization. For purposes of calculating amortization and assessing realizability, which are discussed in paragraphs .46 to .48, each significant advertising effort establishes a separate stand-alone cost pool.

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<sup>6</sup> Deferring the costs of advertising until the advertising takes place assumes that the costs have been incurred for advertising that will occur. Such costs should be expensed immediately if such advertising is not expected to occur.

**.29** The accounting policy selected from the two alternatives in the beginning of paragraph .26 (whether advertising costs are expensed as incurred or the first time the advertising takes place), should be applied consistently to similar kinds of advertising activities.

## **Tangible Assets**

**.30** Tangible assets, such as blimps or billboards, may be used for several advertising campaigns. The costs of such assets should be capitalized and depreciated or amortized using a systematic and rational method over their expected useful lives. That depreciation or amortization may be a cost of advertising if the tangible asset is used for advertising.

**.31** For purposes of applying this SOP, costs incurred to produce film or audio and video tape to be used to communicate advertising do not create tangible assets.

**.32** Sales materials, such as brochures and catalogues, may be accounted for as prepaid supplies until they no longer are owned or expected to be used, in which case their cost would be a cost of advertising and should be accounted for in conformity with the guidance in this SOP.

## **Direct-Response Advertising**

**.33** The costs of direct-response advertising should be capitalized if both of the following conditions are met:

- a. The primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising. (Paragraph .34 discusses the conditions that must exist in order to conclude that the advertising's purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising.)
- b. The direct-response advertising results in probable future benefits. (Paragraph .37 discusses the conditions that must exist in order to conclude that direct-response advertising results in probable future benefits.)

**.34** In order to conclude that advertising elicits sales to customers who could be shown to have responded specifically to the advertising, there must be a means of documenting that response, including a record that can identify the name of the customer and the advertising that elicited the direct response. Examples of such documentation include the following:

- Files indicating the customer names and the related direct-response advertisement
- A coded order form, coupon, or response card, included with an advertisement, indicating the customer name
- A log of customers who have made phone calls to a number appearing in an advertisement, linking those calls to the advertisement

**.35** Direct-response advertising activities exclude advertising that, though related to the direct-response advertising, is directed to an audience that could not be shown to have responded specifically to the direct-response advertising. For example, a television commercial announcing that order forms

(that are direct-response advertising) soon will be distributed directly to some people in the viewing area would not be a direct-response advertising activity because the television commercial is directed to a broad audience, not all of which could be shown to have responded specifically to the direct-response advertising.

### **Probable Future Benefits of Direct-Response Advertising**

**.36** The probable future benefits of direct-response advertising activities are probable future revenues arising from that advertising in excess of future costs to be incurred in realizing those revenues.

**.37** Demonstrating that direct-response advertising will result in future benefits requires persuasive evidence that its effects will be similar to the effects of responses to past direct-response advertising activities of the entity that resulted in future benefits. Such evidence should include verifiable historical patterns of results for the entity. Attributes to consider in determining whether the responses will be similar include (a) the demographics of the audience, (b) the method of advertising, (c) the product, and (d) economic conditions.

**.38** Industry statistics would not be considered objective evidence that direct-response advertising will result in future benefits in the absence of the specific entity's operating history. If the entity does not have an operating history for a particular product or service but does have operating histories for other new products or services, statistics for the other products or services may be used if it can be demonstrated that the statistics for the other products or services are likely to be highly correlated to the statistics of the particular product or service being evaluated. For example, test market results for a new product or service may be used to support the view that the results of advertising for current new products or services are likely to be highly correlated with the results of advertising for new products or services previously sold by the entity. In the absence of the expectation of a high degree of correlation, a success rate based on historical ratios of successful products or services to total products or services introduced to the marketplace would not be a sufficient basis for reporting a portion of the costs of current-period advertising as resulting in assets.

**.39** Direct-response advertising costs that are not capitalized because it cannot be demonstrated that the direct-response advertising will result in future benefits should not be retroactively capitalized in subsequent periods if historical evidence in those subsequent periods indicates that the advertising did in fact result in future benefits.

### **Basis of Measurement**

**.40** Based on the potential customers and the probable customer response rates, direct-response advertising that is expected to produce future revenues generally is undertaken before the customers' identity is known. Such advertising is undertaken with the expectation that not all targets of the direct-response advertising will provide benefits but that the benefits created by the customers who do respond to the advertising will justify the total advertising costs. Accordingly, the cost of the direct-response advertising directed to all prospective customers, not only the cost related to the portion of the potential customers that are expected to respond to the advertising, should be used to measure the amounts of such reported assets.

## Costs of Direct-Response Advertising

.41 Costs of direct-response advertising that should be included in amounts reported as assets include only the following:

- a. *Incremental direct costs of direct-response advertising incurred in transactions with independent third parties*—Examples of those costs may include, but are not limited to, costs of idea development, writing advertising copy, artwork, printing, magazine space, and mailing.
- b. *Payroll and payroll-related costs for the direct-response advertising activities of employees who are directly associated with and devote time to the advertising reported as assets*—Examples of those activities may include, but are not limited to, idea development, writing advertising copy, artwork, printing, and mailing. The costs directly related to those advertising activities should include only that portion of employees' total compensation and payroll-related fringe benefits directly related to time spent performing such activities.

For purposes of this SOP, administrative costs, rent, depreciation other than depreciation of assets used directly for advertising activities (as discussed in paragraph .30), and other occupancy costs are not costs of direct-response advertising activities.

## Components of Advertising Activities

.42 Advertising activities may have several component costs. Two primary components, which are made up of other components, are the costs of (a) producing advertisements, such as the costs of idea development, writing advertising copy, artwork, printing, audio and video crews, actors, and other costs, and (b) communicating advertisements that have been produced, such as the costs of magazine space, television airtime, billboard space, and distribution (postage stamps, for example).

### Producing Advertising

.43 Costs of producing advertising are incurred during production rather than when the advertising takes place.

### Communicating Advertising

.44 Costs of communicating advertising are not incurred until the item or service has been received and should not be reported as expenses before the item or service has been received, except as discussed in paragraph .27. For example—

- The costs of television airtime should not be reported as advertising expense before the airtime is used. Once it is used, the costs should be expensed, unless the airtime was used for direct-response advertising activities that meet the criteria for capitalization under this SOP.
- The costs of magazine, directory, or other print media advertising space should not be reported as advertising expense before the space is used. Once it is used, the costs should be expensed, unless the space was used for direct-response advertising activities that meet the criteria for capitalization under this SOP.

### Executory Contracts

.45 Some activities, such as product endorsements and sponsorships of events, may be performed pursuant to executory contracts. Costs incurred un-

der executory contracts generally are recognized as performance under the contract is received. Executory contracts should be evaluated to determine whether the costs recognized under such contracts are advertising costs. To the extent that those costs are advertising costs, such costs should be accounted for in conformity with the guidance in this SOP.

## Amortization of Capitalized Advertising Costs

.46 The amounts at which direct-response advertising is reported as assets should be amortized on a cost-pool-by-cost-pool basis over the period during which the future benefits are expected to be received using the method described in paragraph .47.

.47 The amortization should be the amount computed using the ratio that current period revenues for the direct-response advertising cost pool bear to the total of current and estimated future period revenues for that direct-response-advertising cost pool. The amounts in this calculation should not be discounted to net present value. The estimated amounts of future revenues for that cost pool may increase or decrease over time, and the ratio should be recalculated at each reporting date.<sup>7</sup>

## Assessment of Realizability and Subsequent Measurement

.48 The realizability of the amounts of direct-response advertising reported as assets should be evaluated at each balance-sheet date by comparing the carrying amounts of such assets on a cost-pool-by-cost-pool basis to the probable remaining future net revenues expected to result directly from such advertising. (For this evaluation, future net revenues are gross revenues less the probable future costs of all goods and activities necessary to earn those revenues, except amortization of direct-response advertising. Examples of such future costs are the costs of goods sold, sales commissions, and payroll and payroll-related costs associated with the future revenues.) If the carrying amounts of such advertising exceed the remaining future net revenues that probably will be realized from such advertising, the excess should be reported as advertising expense of the current period. The reduced carrying amounts should not be adjusted upward if estimates of future net revenues are subsequently increased.<sup>[8]</sup>

## Disclosures

.49 The notes to the financial statements should disclose the following:

- a. The accounting policy selected from the two alternatives in the beginning of paragraph .26 for reporting advertising, indicating whether such costs are expensed as incurred or the first time the advertising takes place
- b. A description of the direct-response advertising reported as assets (if any), the accounting policy for it, and the amortization period
- c. The total amount charged to advertising expense for each income statement presented, with separate disclosure of amounts, if any, representing a write-down to net realizable value

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<sup>7</sup> Changes in estimated future revenues for a direct-response-advertising cost pool should be reflected in the amortization calculation for current and future periods. Therefore, such changes in estimates would not result in reporting amounts expensed in prior periods as assets in the current or subsequent periods.

<sup>[8]</sup> [Footnote deleted.]

- d. The total amount of advertising reported as assets in each balance sheet presented

.50 The following illustrates the disclosures discussed in paragraph .49:

Note X. Advertising

The Company expenses the production costs of advertising the first time the advertising takes place, except for direct-response advertising, which is capitalized and amortized over its expected period of future benefits.

Direct-response advertising consists primarily of magazine advertisements that include order coupons for the Company's products. The capitalized costs of the advertising are amortized over the three-month period following the publication of the magazine in which it appears.

At December 31, 19XX, \$1,000,000 of advertising was reported as assets. Advertising expense was \$10,000,000 in 19XX, including \$500,000 for amounts written down to net realizable value.

## Amendments to Other Guidance

.51 This SOP amends SOP 88-1 [section 10,430] by requiring advertising costs incurred in connection with route developmental costs related to the preparation of new route operations to be accounted for in conformity with the guidance in this SOP, rather than expensed as incurred. Paragraph 22 of SOP 88-1 [section 10,430.22] is amended as follows:

Because of the current deregulated environment and the uncertainty regarding the recoverability of route developmental costs, the majority of the Accounting Standards Executive Committee (AcSEC) believes that developmental costs, other than advertising costs, related to preparation of operations of new routes should not be capitalized, as previously permitted under the guide. (Advertising costs should be accounted for in conformity with the guidance in SOP 93-7, *Reporting on Advertising Costs*.) Route expansion or alteration has become a recurring activity among the airlines, and any related cost is considered a normal and recurring cost of conducting business.

.52 This SOP amends SOP 89-5 by requiring advertising costs incurred as contract acquisition costs to be accounted for in conformity with the guidance in this SOP, rather than expensed as incurred. Paragraph 54 of SOP 89-5 is amended as follows:

Although there is theoretical support for deferring certain acquisition costs, acquisition costs of providers of prepaid health care services, other than costs of advertising, should be expensed as incurred. (Advertising costs should be accounted for in conformity with the guidance in SOP 93-7, *Reporting on Advertising Costs*.)

.53 This SOP amends SOP 90-8 by clarifying that advertising costs incurred in connection with acquiring initial continuing care contracts should be accounted for in conformity with the guidance in this SOP. SOP 90-8 is amended by adding the following as a footnote after the word "advertising" in the second bullet in paragraph 15:

Accounting for costs of advertising is not covered by this SOP. (Advertising costs should be accounted for in conformity with the guidance in SOP 93-7, *Reporting on Advertising Costs*.)

## Effective Date and Transition

.54 This SOP is effective for financial statements for years beginning after June 15, 1994. Earlier application is encouraged in fiscal years for which

financial statements previously have not been issued. Costs incurred, regardless of whether or not they are reported as assets, before the initial application of this SOP should not be adjusted to the amounts that would have been reported as assets had this SOP been in effect when those costs were incurred. However, the concepts included in the provisions of paragraphs .46 and .47 (amortization), paragraph .48 (assessment of realizability), and paragraph .49 (disclosures) of this SOP should be applied to any unamortized costs reported as assets before the initial application of this SOP that continue to be reported as assets after the effective date. In the year this SOP is first applied, the financial statements should disclose the nature of the accounting changes adopted to conform to the provisions of this SOP and their effect on income before extraordinary items, net income, and related per share amounts.

## Discussion of Conclusions and Implementation Guidance

### Expensing the Costs of Advertising Either as Incurred or the First Time the Advertising Takes Place, Unless the Advertising Is Direct-Response Advertising That Is Capitalized Under the SOP

.55 Practice for reporting the costs of advertising is diverse and includes the following:

- Some entities expense all such costs as the component services or items are performed or received. For example, the costs of hiring an actor to film a television commercial, which is one kind of component cost of television advertising, may be expensed when the actor has completed his or her acting assignment.
- Some entities expense such costs the first time the advertising takes place.
- Some entities expense such costs over the estimated life of the advertising.
- Some entities view the practices described in the three previous bulleted items as points on a continuum, and they expense those costs at some point on that continuum.
- Some entities expense such costs over the period that revenues are expected to result from the advertising.

.56 Some believe that all costs of advertising activities, other than direct-response advertising that results in probable future benefits and is capitalized in conformity with the guidance in paragraph .26, should be expensed as the component activities occur. They believe that if the costs of the component activities are not capitalized under the SOP because it cannot be demonstrated that there is an asset after the advertising occurs, it follows that there is no basis for concluding that there is an asset before the advertising occurs.

.57 FASB Concepts Statement No. 5, paragraph 86, states that—

Consumption of economic benefits during a period may be recognized either directly or by relating it to revenues recognized during the period:

... b. Many expenses, such as selling and administrative salaries, are recognized during the period in which cash is spent or liabilities are incurred for goods and services that are used up either simultaneously with acquisition or soon after. *[Footnote reference omitted.]*

Some believe that the component costs of advertising activities, other than direct-response advertising that results in probable future benefits and is capitalized in conformity with the guidance in paragraph .26, result in assets until at least the first time the advertising occurs. They believe that such costs are not capitalized under this SOP after the advertising occurs because they do not result in *demonstrable* probable future economic benefits, not because they do not result in any probable future economic benefits. However, they believe that the component costs of advertising have, at a minimum, benefits that are received simultaneously with the advertising. They note that there must be some economic benefit to advertising activities because entities continue to undertake them. They also note that there is no opportunity for an entity to benefit from advertising until it occurs. Therefore, they conclude that it is reasonable to defer such costs until the first time the advertising takes place.

.58 Some believe the component costs of advertising activities, other than direct-response advertising that results in probable future benefits and is capitalized in conformity with the guidance in paragraph .26, result in assets and should be amortized over the life of the advertising. They believe that the component costs of advertising have benefits that are received over the period the advertising is used. They note that there must be some economic benefit to advertising activities over the period they are used, because entities incur incremental costs to undertake them. Some believe that advertising should be expensed over the period in which revenues are expected to result from the advertising.

.59 AcSEC believes that the views discussed in paragraphs .55 through .58 have merit and acknowledges that choosing from among the accounting methods resulting from them is based to some extent on arbitrary judgments. AcSEC believes that the views discussed in paragraph .58 should not be adopted for advertising other than direct-response advertising, because probable future benefits beyond the first time the advertising takes place are too uncertain and are not demonstrable or measurable with the degree of reliability required to recognize an asset. Further, AcSEC believes the diversity in practice should be limited. AcSEC believes that the costs of advertising that otherwise would not be capitalized under the SOP should be expensed no later than the first time the advertising takes place. However, AcSEC is unable to reach a consensus on whether the costs of advertising that would otherwise not be capitalized under this SOP should be expensed (a) as incurred or (b) the first time the advertising takes place. Therefore, for practical reasons (including the likelihood that, for most entities, the financial statement effect of choosing the accounting described by (a) to the exclusion of (b), or vice versa, would be immaterial), AcSEC has concluded that entities should expense the costs of advertising that otherwise would not be capitalized under this SOP either as incurred or the first time the advertising takes place.

### **Capitalization of Direct-Response Advertising Costs Based on FASB Concepts Statements**

.60 AcSEC based its conclusions for capitalizing direct-response advertising on FASB Concepts Statement Nos. 5 and 6. AcSEC also considered other authoritative financial reporting literature that could be relevant to financial reporting for advertising. Such other literature is excerpted in the appendix [paragraph .81].

.61 AcSEC believes that advertising that results in an entity's acquiring or increasing probable future economic benefits meets the definition of an as-



set. However, for most advertising, those benefits cannot be measured with the degree of reliability required to report an asset in the financial statements. AcSEC believes that direct-response advertising that meets certain criteria is the only advertising that may result in benefits that can be measured with the degree of reliability required to report an asset in the financial statements after the first time the advertising takes place.

### **Recognition Criteria**

.62 FASB Concepts Statement No. 5, paragraph 63, sets forth the criteria of definition, measurability, relevance, and reliability that should be met to report an item in the financial statements.

### **Definition of an Asset**

.63 Paragraph 25 of Concepts Statement No. 6 states that “assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” Advertising can create assets according to that definition, and the costs of such advertising may qualify to be capitalized.

.64 The probable future benefits are probable future revenues arising from direct-response advertising in excess of the future costs to be incurred in realizing those revenues. Those assets are deferrals, within the meaning of paragraph 141 of Concepts Statement No. 6, resulting from current cash payments or their equivalent. Recognition in income of the costs of such assets is deferred until the future economic benefits underlying the assets are partly or wholly realized or lost.

.65 Historical patterns of responses to the direct-response advertising or contracts that are enforced generally are evidence that the reporting entity obtains the benefits and can control others’ access to them.

### **Measurability**

.66 The probable future revenues that will result from direct-response advertising that meets the conditions for capitalization under this SOP can be measured with the degree of reliability necessary to report the costs to obtain them as an asset in financial statements. The list of attributes in paragraph 67 of Concepts Statement No. 5 includes historical cost, net realizable value, and present value of future cash flows.

### **Relevance**

.67 FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, paragraphs 34 to 40, states that financial reporting should provide information that is useful in making rational economic decisions. That includes information helpful to users in assessing the amounts, timing, and uncertainties of prospective net cash inflows, information about the economic resources of an enterprise, and information about the effects of transactions and circumstances that change resources. Information about the future revenues that will result from direct-response advertising and the costs incurred are relevant because they provide such information.

### **Reliability**

.68 Paragraph 75 of Concepts Statement No. 5 states that to be reliable, information must be “representationally faithful, verifiable, and neutral.” Paragraph 77 amplifies that statement:

Unavailability or unreliability of information may delay recognition of an item, but waiting for virtually complete reliability or minimum cost may make the

information so untimely that it loses its relevance. At some intermediate point, uncertainty may be reduced at a justifiable cost to a level tolerable in view of the perceived relevance of the information. If other criteria are also met, that is the appropriate point for recognition. Thus, recognition may sometimes involve a trade-off between relevance and reliability.

.69 There is a broad spectrum of advertising activities and circumstances in which they are undertaken. AcSEC believes that many kinds of advertising activities may result in assets that meet the recognition criteria of definition, measurability, and relevance. However, AcSEC believes that only certain direct-response advertising can meet the recognition criteria of reliability after the first time the advertising takes place. AcSEC believes advertising other than direct-response advertising would not result in assets that are measurable with the degree of reliability required to report an asset in the financial statements after the first time the advertising takes place.

### **Specificity of Conditions That Must Be Met in Order to Report the Probable Future Benefits of Direct-Response Advertising as Assets**

.70 The conditions in this SOP that must be met in order to report the costs of direct-response advertising as assets beyond the first time the advertising takes place require reliable information. Those conditions are narrow because it is generally difficult to determine the probable future benefits of advertising with the degree of reliability sufficient to report the results of the advertising as assets.

.71 AcSEC considered providing guidance that would require or prohibit capitalization based on the use of econometric models, scanner studies, or other forms of data gathering as evidence that advertising leads to a response resulting in future benefits. Such forms of data gathering generally are designed to isolate the effects of all factors affecting revenue, such as advertising, price, and season, to estimate the effects of advertising on sales. AcSEC concluded that the SOP should prohibit capitalization of advertising based on the use of such information as evidence, because the effects of factors other than advertising on the production of revenue probably would not be measurable with the degree of reliability required to rely on such models.

### **Period and Extent of Expected Future Benefits**

.72 The response to advertising usually occurs shortly after the advertising takes place, but in mail-order catalogue advertising, for example, it can take place over a longer period.

.73 AcSEC considered providing guidance that would either permit or prohibit reporting the costs of direct-response advertising as assets based on the inclusion of future revenues from renewals or repeat sales. Reporting entities with an established operating history, such as certain entities in subscription businesses, may be able to measure such amounts with the required degree of reliability and, if so, should report assets based on renewal amounts. The reporting entity must exercise judgment about (a) the existence of the degree of reliability required to determine the probability of renewals and (b) whether those renewals result from the direct-response advertising being accounted for. In order to conclude that the renewals result from the direct-response advertising being accounted for, the renewals must not result from significant direct-response advertising that took place subsequent to the

direct-response advertising being accounted for. (As discussed in paragraph .28, each significant advertising effort establishes a separate stand-alone cost pool.) Examples of situations in which that required degree of reliability may exist, without significant direct-response advertising subsequent to the direct-response advertising being accounted for, include the following:

- The sale of subscriptions may be offered only through direct-response advertising. The entity may have objective evidence that, historically, a quantifiable percentage of subscriptions is renewed at the end of each subscription period without a significant advertising effort. After the subscription is purchased, in what is deemed to be an insignificant advertising effort, renewal subscriptions are offered for sale by mailing a renewal card to those who have subscriptions that will lapse soon. The amount of direct-response advertising reported as assets and amortized in future periods ordinarily would be based on the expected total revenue to be realized over both the initial and the renewal subscription periods.
- A series of products, such as pieces in a chess set, may be offered for sale only through direct-response advertising. After the first piece is purchased, the remaining pieces are offered for sale by mailing a response card to those who purchased the first piece in what is deemed to be an insignificant advertising effort. The entity may have objective evidence that, historically, each customer who buys the first piece will buy a quantifiable percentage of the remaining pieces. If each of the pieces is bought separately, the amount of direct-response advertising reported as assets and amortized in future periods ordinarily would be based on total revenue from all sales, including estimated future sales.

If significant marketing efforts are required to generate subsequent revenues through renewal or repeat sales, those subsequent revenues would not qualify as revenues resulting from the direct-response advertising that resulted in the initial sale and initial stand-alone cost pool. For example, in the previous bulleted item, if a pamphlet describing the chess set, its monetary and aesthetic value, and the history of the game of chess is sent to those who purchased the first piece, the amount of direct-response advertising reported as assets and amortized in future periods would be based on sales of the first piece rather than on the total of all sales including estimated future sales. However, subsequent direct-response advertising may result in the capitalization of the costs of that subsequent advertising, with its costs accumulated in a stand-alone cost pool, if the conditions for capitalization in this SOP are met.

.74 AcSEC concluded that it should not arbitrarily limit the period over which the direct-response advertising should be amortized. However, AcSEC believes that the reliability of accounting estimates decreases as the length of the period for which such estimates are made increases. Therefore, the period over which the benefits of direct-response advertising are amortized often is no longer than the greater of one year or one operating cycle. However, under certain circumstances, such as those discussed in paragraph .72, an entity may be able to demonstrate that the duration of the probable future benefits is greater than the longer of one year or one operating cycle.

### **Assets Should Be Reported Based on the Costs of the Advertising Directed to All Prospective Customers**

.75 Paragraph .40 of this SOP states, in part, that the "... cost of the direct-response advertising directed to all prospective customers, not only the

cost related to the portion of the potential customers that is expected to respond to the advertising, should be used to measure the amounts of such reported assets." Some believe that guidance to be inconsistent with guidance in other pronouncements issued by the FASB (such as FASB Statement Nos. 19 and 91) that require costs to be capitalized based on the portion of the costs expected to result in successful efforts. Other FASB pronouncements, such as FASB Statement No. 53, permit capitalization of advertising based on the cost of advertising directed to all potential customers.

.76 AcSEC compared and contrasted the guidance in this SOP with the guidance in FASB Statement Nos. 19 and 91. AcSEC concluded that, in general, any comparison of the guidance in Statement Nos. 19 and 91 should consider the differences in the kinds of activities addressed by those Statements and this SOP. In the extractive industries, drilling an oil well in a location without proven reserves can be viewed as a discrete effort; in financial industries, making or acquiring a loan can be viewed as a discrete effort. However, few would view an individual unit of advertising, such as one piece of advertising mailed as part of a direct-response advertising campaign, as a discrete effort. The entire mailing, not merely an individual piece of mail, constitutes the effort, and the advertiser evaluates the success of the advertising based on the response to the entire advertising effort, not on the response to one component of that effort.

.77 AcSEC believes the arguments supporting successful-effort accounting for exploration activities in the oil and gas industry are based on the inability to demonstrate, on an individual company basis, a direct cause-and-effect relationship between unsuccessful acquisition and exploration costs and revenues derived from successful activities in unrelated geological areas. For the kinds of activities capitalized under the guidance in this SOP, there is a reliable and demonstrated relationship between total costs and future benefits that is a direct result of incurring those costs. For example, reporting entities capitalizing advertising in conformity with this SOP would have reliable evidence that they must, for example, send out 1 million pieces of direct-mail advertising in order to get 10 thousand responses. The cost of obtaining those 10 thousand responses is the cost of sending out the million pieces of mail. The effort is the million pieces mailed, and documented operating history enables those reporting entities to make reliable predictions about the relationship between the total number of pieces of advertising mailed and the total future revenues obtained.

### **Acquisition Cost of the Assets**

.78 AcSEC used FASB Statement Nos. 19 and 91 as a basis for determining the kinds of costs of direct-response advertising that result in assets that should be included in the acquisition cost of the assets. AcSEC believes that some activities, such as allocated overhead, may result in assets, but it excluded such costs because measurements of the amounts that should be allocated to advertising are too imprecise. The costs of materials bought from a supplier in the production of advertising materials should be reported as costs of assets from direct-response advertising if those materials can be directly attributed to specific direct-response advertising. An example of such costs and activities is the cost of paper bought from a third party used to produce catalogues.

### **Amortization**

.79 APB Opinion 17, paragraph 32, states that intangible assets should be amortized using the straight-line method, unless a company demonstrates

that another systematic method is more appropriate. AcSEC used FASB Statement No. 86 as a basis for determining the amortization method because it believes the method used in that Statement generally is more appropriate. AcSEC does not require straight-line amortization, because the benefits of advertising sometimes are greater or less in future periods than in current periods. AcSEC believes amortization should match the costs of obtaining the future benefits with those benefits.

.80 In calculating the amortization of the amounts reported as assets resulting from direct-response advertising, the amounts in the calculation should not be discounted to net present value. The FASB currently is studying discounting. Under current generally accepted accounting principles (GAAP), assets resulting from direct-response advertising are nonmonetary assets, and nonmonetary assets generally are not discounted. Further, the effect of discounting generally would not be material, because the amortization period usually would be short.

## Appendix

### Other Financial Reporting Literature

The following sets forth relevant portions of authoritative and other financial reporting literature that was considered by AcSEC in its deliberation of financial reporting on advertising activities.

As discussed in paragraph .06 of this SOP, the guidance in this SOP does not apply to transactions for which pronouncements in category (a) in paragraph 10 of SAS No. 69 provide guidance.

### Guidance Included in Category (a) in Paragraph 10 of SAS No. 69

#### APB Opinion 17

APB Opinion 17, *Intangible Assets*, paragraph 24, states the following:

... [A] company should record as assets the costs of intangible assets acquired from other enterprises or individuals. Costs of developing, maintaining, or restoring intangible assets which are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole—such as goodwill—should be deducted from income when incurred.

However, paragraph 28 states that “a reasonable estimate of the useful life may often be based on upper and lower limits even though a fixed existence is not determinable.”

#### APB Opinion 28

APB Opinion 28, *Interim Financial Reporting*, paragraph 15(a), states the following:

Costs and expenses other than product costs should be charged to income in interim periods as incurred, or be allocated among interim periods based on an estimate of time expired, benefit received or activity associated with the periods. Procedures adopted for assigning specific cost and expense items to an interim period should be consistent with the bases followed by the company in reporting results of operations at annual reporting dates. However, when a specific cost or expense item charged to expense for annual reporting purposes benefits more than one interim period, the cost or expense item may be allocated to those interim periods.

Paragraph 16(d) states the following:

Advertising costs may be deferred within a fiscal year if the benefits of an expenditure made clearly extend beyond the interim period in which the expenditure is made. Advertising costs may be accrued and assigned to interim periods in relation to sales prior to the time the service is received if the advertising program is clearly implicit in the sales arrangement.

#### FASB Statement No. 2

FASB Statement No. 2, *Accounting for Research and Development Costs*, provides no specific guidance on the financial reporting treatment of advertising but does include a discussion from which parallels can be drawn. Appendix B, “Basis for Conclusions,” includes uncertainty of probable future benefits, lack of causal relationship between expenditures and benefits, and measurabil-

ity of probable future economic benefits as bases for the FASB's conclusion that the costs of research and development should be reported as expenses when incurred and, in effect, that the benefits of that activity should not be reported as assets. The FASB considered the concept of selective reporting of assets for those activities, which would involve establishing conditions that would have to be met before the benefits of research and development could be reported as assets. However, because the factors on which such conditions might be based could not be objectively and comparably applied by all enterprises, the FASB rejected this concept for research and development activities.

The Statement, in paragraph 11, includes both internal and external costs among the costs to be identified with research and development activities.

### **FASB Statement No. 13**

FASB Statement No. 13, *Accounting for Leases*, as amended by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, paragraph 24, states that "initial direct costs shall not include costs related to activities performed by the lessor for advertising [and] soliciting potential lessees . . ." and therefore requires that the costs of advertising, as they pertain to leases, be reported as expenses when incurred.

### **FASB Statement No. 19**

FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, is discussed in the "Discussion of Conclusions and Implementation Guidance" section of this SOP.

### **FASB Statement No. 51**

FASB Statement No. 51, *Financial Reporting by Cable Television Companies*, appendix A, paragraph 17, states that "direct selling costs include . . . local advertising targeted for acquisition of new subscribers . . ." and requires that they be reported as expenses when incurred, but initial hookup revenue may be recognized to the extent such costs are incurred.

### **FASB Statement No. 53**

FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*, requires in paragraph 15 that the probable future economic benefits of exploitation activities, including prerelease and early-release advertising of films in both primary and secondary markets that probably will benefit the film in future markets, be reported as film inventory at cost and amortized based on the ratio that gross revenues from the film for the current period bear to total anticipated gross revenues from the film during its useful life. The costs of local advertising that is "not clearly expected to benefit the film in future markets . . . shall be charged to expense in the period incurred."

### **FASB Statement No. 60**

FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, requires in paragraph 29 that the probable future economic benefits of policy acquisition activities be reported as assets at cost and amortized in proportion to premium revenue reported. Appendix A, paragraph 66, defines acquisition costs as—

Costs incurred in the acquisition of new and renewal insurance contracts.  
Acquisition costs include those costs that vary with and are primarily related

to the acquisition of insurance contracts (for example, agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees).

The Statement does not discuss whether acquisition activities include advertising activities.

#### **FASB Statement No. 67**

FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, appendix A, paragraph 28, defines the following terms:

##### *Costs Incurred to Rent Real Estate Projects*

Examples of such costs include costs of model units and their furnishings, rental facilities, semipermanent signs, rental brochures, advertising, "grand openings," and rental overhead including rental salaries.

##### *Costs Incurred to Sell Real Estate Projects*

Examples of such costs include costs of model units and their furnishings, sales facilities, sales brochures, legal fees for preparation of prospectuses, semipermanent signs, advertising, "grand openings," and sales overhead including sales salaries.

The probable future economic benefits of activities undertaken to sell real estate projects are reported as assets at cost if their costs are realizable from the sale of the project and are incurred for tangible assets that are used throughout the selling period to help sell the project. Paragraph 19 states that "capitalized selling costs shall be charged to expense in the period in which the related revenue is recognized as earned."

Paragraphs 20 and 21 state:

If costs incurred to rent real estate projects, other than initial direct costs, under operating leases are related to and their recovery is reasonably expected from future rental operations, they shall be capitalized. Examples of such costs are costs of model units and their furnishings, rental facilities, semipermanent signs, "grand openings," and unused rental brochures. Costs that do not meet the criteria for capitalization shall be expensed as incurred, for example, rental overhead.

Capitalized rental costs directly related to revenue from a specific operating lease shall be amortized over the lease term. Capitalized rental costs not directly related to revenue from a specific operating lease shall be amortized over the period of expected benefit. The amortization period shall begin when the project is substantially completed and held available for occupancy. Estimated unrecoverable amounts of unamortized capitalized rental costs associated with a lease or group of leases shall be charged to expense when it becomes probable that the lease(s) will be terminated. [Footnote reference omitted.]

#### **FASB Statement No. 86**

FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, provides no specific guidance on reporting on advertising, but it does provide guidance from which parallels can be drawn. Under the Statement, all costs incurred internally to create computer software products are reported as expenses when incurred until technological feasibility has been established for the products. For certain production costs of specific activities whose probable future benefits are reported as assets, paragraph 8 states:

The annual amortization shall be the greater of the amount computed using  
(a) the ratio that current gross revenues for a product bear to the total of current



and anticipated future gross revenues for that product or (b) the straight-line method over the remaining estimated economic life of the product including the period being reported on.

The unamortized amount of assets reported is compared to their net realizable value at the reporting date and is written down to the extent that it exceeds the net realizable value.

### **FASB Statement No. 91**

FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, requires the probable future economic benefits of direct loan origination activities to be reported as assets at cost, which should be amortized over the lives of the loans with the amortization reported as yield adjustments. Paragraph 6 states that "direct loan origination costs of a completed loan shall include only (a) incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender for that loan." Those specified activities do not include advertising or marketing. Paragraph 7 states that "all other lending-related costs, including costs related to activities performed by the lender for advertising [and] soliciting potential borrowers . . . shall be charged to expense as incurred."

### **Guidance That Is Not Included in Category (a) of Paragraph 10 of SAS No. 69 but That Is Not Affected by This SOP**

#### **Industry Audit Guide *Audits of Stock Life Insurance Companies***

Paragraphs 8.27 to 8.30 of the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies* state that acquisition expenses should be deferred only if the expense both varies with and is primarily related to the production of new business. Paragraph 8.30 of the guide states that advertising activities are acquisition activities.

Advertising activities that are policy acquisition activities should continue to be accounted for in conformity with the guidance in FASB Statement No. 60 and *Audits of Stock Life Insurance Companies*.

#### **Audit and Accounting Guide *Audits of Property and Liability Insurance Companies***

Paragraphs 3.34 and 8.13 of the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* state that acquisition costs that vary with and are primarily related to the acquisition of new and renewal business should be capitalized as deferred acquisition costs. The guide does not state whether advertising activities are acquisition activities.

Advertising activities that are policy acquisition activities should continue to be accounted for in conformity with the guidance in FASB Statement No. 60 and *Audits of Property and Liability Insurance Companies*.

### **FASB Technical Bulletin No. 90-1**

FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, discusses advertising costs incurred in connection with acquiring extended warranty and product maintenance contracts. Paragraph 4 states the following:

Costs that are directly related to the acquisition of a contract and that would have not been incurred but for the acquisition of that contract (incremental di-

rect acquisition costs) should be deferred and charged to expense in proportion to the revenue recognized. All other costs, such as . . . advertising expenses . . . should be charged to expense as incurred.

## **Guidance That Is Not Included in Category (a) of Paragraph 10 of SAS No. 69 That Is Amended by This SOP**

### **SOP 88-1**

AICPA SOP 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications*, paragraphs 19 to 24 [section 10,430.19–24], amends *Audits of Airlines* by recommending that the probable future economic benefits of developmental activities not be reported as assets, “because of the current deregulated environment and the uncertainty regarding the recoverability” of the costs of such activities. The SOP states that the basis for the conclusion in the guide was that the airline industry operated in a regulated environment and “the expected future benefit and recoverability of such costs was generally not in doubt . . . . Route expansion or alteration has become a recurring activity among the airlines, and any related cost is considered a normal and recurring cost of conducting business.”

Paragraph 51 of this SOP discusses amendments to SOP 88-1 [section 10,430.51].

### **SOP 89-5**

Paragraphs 50 to 54 of SOP 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services*, discuss accounting for contract acquisition costs. Paragraph 51 lists advertising as one kind of contract acquisition cost. Paragraph 54 states that “. . . acquisition costs of providers of prepaid health care services should be expensed as incurred.”

Paragraph 52 of this SOP discusses amendments to SOP 89-5.

### **SOP 90-8**

Paragraph 65 of SOP 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities*, states the following:

Costs of acquiring initial continuing-care contracts that are expected to be recovered from future contract revenues should be capitalized. These costs should be amortized to expense on a straight-line basis over the average expected remaining lives of the residents under contract or the contract term, if shorter. Costs of acquiring continuing-care contracts after a CCRC [continuing-care retirement community] is substantially occupied or one year following completion should be expensed when incurred.

Paragraph 15 states that advertising is not a cost of acquiring an initial continuing-care contract.

Some believe that SOP 90-8 includes no guidance for reporting the costs of advertising activities. Others believe that the exclusion of advertising activities from the definition of the costs of acquiring an initial continuing-care contract is a prohibition against capitalizing advertising under the guidance in paragraph 63.

Paragraph 53 of this SOP discusses amendments to SOP 90-8.

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## Section 10,610

# Statement of Position 94-3 Reporting of Related Entities by Not-for-Profit Organizations

September 2, 1994

### NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## Introduction

.01 The purpose of this statement of position (SOP) is to provide guidance to users and preparers of not-for-profit organizations' financial statements that will produce greater uniformity and comparability in the reporting of investments in majority-owned for-profit subsidiaries, investments in less than 50-percent-owned for-profit entities, and related but separate not-for-profit organizations. This SOP does not address how to prepare consolidated financial statements,<sup>1</sup> nor does it address all the conceptual issues underlying the reporting of relationships not evidenced by ownership.<sup>2</sup>

## Scope

.02 This SOP—

- Amends and makes uniform the guidance concerning the reporting of related entities in the following AICPA publications:

<sup>1</sup> Consolidation of a parent and subsidiary organizations requires the presentation of a single set of amounts for the entire reporting entity. Combination, as discussed in paragraphs 22 and 23 of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, refers to financial statements prepared for organizations among which common control exists but for which the parent-subsidiary relationship does not exist. Both consolidation and combination require elimination of interorganization transactions and balances. This SOP provides no guidance concerning commonly controlled not-for-profit organizations.

<sup>2</sup> As discussed in appendix C [paragraph .18], the Financial Accounting Standards Board (FASB) has on its agenda a project on consolidations and related matters. One of the phases of that project concerns financial reporting guidance for not-for-profit entities.

- Industry Audit Guides *Audits of Voluntary Health and Welfare Organizations* and *Audits of Colleges and Universities*
- Audit and Accounting Guide *Audits of Certain Nonprofit Organizations*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*<sup>3</sup>
- Does not apply to entities or activities that are covered by the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*

## Conclusions

.03 This SOP provides guidance for reporting (a) investments in for-profit majority-owned subsidiaries, (b) investments in common stock of for-profit entities wherein the not-for-profit organization has a 50 percent or less voting interest, and (c) financially interrelated not-for-profit organizations.

.04 Whether the financial statements of a reporting not-for-profit organization and those of one or more other entities should be consolidated, whether those other entities should be reported using the equity method, and the extent of the disclosure that should be required, if any, should be based on the nature of the relationships between the entities.

## Investments in For-Profit Majority-Owned Subsidiaries

.05 Not-for-profit organizations with a controlling financial interest in a for-profit entity through direct or indirect ownership of a majority voting interest in that entity should follow the guidance in ARB 51, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, in determining whether the financial position, results of operations, and cash flows of the for-profit entity should be included in the not-for-profit organization's financial statements.

## Investments in Common Stock of For-Profit Entities Wherein the Not-for-Profit Organization Has a 50 Percent or Less Voting Interest

.06 Investments in common stock of for-profit entities wherein the not-for-profit organization has 50 percent or less of the voting stock in the investee should be reported under the equity method in conformity with Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, if the guidance in that Opinion requires use of the equity method, subject to the exception in paragraph .07 of this SOP. Also, not-for-profit organizations should make the financial statement disclosures required by APB Opinion 18 if the guidance in that Opinion requires them.

.07 Some AICPA audit guides applicable to some not-for-profit organizations permit investment portfolios to be reported at market value. Not-for-profit organizations that choose to report investment portfolios at market value in conformity with the AICPA audit guides may do so instead of applying the equity method to investments covered by paragraph .06 of this SOP.

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<sup>3</sup> SOP 78-10 has no effective date. This SOP amends, but does not affect the status of, SOP 78-10.

## Financially Interrelated Not-for-Profit Organizations

.08 Not-for-profit organizations may be related to one or more other not-for-profit organizations in numerous ways, including ownership, *control*,<sup>4</sup> and *economic interest*.

.09 As discussed in paragraphs .10–.13, the various kinds and combinations of control and economic interest result in various financial reporting. Certain kinds of control result in consolidation (paragraph .10). Other kinds of control result in consolidation only if coupled with an economic interest (paragraph .11). Still other kinds of control result in consolidation being permitted but not required if coupled with an economic interest (paragraph .12). The existence of control or an economic interest, but not both, is discussed in paragraph .13.

.10 Not-for-profit organizations with a controlling financial interest in another not-for-profit organization through direct or indirect ownership of a majority voting interest in that other not-for-profit organization should consolidate that other organization, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.

.11 In the case of (a) control through a majority ownership interest<sup>5</sup> by other than ownership of a majority voting interest, as discussed in paragraph .10, or control through a *majority voting interest in the board of the other entity* and (b) an economic interest in other such organizations, consolidation is required, unless control is likely to be temporary or does not rest with the majority owner, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94.<sup>6</sup>

.12 Control of a separate not-for-profit organization in which the reporting organization has an economic interest may take forms other than majority ownership or voting interest; for example, control may be through contract or affiliation agreement. In circumstances such as these, consolidation is permitted but not required, unless control is likely to be temporary, in which case consolidation is prohibited, as discussed in paragraph 13 of FASB Statement No. 94. If the reporting organization controls a separate not-for-profit organization through a form other than majority ownership or voting interest and has an economic interest in that other organization, and consolidated financial statements are not presented, the notes to the financial statements should include the following disclosures:

- Identification of the other organization and the nature of its relationship with the reporting organization that results in control

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<sup>4</sup> Words or terms defined in the Glossary [paragraph .20] are in italicized type the first time they appear in this SOP.

<sup>5</sup> Ownership of not-for-profit organizations may be evidenced in various ways because not-for-profit organizations may exist in various legal forms, such as corporations issuing stock, corporations issuing ownership certificates, membership corporations issuing membership certificates, joint ventures, and partnerships, among other forms.

<sup>6</sup> Interests by not-for-profit organizations in other not-for-profit organizations may be less than complete interests. For example, a not-for-profit organization may appoint 80 percent of the board of the other not-for-profit organization. If the conditions for consolidation in this SOP are met, the basis of that consolidation would not reflect a minority interest for the portion of the board that the reporting not-for-profit organization does not control, because there is no ownership interest other than the interest of the reporting not-for-profit organization. However, some not-for-profit organizations may enter into agreements with other entities, such as sharing revenue from fund-raising campaigns, resulting in liabilities to those other entities. In such circumstances, those liabilities should be reported.

- Summarized financial data of the other organization including—
  - Total assets, liabilities, net assets, revenue, and expenses
  - Resources that are held for the benefit of the reporting organization or that are under its control
- The disclosures set forth in FASB Statement No. 57, *Related Party Disclosures*

.13 In the case of control and an economic interest, the presentation of consolidated financial statements, as discussed in paragraph .11, or the disclosures, as discussed in paragraph .12, are required. The existence of control or an economic interest, but not both, precludes consolidation, except as stated in the next sentence, but requires the disclosures set forth in FASB Statement No. 57.<sup>7</sup> Entities that otherwise would be prohibited from presenting consolidated financial statements under the provisions of this SOP, but that currently present consolidated financial statements in conformity with the guidance in SOP 78-10, may continue to do so.

.14 If consolidated financial statements are presented, they should disclose any restrictions made by entities outside of the reporting entity on distributions from the controlled not-for-profit organization to the reporting organization and any resulting unavailability of the net assets of the controlled not-for-profit organization for use by the reporting organization.

## Effective Date and Transition

.15 This SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than \$5 million in total assets and less than \$1 million in annual expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995. Earlier application is permitted. For organizations that adopt FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, prior to its effective date, earlier application of this SOP is encouraged. Comparative financial statements for earlier periods included with those for the period in which this SOP is adopted should be restated.

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<sup>7</sup> The existence of an economic interest does not necessarily cause the entities to be related parties, as defined in FASB Statement No. 57. However, the disclosures required by that Statement also are required under this SOP if an economic interest exists.



## Appendix A

### Background Information and Discussion of Conclusions

A-1. This section discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

### Background

#### *Characteristics and Objectives of Financial Reporting*

A-2. FASB Statement of Financial Accounting Concepts No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, states, among other things, that financial reporting by not-for-profit organizations should provide information—

... that is useful to ... resource providers ... in making rational decisions about the allocation of resources to those organizations. (paragraph 35)

and that is

... about the economic resources, obligations, and net resources of an organization and the effects of transactions ... that change resources and interests in those resources. (paragraph 43)

A-3. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, as amended by FASB Concepts Statement No. 6, *Elements of Financial Statements*, examines the characteristics that make accounting information useful. The Statement sets forth a hierarchy of qualities, with usefulness for decision making being most important. The two primary characteristics that make accounting information useful are relevance and reliability. Comparability, which includes consistency, interacts with relevance and reliability to increase the usefulness of information.

A-4. Information about the nature of relationships and forms of control among not-for-profit organizations and between not-for-profit organizations and for-profit entities should contribute to the objectives set forth in FASB Concepts Statement No. 4, as well as meet the criteria for accounting information set forth in Concepts Statement No. 2. As indicated in paragraphs A-11 and A-12 of this SOP, the information currently presented in not-for-profit organizations' financial statements may not meet the objectives set forth in Concepts Statement No. 4.

A-5. Related but separate not-for-profit organizations and for-profit entities result from the following:

- a. The decision of not-for-profit organizations to structure their operations in a manner that helps them achieve their mission
- b. Investments by not-for-profit organizations in for-profit entities

#### *Structure of Not-for-Profit Organizations*

A-6. Not-for-profit organizations conduct their operations through a variety of organizational structures. *The Not-For-Profit Organization Reporting Entity* (the Holder Report), a 1986 research report by William W. Holder, identifies three basic kinds of organizational structure:

- a. *Simple structures*, consisting of a single entity that conducts all operations and activities of the organization
- b. *Separate entities*, conducting individual program activities
- c. *Single entity and separate entities*, conducting, respectively, program activities and support and other noncentral activities, such as fund-raising

### **Relationship of Separate Entities to Each Other**

A-7. The Holder Report, as well as other studies, identified a variety of relationships that could indicate that the resources and activities of an entity are controlled by another entity. Among the most widespread are the following:

- *Ownership*—One entity is the legal owner of another entity, either through stock ownership or some other means, such as membership in a membership corporation.
- *Board membership*—(a) One entity has the ability to appoint or elect a voting majority of the board of directors of another entity or (b) a voting majority of one entity's board, as a result of its charter or bylaws, is also a voting majority of the board of another entity.
- *Charter or bylaws*—The corporate charter or bylaws of an entity limits its activities to those that are beneficial to another entity.
- *Oversight relationship*—A national charter establishes conditions, such as financial relationships or an accreditation process, for a separate entity's use of a national name or participation in the activities of a national organization.
- *Contract*—The relationship between separate entities is spelled out in a written contract.

### **Factors Influencing Relationships of Separate Entities to Each Other**

A-8. According to the Holder Report, the most common reasons for establishing separate entities are the following:

- *Taxes*—To ensure the income tax deductibility of contributions by donors and to avoid problems of unrelated business income for taxation purposes
- *Legal*—To limit legal liability; protect funding sources; and avoid laws, rules, and regulations perceived to be overly restrictive
- *Organization*—To establish clear-cut organizational limits of authority and autonomy for various activities
- *Public identity*—To create a separate, distinct public identity for the specific activity in question

Generally, entities that are established for these reasons are not-for-profit organizations; however, they also may be for-profit entities, principally for tax reasons.

### **Not-for-Profit Organization Investment Portfolio Relationships**

A-9. Not-for-profit organizations' investment portfolios may include ownership interests in for-profit entities. Such investments generally are made to earn returns on assets rather than to conduct operating activities and frequently are held for long-term investment purposes. Some not-for-profit organizations holding such investments own more than 20 percent interests in these for-profit organizations; for example—

- A federated fund-raising organization may hold a majority interest in an oil company.
- A not-for-profit organization's endowment fund may include controlling interests in shopping malls, commercial buildings, and venture capital funds.

Current practice for reporting such investments is diverse, including cost, lower of cost or market, fair market value, and the equity method. Such investments generally are not reported by consolidating their financial statements with the financial statements of the reporting not-for-profit organizations.

### **Current Authoritative Literature**

**A-10.** Current authoritative literature on reporting the resources and activities of related entities of which one or more is a not-for-profit organization is inconsistent. Two noteworthy instances are the following:

- Appendix B [paragraph .17] discusses the inconsistencies in the AICPA audit and accounting guides and the SOP listed in paragraph .02 of this SOP. Efforts to correct or address these inconsistencies will take a long time, and no immediate guidance is anticipated other than this SOP.
- There has been uncertainty in practice over whether and to what extent certain pronouncements of the FASB—for example, FASB Statement No. 94—apply to not-for-profit organizations. In September 1994, the AICPA Accounting Standards Executive Committee (AcSEC) issued SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations* [section 10,600], which provides that not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations except for specific pronouncements that explicitly exempt not-for-profit organizations.

Appendix C [paragraph .18] summarizes other projects related to this SOP and their current status.

### **Needs of Financial Statement Users**

**A-11.** Because of the variety of organizational structures, the nature of the relationships among separate entities, and the inconsistency of the guidance in the current authoritative accounting literature, the needs of users of not-for-profit organizations' financial reports described in FASB Concepts Statement Nos. 2 and 4 may not be met.

**A-12.** Among the deficiencies noted by creditors, identified in the Holder Report, are the following:

- Relationships with and among affiliated entities and other related parties are not always clear and readily understandable in an organization's financial reports.
- Creditors sometimes are unable to understand the scope of activities and range of entities that make up the reporting entity simply by reading the financial reports.
- Substantially different reporting practices exist for similar economic circumstances.

Among the deficiencies noted by grantors and contributors, also identified in the Holder Report, are the following:

- Reporting for fund-raising and administrative activities sometimes is fragmented into more than one set of financial statements.
- The level of disclosure in financial statements about the kinds of activities conducted and the existence and inclusion of related entities is inadequate. Of specific concern is whether all the resources controlled and all the activities conducted by a not-for-profit organization are included in its financial statements.

### **Reporting and Disclosures**

**A-13.** Relationships between not-for-profit organizations and other entities range from complete control of the other entities by a central organization to a loose association. These relationships have resulted in the following eight financial reporting alternatives:

- a. Consolidation or combination under the guidelines in ARB 51, FASB Statement No. 94, and SOP 78-10
- b. Reporting the investment under the equity method of accounting for investments
- c. Reporting the investment at cost
- d. Reporting the investment at market
- e. Reporting the investment at the lower of cost or market
- f. Disclosures similar to those under the AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*
- g. Related-party disclosures under the guidelines of FASB Statement No. 57
- h. No reporting or disclosures

### **Consolidation and Combination**

**A-14.** Drawing on ARB 51, FASB Statement No. 94, paragraph 1, states:

The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions.

**A-15.** SOP 78-10, which is included in the AICPA Audit and Accounting Guide *Audits of Certain Nonprofit Organizations* and which predates FASB Statement No. 94, states in paragraphs 42 and 43:

For a reporting organization that controls another organization having a compatible purpose, it is presumed that combined or combining financial statements are more meaningful than separate statements and are usually necessary for a fair presentation in conformity with generally accepted accounting principles. *Control* means the direct or indirect ability to determine the direction of the management and policies through ownership, by contract, or otherwise.

The accounting standards division has considered the foregoing definition in relation to the nonprofit organizations covered by this statement of position and has concluded that it may be construed by some to be so broad, considering

the structure of some nonprofit organizations, that presentation of combined financial statements might have relatively little value to users of such combined statements, particularly in relation to the cost of their preparation.

SOP 78-10, paragraph 44, states, in part:

... combined financial statements should be presented if (1) control exists as defined in paragraph 42 and (2) any of the following circumstances exists:

- a. Separate entities solicit funds in the name of and with the expressed or implied approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or used at its discretion or direction.
- b. A reporting organization transfers some of its resources to another separate entity whose resources are held for the benefit of the reporting organization.
- c. A reporting organization assigns functions to a controlled entity whose funding is primarily derived from sources other than public contributions.

### ***Equity Method***

A-16. APB Opinion 18 states in paragraph 17:

... the equity method of accounting for an investment in common stock should ... be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency.

### ***Disclosures***

A-17. Paragraph 13.04 of *Audits of Providers of Health Care Services* suggests presenting "summarized information about the assets, liabilities, results of operations, and changes in fund balances of related organizations" that "describe the nature of the relationships between ... the related organizations."

A-18. FASB Statement No. 57 requires the following disclosures for material related-party transactions:

- The existence and nature of the relationship
- A description of the transactions between the entities, summarized if appropriate, for the period reported on, including amounts, if any, and any other information deemed necessary to an understanding of the effects of those transactions on the reporting organization's financial statements
- The dollar volume of transactions between the entities and the effects of any changes in the method of establishing their terms from the preceding period
- Amounts due from or to the related entities, and, if not otherwise apparent, the terms and manner of settlement

## Discussion of Conclusions

### Scope

**A-19.** Consistent with the May 19, 1993, exposure draft of this SOP, this SOP does not apply to entities that are included in the scope of *Audits of Providers of Health Care Services*. AcSEC considered including those entities in the scope of this SOP but exempted them for practical purposes. The ways those entities are related to each other are evolving and may not be contemplated by this SOP. For example, many of those entities are affiliated based on participation in networks of health care providers, with complex contractual agreements that make it difficult to determine whether control and economic interest exist based on the definitions in this SOP. While AcSEC believes the basic principles in this SOP also may apply to those entities, further study and deliberation are necessary to determine whether this SOP would require clarification for it to be made operational for those entities. Further, AcSEC believes (a) there is a need for guidance now for entities included in the scope of this SOP and (b) including entities covered by *Audits of Providers of Health Care Services* in the scope of this SOP likely would delay its issuance. Accordingly, AcSEC concluded it should exclude entities that are required to follow *Audits of Providers of Health Care Services* from the scope of this SOP. Guidance for reporting related entities for entities covered by *Audits of Providers of Health Care Services* is expected to be included as part of the current project to revise that guide.

### Underlying Principles

**A-20.** The conclusions in this SOP are based on the premise that (a) whether the financial statements of a reporting not-for-profit organization and those of one or more other entities (either a not-for-profit organization or a for-profit entity) should be consolidated and (b) the extent of disclosure that should be required, if any, if consolidated financial statements are not presented should be based on the nature of the relationship between the entities.

### Control

**A-21.** This SOP does not develop new concepts concerning the definition of control. Because the FASB currently has on its agenda a project on consolidations and related matters that may result in a definition of control different from that contained in SOP 78-10, AcSEC concluded that it should not revise the definition of control at this time.

### Relation to Other Guidance

**A-22.** This SOP makes uniform the application of APB Opinion 18 and FASB Statement No. 94 for not-for-profit organizations with the following exception: This SOP permits not-for-profit organizations that otherwise would report their investment portfolios at market value in conformity with guidance in the not-for-profit audit guides to do so instead of adopting the equity method for unconsolidated subsidiaries and 50 percent or less owned entities. AcSEC permitted this exception because it believes uniform guidance will be issued by the FASB on reporting the overall investment activities of not-for-profit organizations as part of the FASB's project on not-for-profit organizations.

**A-23.** The conclusions in this SOP evolve from and consider the conclusions of SOP 78-10 and *Audits of Providers of Health Care Services* to provide uniform

criteria for consolidation. They provide for financial statement disclosures that can be applied objectively and that can curb potential abuses in not reporting (a) the results of separate but related entities established by a not-for-profit organization to raise funds on its own behalf and (b) assets controlled by another not-for-profit organization. (This SOP does not revise *Audits of Providers of Health Care Services*.)

**A-24.** This SOP requires consolidation if there is an economic interest and control by either a majority voting interest in the board of the other entity or the ability to appoint a majority of its board members. Some not-for-profit organizations are related to each other in ways that would meet the definition of control under this SOP. However, in the case of some of the organizations, no such economic interest exists. In circumstances of control other than a controlling financial interest in another not-for-profit organization through direct or indirect ownership of a majority voting interest, this SOP requires the existence of an economic interest for consolidation to be required or permitted. That provision is included in order to preclude the reporting of misleading information about the assets, liabilities, results of operations, and cash flows of the reporting organization.

### ***Economic Interest***

**A-25.** The Glossary [paragraph .20] of this SOP states that “[a]n *economic interest* in another entity exists if (a) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the not-for-profit organization, either directly or indirectly by producing income or providing services, or (b) the reporting organization is responsible for the liabilities of the other organization.” The Glossary [paragraph .20] includes examples of circumstances that result in economic interests, including a reporting organization assigning certain of its functions to another entity. For example, an educational institution assigning its research functions to a research corporation that holds significant resources that must be used for the unrestricted or restricted purposes of the reporting organization, either directly or indirectly, results in an economic interest in that research corporation. Also, an organization may have an economic interest in a lobbying organization if that lobbying organization conducts any of the organization’s lobbying functions and uses significant resources that must be used for the unrestricted or restricted purposes of the reporting organization, either directly or indirectly.

### ***Circumstances Permitting but Not Requiring Consolidation***

**A-26.** Paragraph .12 of this SOP permits but does not require consolidation if the reporting not-for-profit organization controls a separate not-for-profit organization in which it has an economic interest and that control is achieved other than control through—

- a. A controlling financial interest in the other not-for-profit organization through direct or indirect ownership of a majority voting interest or
- b. A majority voting interest in the board of the other entity.

AcSEC considered requiring consolidation in all circumstances in which the reporting not-for-profit organization controls and has an economic interest in another not-for-profit organization. However, AcSEC believes consolidation may not be meaningful in all situations in which there is control and an econo-

mic interest. For example, some national organizations may control local chapters through affiliation agreements and receive funds from those local chapters. In such circumstances, both control and an economic interest exist. However, consolidation may not be meaningful. AcSEC encourages consolidation if—

- a. The reporting not-for-profit organization controls a separate not-for-profit organization in which it has an economic interest and that control is other than control through—
  - i. A controlling financial interest in the other not-for-profit organization through direct or indirect ownership of a majority voting interest or
  - ii. A majority voting interest in the board of the other entity and
- b. Consolidation would be meaningful.

### ***Disclosures***

**A-27.** AcSEC believes the disclosures required by this SOP in circumstances in which control exists by contract, agreement, or otherwise provide financial statement users with information that is more meaningful than the information they now receive under the existing not-for-profit audit guides. The disclosure requirements in this SOP are an interim step until the FASB completes its consolidations and related matters project.

### ***Combined Financial Statements***

**A-28.** This SOP provides guidance concerning consolidated financial statements. As discussed in footnote 1, ARB 51 provides guidance concerning combined financial statements. Paragraph 22 of ARB 51 states that “there are circumstances, however, where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate statements.” This SOP prohibits consolidated financial statements in certain circumstances. However, it provides no guidance concerning combined financial statements of commonly controlled not-for-profit organizations, which may be presented, in certain circumstances, in conformity with the guidance in ARB 51.

### ***Parent or Subsidiary-Only Financial Statements***

**A-29.** This SOP provides no guidance concerning parent-entity-only or subsidiary-entity-only financial statements. Paragraph 15 of FASB Statement No. 94 precludes the use of parent-company financial statements for use as the general-purpose financial statements of the primary reporting entity. However, that Statement is silent concerning parent-company financial statements as other than general-purpose financial statements for the primary reporting entity. Generally accepted accounting principles do not preclude the issuance of subsidiary-only financial statements. However, care should be taken to include all disclosures required by FASB Statement No. 57 and other relevant pronouncements.



## Appendix B

### Other Financial Reporting Literature

**B-1.** The following discusses the authoritative and other financial reporting literature that is relevant to AcSEC's consideration of consolidated financial statements involving not-for-profit organizations. All references and discussion pertain to literature as it exists prior to being revised by this SOP. As discussed in paragraph .02, this SOP revises certain AICPA literature.

#### SOP 78-10

**B-2.** SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, is discussed in paragraph A-15 of this SOP. (As discussed in paragraph .02 of this SOP, this SOP amends SOP 78-10.)

### Audits of Providers of Health Care Services

**B-3.** The AICPA Audit and Accounting Guide *Audits of Providers of Health Care Services*, paragraph 13.02, recommends consolidation or combination of organizations related to health care entities by direct or common ownership in accordance with the provisions of ARB 51. In cases in which related organizations are controlled through means other than direct or common ownership and ARB 51 does not require consolidation, *Audits of Providers of Health Care Services* does not recommend consolidation or combination.

**B-4.** In circumstances in which *Audits of Providers of Health Care Services* does not recommend consolidation or combination, paragraph 13.04 of that guide requires disclosure of certain summarized information concerning the related organizations if control and at least one of the following circumstances exist:

- a. The organization has solicited funds in the name of the health care entity and with the expressed or implied approval of the health care entity, and substantially all the funds solicited by the organization were intended by the contributor, or were otherwise required, to be transferred to the health care entity or used at its discretion or direction.
- b. The health care entity has transferred some of its resources to the organization, and substantially all of the organization's resources are held for the benefit of the health care entity.
- c. The health care entity has assigned certain of its functions (such as the operation of a dormitory) to the organization, which is acting primarily for the benefit of the health care entity.

(As discussed in paragraph .02 of this SOP, this SOP does not amend *Audits of Providers of Health Care Services*.)

### Audits of Colleges and Universities

**B-5.** The AICPA Industry Audit Guide *Audits of Colleges and Universities*, paragraph 11.09, states:

For adequate disclosure, all separately incorporated but related units for which the reporting institution is fiscally responsible, such as university presses, in-

tercollegiate athletics, and research foundations, should be (1) included in the financial statements, (2) adequately disclosed by notes, or (3) presented in separate financial statements accompanied by and cross-referenced in the basic financial statements of the institution.

(As discussed in paragraph .02 of this SOP, this SOP amends *Audits of Colleges and Universities*.)

### **Audits of Voluntary Health and Welfare Organizations**

**B-6.** The AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* provides no guidance on whether consolidated financial statements should be presented. However, paragraphs 7.08 and 7.09 provide guidance for determining whether auditors should audit the financial statements of organizations associated with the reporting not-for-profit organization. (As discussed in paragraph .02 of this SOP, this SOP amends *Audits of Voluntary Health and Welfare Organizations*.)

## Appendix C

### Other Projects Related to This SOP

#### FASB Project on Consolidations and Related Matters

C-1. This project is addressing various issues concerning the reporting entity, including those relating specifically to not-for-profit organizations. The FASB issued its September 10, 1991, Discussion Memorandum, *Consolidation Policies and Procedures*. The conclusions in this SOP will be reconsidered when the FASB completes its project on consolidations and related matters, which may affect the definition of control and other related matters.

#### FASB Project on Investments

C-2. This project is addressing various issues concerning investments held by not-for-profit organizations. The project is in the preliminary stages. The conclusions in this SOP will be reconsidered when the FASB completes its project on investments, which may affect the conclusions concerning investments in common stock of for-profit entities wherein the not-for-profit organization has a 50 percent or less voting interest and other related matters.

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

C-3. In September 1994, AcSEC issued SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations* [section 10,600], which provides that not-for-profit organizations should follow the guidance in effective provisions of ARBs, APB Opinions, and FASB Statements and Interpretations except for specific pronouncements that explicitly exempt not-for-profit organizations.

#### AICPA Accounting and Audit Guide Revisions

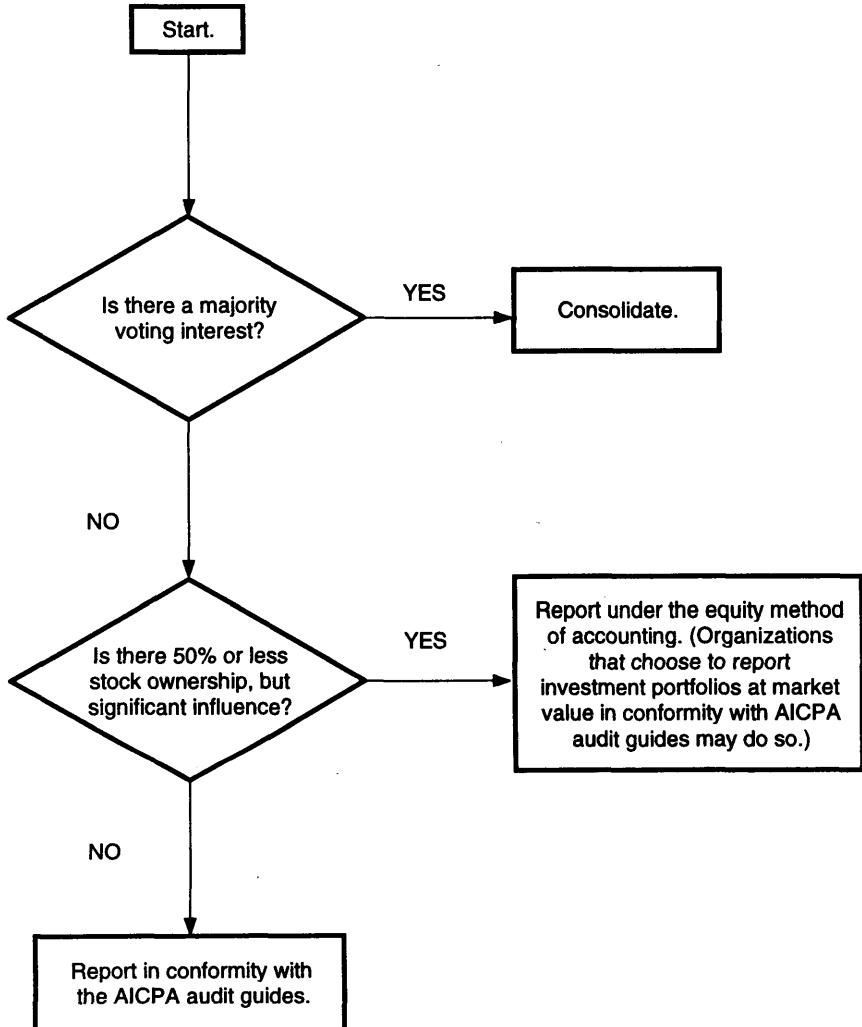
C-4. The AICPA will revise the existing audit and accounting guides for not-for-profit organizations and colleges and universities to reflect the accounting and reporting requirements of FASB Statement Nos. 116, *Accounting for Contributions Received and Contributions Made*, and 117, *Financial Statements of Not-for-Profit Organizations*, among other things.

.19

## Appendix D

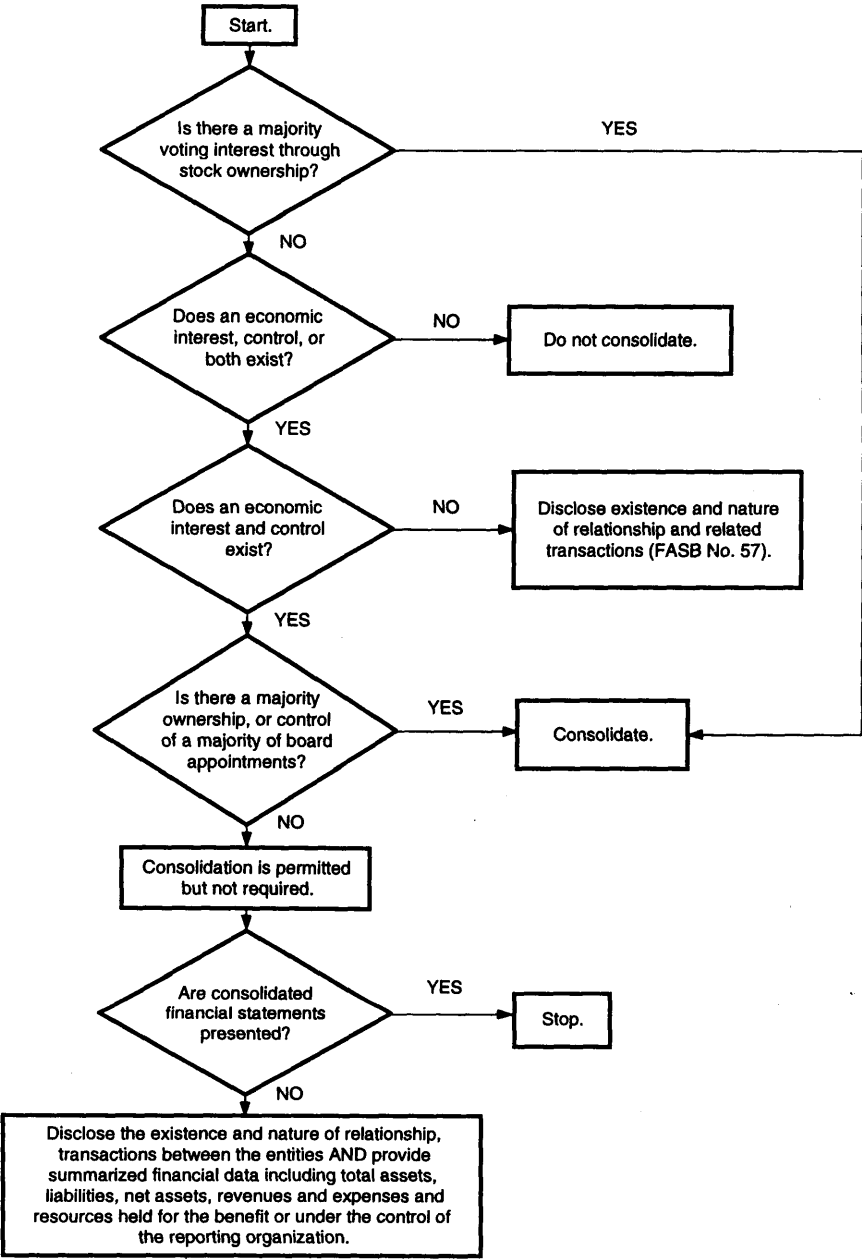
### Flowcharts and Decision Trees<sup>8</sup>

#### Ownership of a For-Profit Entity



<sup>8</sup> The flowcharts and decision trees summarize certain guidance in this SOP and are not intended as substitutes for the SOP.

Relationship With Another Not-for-Profit Organization



## Glossary

**Control.** The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.

**Economic interest.** An interest in another entity that exists if (a) the other entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the not-for-profit organization, either directly or indirectly by producing income or providing services, or (b) the reporting organization is responsible for the liabilities of the other entity. The following are examples of economic interests:

- Other entities solicit funds in the name of and with the expressed or implied approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or used at its discretion or direction.
- A reporting organization transfers significant resources to another entity whose resources are held for the benefit of the reporting organization.
- A reporting organization assigns certain significant functions to another entity.
- A reporting organization provides or is committed to provide funds for another entity or guarantees significant debt of another entity.

**Majority voting interest in the board of another entity.** For purposes of this SOP, a majority voting interest in the board of another entity is illustrated by the following example. Entity B has a five-member board, and a simple voting majority is required to approve board actions. Entity A will have a majority voting interest in the board of entity B if three or more entity A board members, officers, or employees serve on or may be appointed at entity A's discretion to the board of entity B. However, if three of entity A's board members serve on the board of entity B but entity A does not have the ability to require that those members serve on the entity B board, entity A does not have a majority voting interest in the board of entity B.

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The committees gratefully acknowledge the significant contributions of Mary F. Foster and Richard F. Larkin.

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[The next page is 19,961.]





## Section 10,620

### ***Statement of Position 94-4 Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans***

September 23, 1994

#### **NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## **Introduction**

.01 The American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) includes standards of financial accounting and reporting for the financial statements of health and welfare benefit plans and defined-contribution pension plans. The Guide states that plan investments are generally to be presented at their fair value at the reporting date. Paragraph 3.15 of the Guide states that "contracts with insurance companies are to be included as plan assets in the manner required by [the Employee Retirement Income Security Act of 1974] ERISA annual reporting requirements and are to be reported in a manner consistent with the requirements of [Department of Labor] DOL Form 5500 or 5500-C/R." Paragraph 4.10 of the Guide and paragraph 26 of AICPA Statement of Position (SOP) 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* [section 10,530.26], contain similar language. The instructions to DOL Forms 5500 and 5500-C/R permit unallocated insurance contracts to be reported at either fair value or amounts determined by the insurance company, that is, contract value. Currently, "contracts with insurance companies" include investment contracts that do not incorporate mortality or morbidity risk. The Guide specifically excludes contract value reporting for investments in similar contracts issued by banks, savings institutions, or other financial institutions. Contract value generally equals the principal balance plus accrued interest.

.02 The Financial Accounting Standards Board (FASB) has issued Statement of Financial Accounting Standards Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*, which requires defined-benefit pension plans to report investment contracts issued by either an insurance enterprise or other entity at fair value. It amends FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, to permit defined-benefit pension plans to report only contracts that incorporate mortality or morbidity risk at contract value. The FASB decided not to address the measurement of plan assets held by health and welfare benefit plans or defined-contribution pension plans. Instead, the FASB asked the AICPA, in view of its experience with those plans, to address further the appropriate reporting of investments held by those plans.

## Scope

.03 This SOP provides guidance on the reporting of investment and insurance contracts held by health and welfare benefit plans and defined-contribution pension plans. It applies to all health and welfare benefit plans and defined-contribution pension plans. The Appendix [paragraph .20] provides guidance for determining the values of investment contracts held by defined-contribution plans, including both health and welfare, and pension plans; however, certain examples may also be useful in determining the fair value of investment contracts held by other types of plans.

## Conclusions

### Reporting of Contracts

.04 Defined-benefit health and welfare benefit plans should report investment contracts at fair value. Defined-contribution plans, including both health and welfare and pension plans, should report fully benefit-responsive investment contracts at contract value, which may or may not be equal to fair value, and all other investment contracts at fair value. If, however, plan management is aware that an event has occurred that may affect the value of a fully benefit-responsive contract (for example, a decline in the creditworthiness of the contract issuer or third-party guarantor—if different from the contract issuer—or the possibility of premature termination of the contract by the plan), pursuant to FASB Statement No. 5, *Accounting for Contingencies*, disclosure of the event or reporting the investment at less than contract value may be appropriate.

.05 Health and welfare benefit plans and defined-contribution pension plans should report insurance contracts in the same manner required by ERISA annual reporting requirements of DOL Form 5500 or 5500-C/R. For purposes of this SOP, the terms *insurance contract* and *investment contract* are used as those terms are described for accounting purposes in FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises*, and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (see paragraphs .13 and .14).

## Background

.06 Defined-benefit plans provide participants with a determinable benefit based on a formula provided for in the plans, whereas defined-contribution

plans provide benefits based on amounts contributed to an employee's individual account plus or minus forfeitures, investment experience, and administrative expenses. The Internal Revenue Code (IRC) generally requires that all investment experience under defined-contribution plans be allocated to individual account balances.

.07 Consequently, information relevant to the primary users of defined-contribution plan financial statements—plan participants—is different from that which is relevant to users of defined-benefit plan financial statements. In defined-contribution plans, plan participants have a greater vested interest in monitoring the financial condition and operations of the plan since they bear investment risk under these plans and plan transactions can directly affect their benefits.

.08 The primary objective of a defined-contribution plan's financial statements is to provide information that is useful in assessing the plan's present and future ability to pay benefits when they are due. In a defined-contribution plan, the plan's net assets available to pay benefits equal the sum of participants' individual account balances. Accordingly, benefits that can be paid by the plan when they are due relate to the value of the assets that may currently be made available to the individual participants.

.09 Consistent with the objective of a defined-contribution plan's financial statements, plan assets of defined-contribution plans should be measured and reported at values that are meaningful to financial statement users. Information that is useful to plan participants includes the amount they would receive currently if they were to withdraw or borrow funds from or transfer funds within the plan.

.10 A fully benefit-responsive investment contract (whether with an insurance enterprise or other entity) provides a liquidity guarantee by a financially responsible third party of principal and previously accrued interest for liquidations, transfers, loans, or hardship withdrawals initiated by plan participants exercising their rights to withdraw, borrow, or transfer funds under the terms of the ongoing plan. From the perspective of the participants, the contract value of a fully benefit-responsive investment contract held by a plan is the amount they would receive if they were to initiate transactions under the terms of the ongoing plan.

.11 For purposes of this SOP, benefit responsiveness is defined as the extent to which a contract's terms or related agreement and the plan itself permit and require withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Investment contracts frequently are negotiated directly between the plan and the issuer and generally prohibit assignment of the contracts or their proceeds to another party. Investment contracts must transfer principal and accrued interest risk to a financially responsible third party (that is, they provide for all participant-initiated transactions permitted by an ongoing plan at contract value with no conditions, limits, or restrictions) to be considered fully benefit-responsive. The plan itself must also allow plan participants reasonable access to their funds. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally

not be deemed to be fully benefit-responsive. However, in plans with a single investment fund that allow reasonable access to assets by inactive participants, restrictions on access to assets by active participants consistent with the objective of the plan (for example, retirement or health and welfare benefits) will not affect the benefit responsiveness of the investment contracts held by those single-fund plans. Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control the administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan. In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed-rate investment options to limit arbitrage among those investment options (*equity wash* provisions) would not affect a contract's benefit responsiveness.

.12 If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive. Contracts that provide for prospective interest adjustments may still be fully benefit-responsive provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero. The Appendix [paragraph .20] to this SOP includes examples of the application of fair value and contract value reporting for defined-contribution plan investments.

.13 As discussed in paragraph .05, for purposes of this SOP, the terms *insurance contract* and *investment contract* are described for accounting purposes in FASB Statements No. 60 and No. 97. Paragraph 1 of FASB Statement No. 60 describes insurance contracts:

The primary purpose of insurance is to provide economic protection from identified risks occurring or discovered within a specified period. Some types of risks insured include death, disability, property damage, injury to others, and business interruptions. Insurance transactions may be characterized generally by the following:

- a. The purchaser of an insurance contract makes an initial payment or deposit to the insurance enterprise in advance of the possible occurrence or discovery of an insured event.
- b. When the insurance contract is made, the insurance enterprise ordinarily does not know if, how much, or when amounts will be paid under the contract.

.14 Paragraphs 7 and 8 of FASB Statement No. 97 describe insurance and investment contracts:

Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are referred to in this Statement as investment contracts. A mortality or morbidity risk is present if, under the terms of the contract, the enterprise is required to make payments or forego required premiums contingent upon the death or disability (in the case of life insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals. A contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms.

Annuity contracts may require the insurance enterprise to make a number of payments that are not contingent upon the survival of the beneficiary, followed by payments that are made if the beneficiary is alive when the payments are due (often referred to as life-contingent payments). Such contracts are considered insurance contracts under this Statement and Statement 60 unless (a) the probability that life-contingent payments will be made is remote or (b) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant. [Footnote references omitted.]

## Disclosure Requirements

.15 Defined-contribution plans, including both health and welfare, and pension plans, should disclose the following in connection with fully benefit-responsive investment contracts in the aggregate by investment option:

- a. The average yield for each period for which a statement of net assets available for benefits is presented
- b. The crediting interest rate as of the date of each statement of net assets available for benefits presented
- c. The amount of valuation reserves recorded to adjust contract amounts (for example, due to problems with the creditworthiness of the contract issuer or third-party guarantor)
- d. The fair value of investment contracts reported at contract value, in accordance with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*.

Those plans should also provide a general description of the basis and frequency of determining crediting interest-rate resets and any minimum crediting interest rate under the terms of the contracts and any limitations on guarantees (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives).

.16 For ERISA-covered plans, if a fully benefit-responsive investment contract does not qualify for contract-value reporting in the DOL Form 5500 but is reported in the financial statements at contract value, and the contract value does not approximate fair value, the DOL's rules and regulations require that a statement explaining the differences between amounts reported in the financial statements and DOL Form 5500 be added to the financial statements.

## Amendments to the Guide

.17 The Guide is amended as follows:

- a. The parenthetical comment (*see paragraph 3.15 for special provisions concerning the valuation of contracts with insurance companies*) in paragraph 3.12 is replaced by (*see paragraph 3.13 for special provisions concerning the valuation of insurance contracts and paragraph 3.17 for special provisions concerning the valuation of fully benefit-responsive investment contracts*).
- b. The following paragraph is inserted as paragraph 3.13:

Insurance contracts, as defined by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, should be presented in

the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA; that is, either at fair value or at amounts determined by the insurance enterprise (contract value). Plans not subject to ERISA should present insurance contracts as if the plans were subject to the reporting requirements of ERISA.

- c. Paragraph 3.13 is renumbered as paragraph 3.14. The second sentence of that paragraph is replaced by the following:

Examples include real estate, mortgages, or other loans (including loans to participants of a 401(k) plan), restricted securities, unregistered securities, securities for which the market is thin, and non-transferable investment contracts.

- d. Paragraph 3.14 is renumbered as paragraph 3.15.

- e. Paragraph 3.15 is replaced by the following:

3.16 Defined-contribution pension plans provide benefits based on the amounts contributed to employees' individual accounts plus or minus forfeitures, investment experience, and administrative expenses. In such plans, plan participants have a vested interest in monitoring the financial condition and operations of the plan since they bear investment risk under these plans, and plan transactions can directly affect their benefits (for example, investment mix, and risk and return).

3.17 Plan assets of defined-contribution pension plans should be measured and reported at values that are meaningful to financial statement users, including plan participants. The contract value of a *fully benefit-responsive* investment contract held by a plan is the amount a participant would receive if he or she were to initiate transactions under the terms of the ongoing plan. Defined-contribution pension plans should report fully benefit-responsive investment contracts at contract value, which may or may not be equal to fair value. If, however, plan management is aware that an event has occurred that may affect the value of the contract (for example, a decline in the creditworthiness of the contract issuer or third-party guarantor—if different from the contract issuer—or the possibility of premature termination of the contract by the plan), pursuant to FASB Statement No. 5, *Accounting for Contingencies*, disclosure of the event or reporting the investment at less than contract value may be appropriate.

3.18 *Benefit responsiveness* is the extent to which a contract's terms permit and require withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Investment contracts frequently are negotiated directly between the plan and the issuer and generally prohibit assignment of the contracts or their proceeds to another party. Investment contracts must transfer the risk of principal and accrued interest to a financially responsible third party (that is, they provide for all participant-initiated transactions permitted by an ongoing plan at contract value with no conditions, limits, or restrictions) to be considered fully benefit-responsive. The plan itself must also allow plan participants reasonable access to their funds. If access to funds

is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally not be deemed to be fully benefit-responsive. However, in plans with a single investment fund that allow reasonable access to assets by inactive participants, restrictions on access to assets by active participants consistent with the objective of the plan (for example, retirement or health and welfare benefits) will not affect the benefit responsiveness of the investment contracts held by those single-fund plans. Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control the administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan. In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed-income investment options to limit arbitrage among those investment options (*equity wash* provisions) would not affect a contract's benefit responsiveness.

3.19 If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive. Contracts that provide for prospective interest adjustments may still be fully benefit-responsive provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero.

- f. The phrase *contracts with insurance companies* in paragraph 3.22 is replaced by *insurance contracts*.
- g. The following is added to paragraph 3.23:
  - o. For benefit-responsive investment contracts in the aggregate by investment option—
    - The average yield for each period for which a statement of net assets available for benefits is presented
    - The crediting interest rate as of the date of each statement of net assets available for benefits presented
    - The amount of valuation reserves recorded to adjust contract amounts (for example, due to problems with the creditworthiness of the contract issuer or third-party guarantor)
    - The fair values of fully benefit-responsive investment contracts reported at contract value, in accordance with FASB Statement No. 107.
  - p. A general description of the basis and frequency of determining crediting interest rate resets and any minimum crediting inter-

est rate under the terms of fully benefit-responsive investment contracts and any limitations on related liquidity guarantees (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives).

- q. For ERISA-covered plans, if a fully benefit-responsive investment contract does not qualify for contract-value reporting in the DOL Form 5500, but is reported in the financial statements at contract value, and the contract value does not approximate fair value, the DOL's rules and regulations require that a statement explaining the differences between amounts reported in the financial statements and DOL Form 5500 be added to the financial statements.
- h. The parenthetical comment (*excluding contracts with insurance companies*) in paragraph 4.09 is replaced by (*excluding insurance contracts and fully benefit-responsive investment contracts held by defined-contribution health and welfare plans*).

- i. Paragraph 4.10 is replaced by the following:

4.10 Insurance contracts, as defined by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, should be presented in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA; that is, either at fair value or at amounts determined by the insurance enterprise (contract value). Plans not subject to ERISA should present insurance contracts as if the plans were subject to the reporting requirements of ERISA.

4.11 Investment contracts held by defined-benefit health and welfare benefit plans should be reported at their fair values.

4.12 Defined-contribution health and welfare benefit plans provide benefits based on the amounts contributed to employees' individual accounts plus or minus forfeitures, investment experience, and administrative expenses. In such plans, plan participants have a vested interest in monitoring the financial condition and operations of the plan since they bear investment risk under these plans, and plan transactions can directly affect their benefits (for example, investment mix, and risk and return).

4.13 Plan assets of defined-contribution health and welfare benefit plans should be measured and reported at values that are meaningful to financial statement users including plan participants. The contract value of a *fully benefit-responsive* investment contract held by a defined-contribution health and welfare benefit plan is the amount a participant would receive if he or she were to initiate transactions under the terms of the ongoing plan. Defined-contribution health and welfare plans should report fully benefit-responsive investment contracts at contract value, which may or may not be equal to fair value. If, however, plan management is aware that an event has occurred that may affect the value of the contract (for example, a decline in the creditworthiness of the contract issuer or third-party guarantor—if different from the contract issuer—or the possibility of premature termination of the contract by the plan),



pursuant to FASB Statement No. 5, *Accounting for Contingencies*, disclosure of the event or reporting the investment at less than contract value may be appropriate.

4.14 *Benefit responsiveness* is the extent to which a contract's terms permit and require withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Investment contracts frequently are negotiated directly between the plan and the issuer and generally prohibit assignment of contracts or their proceeds to another party. Investment contracts must transfer the risk of principal and accrued interest to a financially responsible third party (that is, they provide for all participant-initiated transactions permitted by an ongoing plan at contract value with no conditions, limits, or restrictions) to be considered fully benefit-responsive. The plan itself must also allow plan participants reasonable access to their funds. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally not be deemed to be fully benefit-responsive. However, in plans with a single investment fund that allow reasonable access to assets by inactive participants, restrictions on access to assets by active participants consistent with the objective of the plan (for example, retirement or health and welfare benefits) will not affect the benefit responsiveness of the investment contracts held by those single-fund plans. Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan. In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed income investment options to limit arbitrage among those investment options (*equity wash* provisions) would not affect a contract's benefit responsiveness.

4.15 If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive. Contracts that provide for prospective interest adjustments may still be fully benefit-responsive, provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero.

- j. Paragraph 4.11 is renumbered as paragraph 4.15. References to 4.26f and 4.26g are changed to 4.30f and 4.30g, respectively.
- k. The phrase *contracts with insurance companies* in paragraph 4.25a is replaced by *insurance contracts*.

- l. The following is added to paragraph 4.26:
  - i. For benefit-responsive investment contracts held by defined-contribution health and welfare plans, in the aggregate by investment option—
    - The average yield for each period for which a statement of net assets available for benefits is presented
    - The crediting interest rate as of the date of each statement of net assets available for benefits presented
    - The amount of valuation reserves recorded to adjust contract amounts (for example, due to problems with the credit-worthiness of the contract issuer or third-party guarantor)
    - The fair values of fully benefit-responsive investment contracts reported at contract value, in accordance with FASB Statement No. 107
  - j. A general description of the basis and frequency of determining crediting interest rate resets and any minimum crediting interest rate under the terms of fully benefit-responsive investment contracts and any limitations on related liquidity guarantees (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives).
  - k. For ERISA-covered plans, if a fully benefit-responsive investment contract does not qualify for contract-value reporting in the DOL Form 5500 but is reported in the financial statements at contract value, and the contract value does not approximate fair value, the DOL's rules and regulations require that a statement explaining the differences between amounts reported in the financial statements and DOL Form 5500 be added to the financial statements.
- m. The heading that precedes paragraph 7.23, *Insurance Contracts*, is replaced by *Contracts With Insurance Companies*.
- n. The second sentence in footnote 32 to paragraph 7.36 is replaced by the following:
 

A plan's share would be the value of its units determined in accordance with applicable guidance for valuing investment contracts, and the funds held in the separate account should be viewed as an unallocated funding arrangement. Each investment contract in the pooled account should be evaluated individually for benefit responsiveness. However, if the separate account places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive.
- o. The last sentence of paragraph 7.37 is replaced by the following:
 

These contracts are unallocated and are generally to be included as plan assets at their contract or fair values, as appropriate (see paragraphs 3.17 and 4.13).
- p. The phrase *insurance contracts* in paragraph 7.38a is replaced by *contracts with insurance companies*.

- q. The phrase *insurance contracts* in paragraph 7.39 is replaced by *contracts with insurance companies*.
- r. The third item of paragraph 7.39b is replaced by the following:
  - The value of the funds in the general or separate account at the plan's year-end and the basis for determining such value
- s. The Appendix [paragraph .20] of this SOP, *Application of Fair Value and Contract Value Reporting for Defined-Contribution Plan Investments*, is added as appendix I.

## Amendment to SOP 92-6 [section 10,530]

.18 SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* [section 10,530], is amended as follows:

- a. The parenthetical comment (*excluding contracts with insurance companies*) in paragraph 25 [section 10,530.25] is replaced by (*excluding insurance contracts and fully benefit-responsive investment contracts held by defined-contribution health and welfare benefit plans*).
- b. Paragraph 26 [section 10,530.26] is replaced by the following:

Insurance contracts, as defined by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, should be presented in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA; that is, either at fair value or at amounts determined by the insurance enterprise (contract value). Plans not subject to ERISA should present insurance contracts as if the plans were subject to the reporting requirements of ERISA.

- c. The following paragraphs are inserted as paragraphs 27, 28, 29, 30, and 31 [section 10,530.27 through .31]:

27. Investment contracts held by defined-benefit health and welfare benefit plans should be reported at their fair values.

28. Defined-contribution health and welfare benefit plans provide benefits based on the amounts contributed to employees' individual accounts plus or minus forfeitures, investment experience, and administrative expenses. In such plans, plan participants have a vested interest in monitoring the financial condition and operations of the plan since they bear investment risk under these plans, and plan transactions can directly affect their benefits (for example, investment mix, and risk and return).

29. Plan assets of defined-contribution health and welfare benefit plans should be measured and reported at values that are meaningful to financial statement users including plan participants. The contract value of a *fully benefit-responsive* investment contract held by a defined-contribution health and welfare benefit plan is the amount a participant would receive if he or she were to initiate transactions under the terms of the ongoing plan. Defined-contribution health and welfare benefit plans should report fully benefit-responsive investment contracts at contract value, which may or may not be equal to fair value. If, however, plan management is aware

that an event has occurred that may affect the value of the contract (for example, a decline in the creditworthiness of the contract issuer or third-party guarantor—if different from the contract issuer—or the possibility of premature termination of the contract by the plan), pursuant to FASB Statement No. 5, *Accounting for Contingencies*, disclosure of the event or reporting the investment at less than contract value may be appropriate.

30. *Benefit responsiveness* is the extent to which a contract's terms permit and require withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Investment contracts frequently are negotiated directly between the plan and the issuer and generally prohibit assignment of contracts or their proceeds to another party. Investment contracts must transfer the risk of principal and accrued interest to a financially responsible third party (that is, they provide for all participant-initiated transactions permitted by an ongoing plan at contract value with no conditions, limits, or restrictions) to be considered fully benefit-responsive. The plan itself must also allow plan participants reasonable access to their funds. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally not be deemed to be fully benefit-responsive. However, in plans with a single investment fund that allow reasonable access to assets by inactive participants, restrictions on access to assets by active participants consistent with the objective of the plan (for example, retirement or health and welfare benefits) will not affect the benefit responsiveness of the investment contracts held by those single-fund plans. Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control the administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan. In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed income investment options to limit arbitrage among those investment options (*equity wash* provisions) would not affect a contract's benefit responsiveness.

31. If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive. Contracts that provide for prospective interest adjustments may still be fully benefit-responsive provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero.

- d. Paragraph 27 is renumbered as paragraph 32 [section 10,530.32].

- e. The following is added to paragraph 53 [section 10,530.58]:
- For benefit-responsive investment contracts in the aggregate by investment option:
    - The average yield for each period for which a statement of net assets available for benefits is presented
    - The crediting interest rate as of the date of each statement of net assets available for benefits presented
    - The amount of valuation reserves recorded to adjust contract amounts (for example, due to problems with the credit-worthiness of the contract issuer or third-party guarantor)
    - The fair values of fully benefit-responsive investment contracts reported at contract value, in accordance with FASB Statement No. 107
  - A general description of the basis and frequency of determining crediting interest-rate resets and any minimum crediting interest rate under the terms of fully benefit-responsive investment contracts and any limitations on related liquidity guarantees (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives).
  - For ERISA-covered plans, if a fully benefit-responsive investment contract does not qualify for contract-value reporting in the DOL Form 5500 but is reported in the financial statements at contract value, and the contract value does not approximate fair value, the DOL's rules and regulations require that a statement explaining the differences between amounts reported in the financial statements and DOL Form 5500 be added to the financial statements.

## Effective Date and Transition

.19 This SOP is effective for financial statements for plan years beginning after December 15, 1994, except that the application of this SOP to investment contracts entered into before December 31, 1993, is delayed to plan years beginning after December 15, 1995. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this SOP should be made as of the beginning of the year in which the change is adopted. The effect of initially applying this SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle (Accounting Principles Board [APB] Opinion No. 20, *Accounting Changes*, paragraph 20). Pro forma effects of retroactive application (APB Opinion 20, paragraph 21) are not required. Restatement of financial statements of prior years is not permitted.

## Appendix

### Application of Fair Value and Contract Value Reporting for Defined-Contribution Plan Investments

**A.1** Fully benefit-responsive investment contracts held by defined-contribution plans, including both health and welfare, and pension plans that provide a liquidity guarantee by a financially responsible third party of principal and previously accrued interest for participant-initiated liquidations, transfers, loans, or hardship withdrawals under the terms of the ongoing plan, should be reported at contract value, which may or may not be equal to fair value. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. Other investment contracts should generally be reported at fair value.

**A.2** Investment contracts that do not provide a liquidity guarantee as discussed in paragraph A.1 may be valued by discounting the related cash flows based on current yields of similar investments with comparable durations. In determining the similarity of investments, appropriate consideration should be given to the credit quality of the contract issuer. Generally, contract termination (penalty) clauses need not be considered unless it is probable that the plan intends to terminate the contract.

**A.3** In the following examples, value is determined within the context of the objectives of financial statements for a defined-contribution plan. The valuation must reflect the ability of the plan to pay benefits from the perspective of the participants. This value is then reflected on participants' statements to disclose the amount they can expect to receive when they exercise their rights to withdraw, borrow, or transfer funds under the terms of the plan.

#### EXAMPLE 1

##### **A Five-Year Public Bond (or Portfolio of Bonds) Which Is Guaranteed by a Third Party to Have a Fixed Value at the End of Three Years**

**A.4** The guarantee applies only to the extent that the bond (or portfolio) is not liquidated prior to the end of three years. Liquidation within three years is at market value.

**A.5** Because guaranteed proceeds from the bond are not available for benefit withdrawals or transfers prior to maturity, the contract should be valued at fair value. Fair value may be determined as the amount at which the bond could be exchanged in a current transaction between parties, other than in a forced or liquidation sale, considering the guaranteed fixed value of the bond at the end of three years.

#### EXAMPLE 2

##### **A Benefit-Responsive Investment Contract**

**A.6** This contract provides a fixed crediting interest rate, and a financially responsible entity guarantees liquidity at contract value prior to maturity for

any and all participant-initiated benefit withdrawals, loans, or transfers arising under the terms of the plan, which allows access for all participants on a quarterly basis.

**A.7** The contract should be reported at contract value, because the plan will receive such value and only such value if the contract is accessed to pay participant benefits or transfers.

**A.8** The contract described in the preceding paragraph would be viewed as fully benefit-responsive. Examples of some variations on this contract, and their impact on the valuation, follow.

- a. *Liquidity at contract value is not guaranteed for benefits that are attributable to termination of the plan, a plan spin-off to a new employer plan, or amendments to plan provisions.* The contract should be reported at contract value unless it is probable that the plan will be terminated, spun off, or amended.
- b. *Liquidity at contract value is not guaranteed for benefits that are attributable to the layoff of a large group of workers or an early retirement program.* The contract should be reported at contract value unless it is probable that termination of the employment of a significant number of employees will occur.
- c. *The contract will pay for benefits of up to 30 percent of the contract at contract value, and any excess benefits will be at some adjusted value.* The contract should be reported at fair value. Fair value may be determined as the guaranteed amount plus the estimated discounted cash flows related to the amount in excess of 30 percent of the contract value.
- d. *The contract will pay benefits at contract value, but only if the issuer of the contract determines that there is sufficient liquidity in the portfolio of assets that backs the contract.* Because the third party has not guaranteed liquidity for participant-initiated withdrawals, the contract should be reported at fair value.
- e. *The contract will not pay benefits at contract value if benefits are due to participant transfers to another fixed income investment option, unless the funds are invested in an equity option for at least three months (equity wash provisions).* The contract should be reported at contract value.

### EXAMPLE 3

#### **A Five-Year, Nonbenefit-Responsive Investment Contract That Has No Liquid Market for Trading**

**A.9** The contract should be reported at fair value because there is no guarantee of liquidity at contract value. Fair value would be determined in the same manner as for an illiquid bond. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*, includes a discussion of methods used to determine the fair values of illiquid instruments.

**EXAMPLE 4****A Benefit-Responsive, Participating, Separate Account Investment Contract**

**A.10** A financially responsible issuer pays contract value for participant withdrawals, regardless of the value of the assets in the separate account. The credited interest rate is a function of the relationship between the contract value and the value of the assets in the separate account. The rate is reset periodically, daily, monthly, quarterly, and so on, by the issuer and cannot be less than zero. There may or may not be a specified maturity date on the contract. The contractholder may terminate the contract at any time, and receive the value of the assets in the separate account.

**A.11** The contract should be reported at contract value because participants are guaranteed return of principal and accrued interest.

**• EXAMPLE 5****A Synthetic Investment Contract—"Managed" Type**

**A.12** This contract operates similarly to a separate account guaranteed investment contract (GIC), except that the assets are placed in a trust (with ownership by the plan) rather than a separate account of the issuer and a financially responsible third party issues a *wrapper* contract that provides that participants can, and must, execute plan transactions at contract value.

**A.13** Inasmuch as trust assets are owned by the plan, the wrapper contract and the assets in trust should be separately valued and disclosed. The wrapper contract would be valued at the difference between the fair value of the trust assets and the contract value attributable by the wrapper to such assets. When considered together, the trust assets and the wrapper contract should be reported at the wrapper contract value because participants are guaranteed return of principal and accrued interest.

**EXAMPLE 6****A Synthetic Investment Contract—"Repurchase" Type**

**A.14** Under this contract, the plan purchases a bond and places it in trust. The plan then contracts with a financially responsible third party to provide benefit responsiveness. Under the contract, should the bond need to be sold to meet a participant-initiated withdrawal benefit, loan, or transfer, the plan is obligated to sell the bond to the contract issuer, and the issuer is obligated to buy the bond. The transaction price is defined under the contract (for example, amortized cost). The issuer is not obligated, however, to purchase securities that are in default.

**A.15** The contract, when considered together with the bond, should be reported at contract value (refer to paragraph A.13) absent impairment of the value of the securities due to credit risk because return of principal and accrued interest has been guaranteed to participants.



**A.16** If the contract provided only an *option* for the sponsor to sell the bond to the issuer, rather than an obligation to do so, contract value would only apply when the fair value of the bond was less than contract value, because the option would then have value. Fair value may be determined as the greater of the estimated discounted cash flows or the option price.

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The Employee Benefit Plans Committee gratefully acknowledges the contributions of Mary Ann Arlt, George Cowles, Victor Gallo, Timothy P. Moran, and Randi L. Starr, ad hoc task force members.

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[The next page is 19,991.]

**Section 10,630****Statement of Position 94-5  
Disclosures of Certain Matters in the  
Financial Statements of Insurance Enterprises****December 15, 1994****NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

**Introduction**

.01 Most of the accounting principles related to disclosures for insurance enterprises were promulgated over twenty years ago when the insurance regulatory and business environments were less complex and volatile. Accordingly, the AICPA Accounting Standards Executive Committee (AcSEC) added a project to its agenda to consider whether new disclosures should be required in insurance enterprises' financial statements. This statement of position (SOP) is a result of that project.

**Scope**

.02 This SOP applies to annual and complete sets of interim financial statements prepared in conformity with generally accepted accounting principles (GAAP) of life and health insurance enterprises (including mutual life insurance enterprises), property and casualty insurance enterprises, reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. Furthermore, AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis" (AICPA, *Professional Standards*, vol. 1, AU section 9623.60-.79), requires auditors to apply the same disclosure criteria for statutory financial statements as they do for financial statements prepared in conformity with GAAP.

## Relationship to Other Pronouncements

.03 In some circumstances, the disclosure requirements in this SOP may be similar to, or overlap, the disclosure requirements in certain other authoritative accounting pronouncements issued by the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), and the Securities and Exchange Commission (SEC). For example—

- FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, requires certain disclosures related to loss contingencies, including catastrophe losses of property and casualty insurance companies.
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, requires certain disclosures about liabilities for unpaid claims and claim adjustment expenses and statutory capital.
- FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, requires certain disclosures about reinsurance transactions.
- AICPA Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640], requires disclosures about certain significant estimates.
- The SEC Securities Act Guide 6, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters*, requires disclosures of information about liabilities for unpaid claims and claim adjustment expenses.

The disclosure requirements in this SOP supplement the disclosure requirements in other authoritative pronouncements. This SOP does not alter the requirements of any FASB or SEC pronouncement.

## Conclusions

.04 The disclosure requirements in this section should be read in conjunction with appendix A, "Illustrative Disclosures" [paragraph .13], and appendix B, "Discussion of Conclusions" [paragraph .14], of this SOP.

## Permitted Statutory Accounting Practices

.05 Insurance enterprises currently prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the insurance department of their state of domicile. The National Association of Insurance Commissioners (NAIC) currently has a project under way to codify statutory accounting practices through a complete revision of its *Accounting Practices and Procedures Manuals*, that, when complete, is expected to replace prescribed or permitted statutory accounting practices as the statutory basis of accounting for insurance enterprises (referred to hereafter as the "codification"). Therefore, the codification will likely result in changes to what is currently considered a prescribed statutory accounting practice. Furthermore, postcodification-permitted statutory accounting practices will be exceptions to the statutory basis of accounting.

.06 Prescribed precodification statutory accounting practices include state laws, regulations, and general administrative rules applicable to all in-

insurance enterprises domiciled in a particular state; *NAIC Annual Statement Instructions*; the *NAIC Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the *NAIC Examiners' Handbook*.

**.07** Permitted statutory accounting practices include practices not described in paragraph .06 but allowed by the domiciliary state insurance department. Insurance enterprises may request permission from the domiciliary state insurance department to use a specific accounting practice in the preparation of their statutory financial statements (a) when the enterprise wishes to depart from the prescribed statutory accounting practices, or (b) when prescribed statutory accounting practices do not address the accounting for the transaction.

**.08** The disclosures in this paragraph should be made for permitted statutory accounting practices for the most recent fiscal year presented, regardless of when the permitted statutory accounting practice was initiated. Insurance enterprises should disclose the following information about permitted statutory accounting practices that individually or in the aggregate materially affect statutory surplus or risk-based capital, including GAAP practices when the permitted practices differ from the prescribed statutory accounting practices:

- a. A description of the permitted statutory accounting practice
- b. A statement that the permitted statutory accounting practice differs from prescribed statutory accounting practices
- c. The monetary effect on statutory surplus

Insurance enterprises should disclose the following information about permitted statutory accounting practices, excluding GAAP practices used, when prescribed statutory accounting practices do not address the accounting for the transaction:

- a. A description of the transaction and of the permitted statutory accounting practice used
- b. A statement that prescribed statutory accounting practices do not address the accounting for the transaction

## **Liability for Unpaid Claims and Claim Adjustment Expenses**

**.09** The liability for unpaid claims and claim adjustment expenses represents the amounts needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the statement of financial position date). The estimated liability includes the amount of money that will be required for future payments of (a) claims that have been reported to the insurer, (b) claims related to insured events that have occurred but that have not been reported to the insurer as of the date the liability is estimated, and (c) claim adjustment expenses. Claim adjustment expenses include costs incurred in the claim settlement process such as legal fees; outside adjuster fees; and costs to record, process, and adjust claims.

**.10** Financial statements should disclose for each fiscal year for which an income statement is presented the following information about the liability for unpaid claims and claim adjustment expenses:

- a. The balance in the liability for unpaid claims and claim adjustment expenses at the beginning and end of each fiscal year presented, and the related amount of reinsurance recoverable
- b. Incurred claims and claim adjustment expenses with separate disclosure of the provision for insured events of the current fiscal year and of increases or decreases in the provision for insured events of prior fiscal years
- c. Payments of claims and claim adjustment expenses with separate disclosure of payments of claims and claim adjustment expenses attributable to insured events of the current fiscal year and to insured events of prior fiscal years

Also, insurance enterprises should discuss the reasons for the change in the provision for incurred claims and claim adjustment expenses attributable to insured events of prior fiscal years and should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects.

.11 In addition to the disclosures required by FASB Statement No. 5 and other accounting pronouncements, insurance enterprises should disclose management's policies and methodologies for estimating the liability for unpaid claims and claim adjustment expenses for difficult-to-estimate liabilities, such as for claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures.

## Effective Date and Transition

.12 This SOP is effective for annual and complete sets of interim financial statements for periods ending after December 15, 1994. Disclosures of information required by paragraph .10 should be included for each fiscal year for which an income statement is presented.

## Appendix A

### Illustrative Disclosures

**A-1.** The illustrations included in this appendix are guides to implementation of the disclosures required by this SOP. Insurance enterprises are not required to display the information contained herein in the specific manner or in the degree of detail illustrated. Alternative disclosure presentations are permissible if they satisfy the disclosure requirements of this SOP.

### Permitted Statutory Accounting Practices

**A-2.** The following is an illustration of disclosures that an insurance enterprise would make before the codification is complete, to meet the requirements of paragraph .08 of this SOP.

#### *Note X. Permitted Statutory Accounting Practices*

Property and Casualty Company, Inc., domiciled in ABC State, prepares its statutory financial statements in accordance with accounting practices prescribed or permitted by the ABC State Insurance Department. Prescribed statutory accounting practices include a variety of publications of the National Association of Insurance Commissioners (NAIC), as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed.

The company received written approval from the ABC State Insurance Department to discount loss reserves at a rate of X percent for statutory accounting purposes, which differs from prescribed statutory accounting practices. Statutory accounting practices prescribed by ABC state require that loss reserves be discounted at Y percent. As of December 31, 19X3, that permitted transaction increased statutory surplus by \$XX million over what it would have been had prescribed accounting practice been followed.<sup>1</sup>

### Liability for Unpaid Claims and Claim Adjustment Expenses

**A-3.** The following is an illustration of information an insurance enterprise would disclose to meet the requirements of paragraph .10 of this SOP. (This illustration presents amounts incurred and paid net of reinsurance.)

The information may also be presented before the effects of reinsurance with separate analysis of reinsurance recoveries and recoverables related to the incurred and paid amounts.)

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<sup>1</sup> If an insurance company's risk-based capital (RBC) would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements.

**Note X. Liability for Unpaid Claims and Claim Adjustment Expenses**

Activity in the liability for unpaid claims and claim adjustment expenses is summarized as follows.

	<u>19X5</u>	<u>19X4</u>
Balance at January 1	\$7,030	\$6,687
Less reinsurance recoverables	1,234	987
Net Balance at January 1	<u>5,796</u>	<u>5,700</u>
Incurred related to:		
Current year	2,700	2,600
Prior years	(171)	96
Total incurred	<u>2,529</u>	<u>2,696</u>
Paid related to:		
Current year	781	800
Prior years	2,000	1,800
Total paid	<u>2,781</u>	<u>2,600</u>
Net Balance at December 31	5,544	5,796
Plus reinsurance recoverables	1,255	1,234
Balance at December 31	<u>\$6,799</u>	<u>\$7,030</u>

As a result of changes in estimates of insured events in prior years, the provision of claims and claim adjustment expenses (net of reinsurance recoveries of \$X and \$X in 19X5 and 19X4, respectively) decreased by \$171 million in 19X5 because of lower-than-anticipated losses on Hurricane Howard, and increased by \$96 million in 19X4 because of higher-than-anticipated losses and related expenses for claims for asbestos-related illnesses, toxic waste cleanup, and workers' compensation.

**A-4.** The following is an illustration of an insurance enterprise disclosure designed to meet the requirements of paragraph .11 of this SOP. (Additional disclosures about the liabilities for unpaid claims and claim adjustment expenses may be required under FASB Statement No. 5, FASB Interpretation 14, *Reasonable Estimation of the Amount of a Loss*, AICPA SOP 94-6 [section 10,640], and SEC requirements.)

**Note X. Environmental-Related Claims**

In establishing the liability for unpaid claims and claim adjustment expenses related to asbestos-related illnesses and toxic waste cleanup, management considers facts currently known and the current state of the law and coverage litigation. Liabilities are recognized for known claims (including the cost of related litigation) when sufficient information has been developed to indicate the involvement of a specific insurance policy, and management can reasonably estimate its liability. In addition, liabilities have been established to cover additional exposures on both known and unasserted claims. Estimates of the liabilities are reviewed and updated continually. Developed case law and adequate claim history do not exist for such claims, especially because significant uncertainty exists about the outcome of coverage litigation and whether past claim experience will be representative of future claim experience.



## Appendix B

### Discussion of Conclusions

**B-1.** This section discusses factors that were deemed significant by members of AcSEC in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

**B-2.** The business and regulatory environment of insurance enterprises has become more complex and volatile, and therefore riskier. Accordingly, AcSEC believed the need existed to reconsider the disclosures made in the financial statements of insurance enterprises.

**B-3.** FASB Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, states financial reporting should “provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions” (paragraph 34). Further, the Concepts Statement says that to support that decision-making process, financial reports should help such users “assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprises” (paragraph 37) by providing “information about the economic resources of an enterprise, the claims to those resources. . . and the effects of transactions, events, and circumstances that change resources and claims to those resources” (paragraph 40).

**B-4.** AcSEC considered a wide variety of potential disclosures, and tried to identify the areas of importance to insurance enterprises for which the current disclosures were lacking. AcSEC concluded that additional disclosures in the financial statements of insurance enterprises about regulatory risk-based capital, the liability for unpaid claims, and certain accounting methods permitted by state insurance departments would help insurance enterprises better meet the objectives of financial reporting in their financial statements.

### Risk-Based Capital

**B-5.** Insurance enterprises operate in a highly regulated environment directed primarily toward safeguarding policyholders’ interests and maintaining public confidence in the safety and soundness of the insurance system. Historically, regulation of insurance enterprises has monitored solvency by focusing on their capital. One of the primary tools used by state insurance departments for ensuring that their objectives are being met is risk-based capital (RBC).

**B-6.** The NAIC has developed an RBC program that is used by state insurance departments to enable them to take appropriate and timely regulatory actions relating to insurers that show signs of weak or deteriorating financial conditions. This program is encompassed in the RBC Model Acts for life and property and casualty insurers, which have been or are intended to be adopted by most of the states. RBC is a series of dynamic surplus-related formulas set forth in the NAIC’s RBC instructions for life and health and for property and casualty insurance enterprises. The formulas contain a variety of weighing factors that are applied to financial balances or to levels of activity based on the perceived degree of certain risks, such as asset risk, credit risk,

interest rate risk (life insurance enterprises only), underwriting risk, and other business risks, such as risks related to management, regulatory action, and contingencies. The amount determined under such formulas, the authorized control level risk-based capital, is required to be disclosed in life insurance enterprises' statutory filings starting for the year ended December 31, 1993, and in property and casualty insurance enterprises' statutory filings starting for the year ended December 31, 1994.

**B-7.** The exposure draft of the SOP contained a requirement that insurance enterprises that are required to calculate RBC should disclose in their financial statements the ratio of total adjusted capital to authorized control level RBC and the amount of total adjusted capital for each fiscal year for which a statement of financial position is presented.

**B-8.** However, the NAIC's RBC Model Acts for both life and property and casualty insurers have a confidentiality provision, which states:

[E]xcept as otherwise required under the provisions of this Act [that is, in the annual financial reports filed with state insurance departments], the making, publishing, disseminating, circulation, or placing before the public, or causing, directly or indirectly to be made, placed before the public, in a newspaper, magazine or other publication . . . with regard to the RBC levels of any insurer . . . would be misleading and is therefore prohibited.

**B-9.** Prior to issuing the exposure draft, based on discussions with the drafters of the RBC Model Acts and some state insurance regulators, and based on the fact that the information is already in the public domain, AcSEC believed that the confidentiality provisions were not intended to apply to disclosures in financial statements. However, a number of respondents to the exposure draft stated that they believe disclosing RBC levels in financial statements would be illegal in states that have enacted the RBC Model Acts. They point out that words in the RBC Model Acts appear to be intended to restrict *all* other disclosure of RBC levels, including in insurers' financial statements.

**B-10.** AcSEC continues to believe, because of the importance of RBC in the regulatory oversight of insurance enterprises, that its disclosure would improve the relevance and usefulness of insurance enterprises' financial statements, and, therefore, it should be disclosed in the financial statements. Nevertheless, AcSEC concluded the legal issues require further consideration.

**B-11.** AcSEC decided that this SOP should not be delayed while the legal issues regarding RBC disclosures are considered. A separate SOP on RBC disclosures will be considered at a later date.

**B-12.** Nevertheless, AcSEC encourages insurance enterprises to disclose RBC levels if they are domiciled in states that have not adopted the RBC Model Acts, or if they have otherwise determined that it is legal to make such disclosures in their financial statements.

**B-13.** The exposure draft also required insurance enterprises whose level of RBC has triggered a regulatory event<sup>2</sup> to disclose certain information in their

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<sup>2</sup> Under the NAIC's RBC Model Acts, when the ratio of total adjusted capital to authorized control level RBC is less than or equal to 2 or less than or equal to 2.5 with negative trends for life insurance enterprises, a regulatory event exists that is, the insurance enterprise would fail to meet the minimum RBC requirements. There are four types of regulatory events, ranging from least to most serious: company action level event, regulatory action level event, authorized control level event, and mandatory control level event.

financial statements. Delaying the issuance of the RBC guidance does not change the fact that under SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, auditors must consider the need for disclosures about the principal conditions and events that triggered the regulatory event and the possible effects of such conditions and events, as well as management's plans.

## Permitted Statutory Accounting Practices

**B-14.** Permitted statutory accounting practices historically have not been disclosed in the notes to the financial statements, except to the extent that they have been disclosed in the accounting practices and procedures note to the statutory financial statements. With increasing frequency, insurance enterprises have transactions that are not explicitly addressed by prescribed accounting practices, or for which no analogous prescribed accounting practices exist. Furthermore, insurance enterprises often request exceptions from certain prescribed accounting practices. Permitted statutory accounting practices may differ from state to state, and from company to company within a state, and may change in the future. Moreover, permitted statutory accounting practices have been used to enhance insurance enterprises' surplus positions. For example, some state insurance departments have permitted certain insurance enterprises to adjust home office facilities to appraised values even though the states' prescribed statutory accounting practices require that such assets be carried at depreciated historical cost.

**B-15.** AcSEC believes the required disclosure of permitted statutory accounting practices will enhance the relevance of the financial statements and fulfill the financial reporting objective of providing current and potential investors, creditors, policyholders, and other users of an insurance enterprise's financial statements with useful information. Not only will such disclosures identify situations in which permitted statutory accounting practices enhance an insurance enterprise's statutory capital and RBC position, but they also will improve the comparability of insurance enterprises' financial statements.

## Liability for Unpaid Claims and Claim Adjustment Expenses

**B-16.** Insurance enterprises estimate their liability for unpaid claims and claim adjustment expenses for reported and unreported claims incurred as of the end of the accounting period in accordance with FASB Statement No. 60. The liability is estimated based on past loss experience, adjusted for current trends and other factors that will modify past experience. The liability may be calculated using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models.

**B-17.** FASB Concepts Statement No. 1, paragraph 21, states:

The information provided by financial reporting largely reflects the financial effects of transactions and events that have already happened. Management may communicate information about its plans or projections, but financial statements and most other financial reporting are historical . . . Estimates resting on expectations of the future are often needed in financial reporting, but their major use, especially of those formally incorporated in financial statements, is to measure financial effects of past transactions or events or the present status of an asset or liability . . . To provide information about the past

as an aid in assessing the future is not to imply that the future can be predicted merely by extrapolating past trends or relationships. Users of the information need to assess the possible or probable impact of factors that may cause change and form their own expectations about the future and its relation to the past.

**B-18.** AcSEC believes that disclosures about an insurance enterprise's liabilities for unpaid claims and claim adjustment expenses development are useful in understanding insurance enterprises' liabilities and results of operations. Furthermore, AcSEC notes the disclosures are the same as some of the loss reserve development disclosures that the SEC requires registrants to file with the commission under Securities Act Guide 6.

**B-19.** Paragraph 60(a) of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, requires all insurance enterprises to disclose the basis for estimating the liabilities for unpaid claims and claim adjustment expenses. Furthermore, FASB Statement No. 5, *Accounting for Contingencies*, requires disclosure of loss contingencies not accrued, for which it is at least reasonably possible that a loss has been incurred. Because of the relatively high degree of coverage litigation and the lack of historical information regarding the amount and nature of both known and unasserted claims relating to difficult-to-estimate liabilities (such as those related to environmental related illness claims and toxic-waste cleanup claims), traditional loss reserving techniques may not be used in estimating such liabilities. Therefore, a high degree of judgment is needed in estimating the amount of losses, and practice is developing in the area. Accordingly, AcSEC believes financial statement users will benefit from disclosure of the policies and methods management has used for estimating these amounts.

## Discussion of Comments Received on Exposure Draft

**B-20.** An exposure draft of a statement of position, *Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises* was issued on April 20, 1994, and distributed to a variety of interested parties to encourage comment by those that would be affected by the proposal. Forty comment letters were received on the exposure draft.

### *Risk-Based Capital*

**B-21.** A number of comments were received on the risk-based capital disclosures. As discussed in paragraphs B-5 through B-13, AcSEC decided to consider a separate SOP at a later date on risk-based capital disclosures. The comments will be addressed at that time.

### *Permitted Statutory Accounting Practices*

**B-22.** A number of respondents to the exposure draft of the SOP requested that the disclosure requirements for permitted statutory accounting practices be postponed until after the codification is complete. AcSEC believes that the disclosures are especially important before codification to improve understanding of the factors that affect comparability among the statutory capital of insurance enterprises.

**B-23.** Respondents asked for clarification of how disclosure of the monetary effect of statutory surplus would be calculated, particularly when there is no prescribed accounting practice to compare with the permitted practice. AcSEC agreed and revised the exposure draft to state that for permitted statutory ac-

counting practices used when prescribed accounting practice is silent, a description of the transaction is sufficient. Respondents also asked for clarification about whether there should be disclosure of GAAP-permitted practices when there is no prescribed statutory accounting. If an insurance company uses a GAAP practice in its statutory financial statements when there is no prescribed practice, that is still considered a permitted statutory accounting practice. However, AcSEC agreed that no disclosures should be made for GAAP practices that are used when prescribed statutory practices do not specify the accounting for the transaction.

**B-24.** Respondents suggested that the requirement in the exposure draft to make a statement about the codification be eliminated. AcSEC agreed the disclosure might be confusing to users of financial statements, and eliminated the requirement.

### ***Liability for Unpaid Claims and Claim Adjustment Expenses***

**B-25.** The exposure draft would have required disclosure of information about actuarial adjustments made for nonrecurring or abnormal experience. A number of respondents suggested that that disclosure requirement be eliminated. AcSEC was persuaded that such actuarial adjustments are a normal part of making estimates that should not be disclosed in the financial statements, and eliminated the requirement.

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**[The next page is 20,031.]**

## Section 10,640

# **Statement of Position 94-6 Disclosure of Certain Significant Risks and Uncertainties**

December 30, 1994

### **NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## **Introduction**

.01 The volatile business and economic environment underscores a need for improved disclosure about the significant risks and uncertainties that face reporting entities. In 1987, the AICPA issued the *Report of the Task Force on Risks and Uncertainties* (the Report), which was intended to help standards-setting bodies and others identify practical methods of improving the information communicated to users of financial statements to help them assess those risks and uncertainties. This statement of position (SOP) is largely based on the Report. The central feature of this SOP's disclosure requirements is selectivity: specified criteria serve to screen the host of risks and uncertainties that affect every entity so that required disclosures are limited to matters significant to a particular entity.

.02 The disclosures focus primarily on risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the reporting entity. The risks and uncertainties this SOP deals with can stem from the nature of the entity's operations, from the necessary use of estimates in the preparation of the entity's financial statements, and from significant concentrations in certain aspects of the entity's operations.

## **Scope**

.03 This SOP applies to financial statements prepared in conformity with generally accepted accounting principles (GAAP) applicable to nongovern-

mental entities. It applies to all entities that issue such statements. While this SOP applies to complete interim financial statements, it does not apply to condensed or summarized interim financial statements.<sup>1</sup> If comparative financial statements are presented, the disclosure requirements apply only to the financial statements for the most recent fiscal period presented.

.04 The disclosure requirements do not encompass risks and uncertainties that might be associated with management or key personnel, proposed changes in government regulations, proposed changes in accounting principles,<sup>2</sup> or deficiencies in the internal control structure. Nor do they encompass the possible effects of acts of God, war, or sudden catastrophes.

## Relationship to Other Pronouncements

.05 The disclosure requirements of this SOP in many circumstances are similar to or overlap the disclosure requirements in certain pronouncements of the Financial Accounting Standards Board (FASB), such as FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and, for public business enterprises, FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*. The disclosure requirements of this SOP in many circumstances also are similar to or overlap the disclosure requirements in certain pronouncements of the Securities and Exchange Commission (SEC). This SOP does not alter the requirements of any FASB or SEC pronouncement.

.06 Certain disclosure requirements in this SOP supplement the requirements of other authoritative pronouncements. In many cases, however, the disclosure requirements in this SOP, particularly those relating to certain significant estimates, will be met or partly met by compliance with such other pronouncements.

## Definitions

.07 This SOP uses the following terms with the definitions indicated:

*Near term.* A period of time not to exceed one year from the date of the financial statements.

*Severe impact.* (Used in reference to current vulnerability due to certain concentrations. See paragraph .21.) A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material,<sup>3</sup> yet they may not be so significant as to dis-

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<sup>1</sup> However, see Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting*, paragraph 30, for guidance on disclosure of contingencies in summarized interim financial information of publicly traded companies.

<sup>2</sup> SEC Staff Accounting Bulletin 74 requires disclosure, both in Management's Discussion and Analysis (MD&A) and in the notes to the financial statements, concerning accounting standards that have been issued but that have not yet been adopted. Also, Auditing Interpretation No. 3 of SAS No. 1, section 410, "The Impact on an Auditor's Report of an FASB Statement Prior to the Statement Effective Date" (AICPA, *Professional Standards*, vol. 1, AU 9410.13-.18), addresses reporting considerations when financial statements will have to be restated in the future because an authoritative accounting pronouncement that is not yet effective will require retroactive application of its provisions by prior-period adjustment.

<sup>3</sup> FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, defines *materiality* as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."



rupt the normal functioning of the entity. Some events are material to an investor because they might affect the price of an entity's capital stock or its debt securities, but they would not necessarily have a severe impact on (disrupt) the enterprise itself. The concept of severe impact, however, includes matters that are less than catastrophic.<sup>4</sup>

## Conclusions

.08 The Accounting Standards Executive Committee (AcSEC) of the AICPA has concluded that reporting entities should make disclosures in their financial statements beyond those now required or generally made in financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

- a. Nature of operations
- b. Use of estimates in the preparation of financial statements
- c. Certain significant estimates
- d. Current vulnerability due to certain concentrations

These four areas of disclosure are not mutually exclusive. The information required by some may overlap. Accordingly, the disclosures required by this SOP may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other authoritative pronouncements.

.09 The following detailed discussion of the four areas of disclosure enumerated in paragraph .08 should be read in conjunction with the "Illustrative Disclosures" in appendix A [paragraph .27] of this SOP, which provide guidance for implementing them.

## Nature of Operations

.10 Financial statements should include a description of the major products or services the reporting entity sells or provides and its principal markets, including the locations of those markets. If the entity operates in more than one business, the disclosure should also indicate the relative importance of its operations in each business and the basis for the determination—for example, assets, revenues, or earnings. Not-for-profit organizations' disclosures should briefly describe the principal services performed by the entity and the revenue sources for the entity's services. Disclosures about the nature of operations need not be quantified; relative importance could be conveyed by use of terms such as *predominately*, *about equally*, or *major and other*.<sup>5</sup>

## Use of Estimates in the Preparation of Financial Statements

.11 Financial statements should include an explanation that the preparation of financial statements in conformity with GAAP requires the use of management's estimates.

## Certain Significant Estimates

.12 Various accounting pronouncements require disclosures about uncertainties addressed by those pronouncements. In particular, paragraphs 9 through

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<sup>4</sup> Matters that are catastrophic include, for example, those that would result in bankruptcy.

<sup>5</sup> See paragraph B-17 in appendix B [paragraph .28] for a comparison of this SOP's disclosure requirements concerning nature of operations with the disclosure requirements for public companies in FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*.

12, and 17b, and footnote 6 of FASB Statement No. 5 specify disclosures to be made about contingencies<sup>6</sup> that exist at the date of the financial statements. The disclosure requirements of paragraphs 9 through 12 of Statement No. 5 are further clarified in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*. In addition to disclosures required by FASB Statement No. 5 and other accounting pronouncements, this SOP requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies, as described below.

.13 Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that *both* of the following criteria are met:

- a. It is at least reasonably possible<sup>7</sup> that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
- b. The effect of the change would be material to the financial statements.

.14 The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible<sup>8</sup> that a change in the estimate will occur in the near term.<sup>9</sup> If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure also should include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.

.15 Many entities use risk-reduction techniques to mitigate losses or the uncertainty that may result from future events. If the entity determines that the criteria in paragraph .13 are not met as a result of risk-reduction techniques, the disclosures described in paragraph .14 and disclosure of the risk-reduction techniques are encouraged but not required.

.16 This SOP's disclosure requirements are separate from and do not change in any way the disclosure requirements or criteria of FASB Statement No. 5; rather, the disclosures required under this SOP supplement the disclosures required under Statement No. 5 as follows:

- If an estimate (including estimates that involve contingencies covered by FASB Statement No. 5) meets the criteria for disclosure under paragraph .13 of this SOP, this SOP requires disclosure of an indication that it is at least reasonably possible that a change in the

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<sup>6</sup> FASB Statement No. 5 defines a *contingency* as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a 'gain contingency') or loss (hereinafter a 'loss contingency') to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability."

<sup>7</sup> The term *reasonably possible* is used in this SOP consistent with its use in FASB Statement No. 5 to mean that the chance of a future transaction or event occurring is more than remote but less than likely.

<sup>8</sup> The words *reasonably possible* need not be used in the disclosures required by this SOP.

<sup>9</sup> FASB Statement No. 5 states in paragraph 17b that "adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization."

estimate will occur in the near term; FASB Statement No. 5 does not distinguish between near-term and long-term contingencies.

- An estimate that does not involve a contingency covered by Statement No. 5, such as estimates associated with long-term operating assets and amounts reported under profitable long-term contracts, may meet the criteria in paragraph .13. This SOP requires disclosure of the nature of the estimate and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.

.17 Whether an estimate meets the criteria for disclosure under this SOP does not depend on the amount that has been reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have had on the financial statements. Simply because an estimate resulted in the recognition of a small financial statement amount, or no amount, does not mean that disclosure is not required under this SOP.

.18 The following are examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term:

- Inventory subject to rapid technological obsolescence
- Specialized equipment subject to technological obsolescence
- Valuation allowances for deferred tax assets based on future taxable income
- Capitalized motion picture film production costs
- Capitalized computer software costs
- Deferred policy acquisition costs of insurance enterprises
- Valuation allowances for commercial and real estate loans
- Environmental remediation-related obligations
- Litigation-related obligations
- Contingent liabilities for obligations of other entities
- Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits
- Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets
- Amounts reported for long-term contracts

The above list is not intended to be all-inclusive.

.19 Paragraph 5 of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, provides examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of an asset should be assessed.<sup>[10]</sup> [Revised, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

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<sup>[10]</sup> [Footnote deleted.]

## Current Vulnerability Due to Certain Concentrations

.20 Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance.

.21 Financial statements should disclose the concentrations described in paragraph .22 if, based on information known to management prior to issuance of the financial statements, *all* of the following criteria are met:

- a. The concentration exists at the date of the financial statements.
- b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
- c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

.22 Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of paragraph .21. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category.

- a. *Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor.* The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For purposes of this SOP, it is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term.
- b. *Concentrations in revenue from particular products, services, or fund-raising events.* The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.
- c. *Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations.* The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.
- d. *Concentrations in the market or geographic area<sup>11</sup> in which an entity conducts its operations.* The potential for the severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For purposes of this SOP, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

.23 Concentrations of financial instruments, and other concentrations not described in paragraph .22, are not addressed in this SOP. However, these other concentrations may be required to be disclosed pursuant to other authoritative pronouncements, such as FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*.

.24 Disclosure of concentrations meeting the criteria of paragraph .21 should include information that is adequate to inform users of the general na-

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<sup>11</sup> FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*, paragraph 34, provides guidance on determining foreign geographic areas.

ture of the risk associated with the concentration. For those concentrations of labor (paragraph .22c) subject to collective bargaining agreements and concentrations of operations located outside of the entity's home country (paragraph .22d) that meet the criteria of paragraph .21, the following specific disclosures are required:

- For labor subject to collective bargaining agreements, disclosure should include both the percentage of the labor force covered by a collective bargaining agreement and the percentage of the labor force covered by a collective bargaining agreement that will expire within one year.
- For operations located outside the entity's home country, disclosure should include the carrying amounts of net assets and the geographic areas in which they are located.

Adequate information about some concentrations may already be presented in diverse parts of the financial statements. For example, adequate information about assets or operations located outside the entity's home country may be included in disclosures made to comply with FASB Statement No. 14. In accordance with paragraph .08 of this SOP, such information need not be repeated.

## Application of Disclosure Criteria

.25 An assessment of whether a disclosure is required should not be found to be in error simply as a result of future events. For example, reporting a concentration not followed by a severe impact does not imply that the disclosure should not have been made, because something that has only a reasonably possible chance of occurring obviously might not occur. Similarly, the occurrence of a severe impact related to a concentration not disclosed in the prior-year financial statements would not suggest noncompliance with this SOP's requirements if an appropriate judgment had been made that a near-term severe impact was not at least reasonably possible at the prior reporting date. In addition, a severe impact may arise from a concentration of which management did not have knowledge at the time the financial statements were issued.

## Effective Date

.26 This SOP is effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which this SOP is to be first applied. Early application is encouraged but not required.

Appendix A

Illustrative Disclosures

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**A-1.** The kinds of disclosures required by this SOP are illustrated below. Each illustrative disclosure is accompanied by a scenario in which the disclosure would likely be made or not made and by a discussion of how and why the illustrative disclosure complies with the requirements of this SOP or why no disclosure is required by this SOP.

## Nature of Operations

### *Illustrative Disclosure A—Nature of Operations*

**A-2. Scenario.** Conglomerate, Inc. is a United States-based multinational corporation. Conglomerate's principal lines of business are automotive products, aerospace products and technologies, textiles, and nonprescription health-care products. The principal markets for the company's automotive and aerospace products and technologies are European- and Far East-based industrial concerns. Textiles are sold primarily to U.S. clothing manufacturers, while nonprescription health-care products are sold to wholesale and retail distributors worldwide. The operations of the company in any one country are not significant in relation to the company's overall operations. The following illustrates disclosure of the nature of operations required by this SOP.

**A-3. Disclosure.** Conglomerate, Inc. is a multinational manufacturer and engineering concern. The company's principal lines of business are automotive products, aerospace products and technologies, textiles, and nonprescription health-care products, all of which are about equal in size based on sales. The principal markets for the automotive and aerospace products and technologies are European- and Far East-based industrial concerns. Textiles are sold primarily to domestic clothing manufacturers, while nonprescription health-care products are sold primarily to wholesale and retail distributors worldwide.

**A-4. Discussion.** This disclosure provides—

- a. Information necessary for users not familiar with the operations of the company to identify and consider the broad risks and uncertainties associated with the businesses and markets in which the company operates and competes. From the disclosures provided, financial statement users having a general knowledge of business matters should be able to assess that the company's product lines are subject to different and varied risks. Those financial statement users familiar with the businesses recognize the general risks associated with each of these businesses and their related markets.
- b. Information that facilitates the overall understanding of the financial information presented. This kind of disclosure could provide users with a basis for comparing an enterprise's financial information with that of competitors or with applicable industry statistics.
- c. Insight into the location of the company's principal markets, although on a broad scale. Because the company's markets are so diverse, it likely would not be useful to enumerate the specific locations of the company's markets. For this reason, the manner in which the information is disclosed in the illustrative disclosure is sufficient to meet the broad objectives of paragraph .10 of this SOP.

**Illustrative Disclosure B—Combined Disclosure: Nature of Operations and Customer Concentration**

**A-5. Scenario.** Smith Corporation, formerly Smith Munitions Corporation, was founded in 1940. At that time, Smith's principal business was the design and manufacture of artillery ammunition and other explosives. In 1959, commensurate with the evolution of its principal business to the design, engineering, and manufacture of military aircraft for sale to the U.S. government, Smith changed its name to Smith Corporation. Smith has one factory, located in New York. The following illustrates disclosure of the nature of operations required by this SOP.

**A-6. Disclosure.** **Smith Corporation is engaged principally in the design, engineering, and manufacturing of military aircraft and related peripheral equipment for sale primarily to the U.S. government.**

**A-7. Discussion.** This disclosure provides—

- a. Information needed by users who are not familiar with the operations of the enterprise to identify and consider the broad risks and uncertainties faced by all or most enterprises operating in a specific business or market, which in this case is the defense contracting business. From this disclosure, financial statement users having a general knowledge of business matters should know that the enterprise's business may be heavily affected by future changes in U.S. defense and foreign policies.
- b. Information that aids in the overall understanding of the other financial information presented. Certain accounting procedures involving estimation may apply only to particular industries or may be relevant in comparing a business enterprise's financial reports with those of business enterprises in other industries.
- c. Insight into the location of the company's principal product markets and information about its current vulnerability due to concentrations. In the illustration, users would be able to recognize and assess the company's dependency on sales to the U.S. government (assuming the loss of the government as a customer would result in a near-term severe impact to the company).

**Use of Estimates in the Preparation of Financial Statements****Illustrative Disclosure—Pervasiveness of Estimates**

**A-8. Scenario.** The following illustrates disclosure of the pervasiveness of estimates in the financial statements of all reporting entities.

**A-9. Disclosure.** **The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.**

**A-10. Discussion.** This disclosure is intended to inform users of the inherent uncertainties in measuring assets and liabilities and related revenues and expenses and contingent assets and liabilities, and that subsequent resolution



of some matters could differ significantly from the resolution that is currently expected. Such disclosure alerts users that uncertainties are present in the financial statements of all reporting entities.

### **Certain Significant Estimates**

*Note: Some of the following disclosures contain certain information that is already required to be disclosed under FASB Statement No. 5; in those cases, the FASB Statement No. 5 requirements are supplemented by an indication that it is at least reasonably possible that a change in an estimate will occur in the near term. Others may not be covered by FASB Statement No. 5.*

#### **Illustrative Disclosure A—Inventories**

**A-11. Scenario.** XYZ Corporation manufactures high technology stereo equipment. In June 19X7, one of XYZ's competitors introduced a new model stereo system with the same features as XYZ's Model A. The competitor's version sells for significantly less than XYZ's suggested retail price for Model A. The introduction of this product resulted in a sharp decrease in the sales volume of Model A. At December 31, 19X7, XYZ has accumulated significant inventory quantities beyond its normal short-term needs of its Model A system. Inventory for Model A (\$6 million) represents approximately 20 percent of XYZ's inventory at that date. The remaining 80 percent of XYZ's inventory consists of products experiencing only normal competitive pressures. XYZ has established provisions for obsolescence for this latter group of products in the normal course of business.

**A-12.** Management has developed a program to provide substantial dealer incentives on purchases of the Model A, which it expects will result in the sale of this inventory in the near term. Because of the existing high profit margin on its stereo systems, XYZ would continue to earn a marginal profit on sales of the Model A under the new program. It is also reasonably possible, however, that the program will not be wholly successful, and, accordingly, a material loss could ultimately result on the disposal of the inventory.

**A-13. Disclosure.** At December 31, 19X7, some portion of \$6 million of inventory of one of the company's products is in excess of XYZ's current requirements based on the recent level of sales. Management has developed a program to reduce this inventory to desired levels over the near term and believes no loss will be incurred on its disposition. No estimate can be made of a range of amounts of loss that are reasonably possible should the program not be successful.

**A-14. Discussion.** This situation meets the criteria for disclosure under paragraph .13 of this SOP because circumstances that existed at the date of the financial statements, including the decreasing sales volume and excessive quantities of inventory of Model A, make it at least reasonably possible that management's plan to liquidate its excess inventory without a loss will be less than fully successful and that such an outcome would have a near-term material effect on the enterprise's financial statements.

**A-15.** In this illustration, XYZ discloses the existence of potentially excess quantities of inventory at the date of the financial statements and indicates that the uncertainty is expected to be resolved in the near term. The disclosure is intended to provide users with insight into management's assessment of recoverability of the cost of inventories existing at the date of the financial statements. Although disclosure of the \$6 million carrying amount of the in-

ventory of Model A is not required because, based on the facts presented, \$6 million does not constitute a reasonable estimate of loss on the disposal of the inventory or the maximum amount in an estimated range of loss, disclosure of this amount is not misleading and may provide useful information.

**A-16.** Discussion of XYZ's provision for obsolescence for the remaining 80 percent of its inventory is not required because it is not considered reasonably possible that additional material losses on this inventory will occur.

### ***Illustrative Disclosure B—Discontinued Operations: Assets Held for Sale***

**A-17. Scenario.** Axel Industries, a manufacturer of automotive components and heavy trucks, currently has facilities in Michigan, Tennessee, and Ontario, Canada. As a result of weak demand in the automobile industry, Axel's management decided during the current year to discontinue Axel's automotive components business, which is located entirely at the company's Michigan facility. Axel has charged current operations with the estimated loss on discontinuing the business based, in part, on valuations by its investment banker and independent appraiser. After year end, Axel entered into negotiations to sell its Michigan facility to a Japanese automobile manufacturer and expects to sell the facility in the near term. The following illustrates disclosure of significant estimates and would likely appear as part of the disclosure of the business segment disposition made pursuant to APB Opinion 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*.

**A-18. Disclosure.** Discontinued operations include management's best estimates of the amounts expected to be realized on the sale of its automotive components business. [While the estimates are based on an analysis of the facilities, including valuations by independent appraisers and investment bankers, there have been limited recent sales of comparable properties to consider in preparing such valuations.<sup>12</sup>] The amounts the company will ultimately realize could differ materially in the near term from the amounts assumed in arriving at the loss on disposal of the discontinued operations.

**A-19. Discussion.** Determining a provision for discontinued operations required the use of assumptions and estimates. In this case, the disclosure is required because circumstances that existed at the date of the financial statements indicated it was at least reasonably possible that estimates of the amount ultimately to be realized on the sale of the facilities could differ in the near term from the current estimates used as a basis for recognizing the charge to income associated with management's disposal plan by an amount that would be material to the entity's financial statements.

### ***Illustrative Disclosure C—Specialized Manufacturing Equipment***

**A-20. Scenario.** Offshore Industries is a manufacturer of offshore drilling rigs and platforms. The company's manufacturing process requires significant specialized equipment, which it currently owns. As a result of a decline in the price of oil, the demand for its products and services has fallen dramatically in the past two years, resulting in a significant underutilization of its manufacturing capacity.

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<sup>12</sup> This is an example of voluntary disclosure that is encouraged by paragraph .14 of this SOP.

**A-21.** The company depreciates its investments in specialized equipment based on its original estimate of the remaining useful lives of the equipment using the units-of-production method, since it believes that the exhaustion of usefulness of these specialized assets relates more to their use than to the passage of time. The company reevaluates these estimates in light of current conditions in accordance with generally accepted accounting principles. The company also monitors the policies of its major competitors and is aware that several have reported large write-downs of similar assets. Nevertheless, while the company believes that it is at least reasonably possible that its estimate that it will recover the carrying amount of those assets from future operations will change during the next year, it believes it is more likely that conditions in the industry will improve and that no write-down for impairment will be necessary.

**A-22. Disclosure.** Offshore's policy is to depreciate specialized manufacturing equipment (with a net book value of \$25 million at December 31, 19X7) over its remaining useful life using the units-of-production method and to evaluate the remaining life and recoverability of such equipment in light of current conditions.<sup>13</sup> [Given the excess capacity in the industry,<sup>14</sup>] it is reasonably possible that the company's estimate that it will recover the carrying amount of this equipment from future operations will change in the near term.

**A-23. Discussion.** In this illustration, the company acknowledges that the carrying amount of the specialized assets is subject to significant uncertainty based on current conditions. The uncertainty relates to the measurement of the specialized assets at the date of the financial statements, and the company's disclosure makes clear that it is at least reasonably possible that the carrying amount will change in the near term.

### ***Illustrative Disclosure D—Capitalized Software Costs***

**A-24. Scenario.** Software, Inc. develops and markets computer programs. In 19X5, it acquired a software company in a business combination accounted for as a purchase. A significant portion of the purchase price was allocated to (capitalized) Product A (present net book value of \$5 million), the most significant and profitable software program currently being marketed by the acquired company. Only nominal amounts of other software costs have been capitalized. Software, Inc. expects Product A and its derivatives to be among its most significant products over the next several years. However, a competitor has recently released a new product designed to compete directly with Product A. Software, Inc. amortizes the capitalized software costs of Product A by the greater of (a) the ratio that current gross revenues for a product bear to the total of current and anticipated future gross revenues for that product or (b) the straight-line method over the remaining estimated economic life of the product including the period being reported on, pursuant to FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. The amount of the amortization computed for year 19X6 was equal to 20 percent of the beginning-of-the-year capitalized amount and was a significant component of cost of sales.

**A-25.** The segment of the computer software industry in which Software, Inc. operates is characterized by sales of products occurring primarily on the

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<sup>13</sup> If this information is already disclosed elsewhere in the notes, it need not be repeated.

<sup>14</sup> This is an example of voluntary disclosure that is encouraged by paragraph .14

basis of customers' perceptions of the relative technical merits of competing products. Those perceptions are greatly influenced by product reviews in technical journals and advertising, and they can change rapidly. Innovative products have been introduced in recent years that have reduced quickly and significantly the volume of sales of pre-existing products in the same market niche. While management of Software, Inc. believes its estimates of future gross revenues and the estimated economic life of Product A used in the determination of the amortization of capitalized software costs are reasonable, new products introduced by its competitors, such as the one discussed in paragraph A-24, could have a significant near-term negative effect on such estimates. As a result, the amount of periodic amortization could increase in the near term in amounts that could be material to the enterprise's financial statements.

**A-26. Disclosure.** Software, Inc.'s policy is to amortize capitalized software costs by the greater of (a) the ratio that current gross revenues for a product bear to the total of current and anticipated future gross revenues for that product or (b) the straight-line method over the remaining estimated economic life of the product including the period being reported on.<sup>15</sup> It is reasonably possible that those estimates of anticipated future gross revenues, the remaining estimated economic life of the product, or both will be reduced significantly in the near term [due to competitive pressures].<sup>16</sup> As a result, the carrying amount of the capitalized software costs for Product A (\$5 million) may be reduced materially in the near term.

**A-27. Discussion.** In this illustration, the company acknowledges that the carrying amount of its capitalized software costs is subject to significant uncertainty. The uncertainty relates to estimates of future years' revenues and useful lives that are made at the date of the financial statements, and the company is aware that circumstances exist that could cause such estimates to change in the near term. The company's disclosure makes clear that it is at least reasonably possible that the carrying amount could be reduced in the near term.

### ***Illustrative Disclosure E—Environmental Remediation Liability***

**A-28. Scenario.** Ace Oil Company is a distributor of heating oil with four storage and distribution facilities located in Anystate. Federal, state, and local laws and regulations govern the operation of the company's facilities. The company has determined that, beginning in the coming year, a significant number of its storage tanks and a significant amount of its other equipment will need to be removed, replaced, or modified to satisfy regulations that go into effect in varying stages over the next seven years. In addition, the company has a present obligation to decontaminate the soil in the near term at its largest facility.

**A-29.** The company hired a consultant to evaluate the technological, regulatory, and legal factors involved. Based on the consultant's findings, the company estimated that total environmental expenditures over the next seven years related to the tanks and equipment will aggregate approximately \$5 million. Of this amount, approximately \$4.75 million represents capital expenditures, which are expected to be recoverable through operations. The existing tanks have a net book value of \$500,000, and the equipment has a net book

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<sup>15</sup> If this information is already disclosed elsewhere in the notes, it need not be repeated.

<sup>16</sup> This is an example of voluntary disclosure that is encouraged by paragraph .14.

value of \$475,000. The cost of soil decontamination is estimated to be at least \$1 million, which is material to the company's operations, and may be as high as \$3 million. Exposure to legal liability to third parties is considered remote.

**A-30.** The consultant has demonstrated substantial experience with similar sites, and the technical aspects of upgrading storage facilities and decontaminating soil appear to be fairly straightforward.

**A-31. Disclosure.** The company will begin a project to decontaminate the soil at its Anytown, Anystate facility in the coming year. The company estimates the cost of decontamination to total at least \$1 million and has accrued that amount as an operating expense in the current year.<sup>17</sup> The ultimate cost [, however, will depend on the extent of contamination found as the project progresses and<sup>18</sup>] may be as much as \$3 million. The company expects decontamination to be substantially completed within one year.

**A-32. Discussion.** This disclosure informs financial statement users of the existence of the soil contamination problem at the financial statement date and indicates that the liability is susceptible to change in the near term. This SOP does not require disclosure of the capital commitment because it is not a present obligation for which an estimate is reflected in the company's financial statements.

**A-33.** Although, in this case, the near-term nature of the possible change is indicated by a statement that the company expects decontamination to be substantially completed within one year, an expectation that decontamination will take more than one year to complete would not preclude the estimate from being susceptible to near-term change. In such cases, the disclosure could be worded to specifically refer to the near term.

### ***Illustrative Disclosure F—Guarantee of Debt***

**A-34. Scenario.** Shipping Company operates a shipping center in Local City. In 19X0, Shipping decided to raise money for modernization of facilities through a debt offering. In order for the offering to take place, Smokestack Company, a local manufacturer, agreed to guarantee the bonds if Shipping's revenues were insufficient to pay debt service. In May 19X4 (four years later when the bonds had an outstanding balance of \$55 million), Shipping lost two of its major shipping customers, constituting 35 percent of its prior-year revenues, to a company in a neighboring port. At Smokestack's June 30, 19X4, year end, Shipping was directing substantial efforts toward finding new customers. It is reasonably possible, however, that Shipping will not replace the lost revenue in time to pay debt service installments at December 30, 19X4, and June 30, 19X5, totaling \$6 million.

**A-35. Disclosure.** In 19X0, Smokestack guaranteed the Series AA debt of Shipping Company, which operates a shipping center within Local City. Smokestack continues as guarantor of such debt totaling \$55 million. In May 19X4, Shipping Company lost two of its major customers. Although Shipping Company is directing substantial efforts toward obtaining new customers, it is at least reasonably possible that Shipping Company will not replace lost revenues sufficient to

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<sup>17</sup> FASB Statement No. 5 states that "disclosure of the nature of an accrual [footnote omitted] made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading."

<sup>18</sup> This is an example of voluntary disclosure that is encouraged by paragraph .14.

make its December 19X4 and June 19X5 debt service payments totaling \$6 million. If so, the company will become responsible for repayment of at least a portion of that amount and possibly additional amounts over the debt term. No amount has been reported in the company's financial statements pending the outcome of Shipping Company's efforts during the next fiscal year.

**A-36. Discussion.** This example illustrates the potential near-term effect of a change in estimate of a contingent liability resulting from the guarantee of the debt of another entity. Shipping's loss of customers causes the potential for a near-term material change in that estimate within the next fiscal year. Although disclosure of Shipping's ongoing efforts to replace those customers is not required, this additional information may be presented.

**Illustrative Disclosure G—Long-Term Construction Contract**

**A-37. Scenario.** Rivet Construction Company is a nonpublic general contractor specializing in the construction of commercial buildings. Rivet has three long-term projects underway that are in various stages of completion. Rivet has a substantial history of making reasonably dependable estimates of the extent of progress towards completion, contract revenues, and contract costs, and it uses the percentage-of-completion method of accounting for all of its long-term contracts.

**A-38.** Shortly after December 31, 19X2, but before the 19X2 financial statements were issued, subsoil conditions were discovered at the site of Project A that will require Rivet to incur substantial additional, unbudgeted costs in completing the project. The nature of the subsoil problem is unusual in the region in which Rivet operates. The additional estimated costs are not considered to be a normal, recurring contract-accounting adjustment. Engineers have estimated the additional construction cost to be 10 to 40 percent of the original estimated construction cost, with 15 percent (\$1.5 million) being their best estimate, and delays in construction are expected to add an additional 3 to 7 percent to the cost of construction, depending on the time involved, with 5 percent (\$500,000) being the best estimate. Accordingly, Rivet has revised upward its estimate of costs to complete the project by \$2 million. Project A, which was begun in 19X1 under a fixed-price contract, is still expected to be completed in the coming year (19X3), and it is still expected to be profitable.

**A-39.** The following is a summary of financial data at December 31, 19X2, for Project A.

	<i>Before Discovery of Condition</i>	<i>After Discovery of Condition</i>
Contract price	\$15,000,000	\$15,000,000
Estimated total cost	10,000,000	12,000,000
Estimated gross profit	5,000,000	3,000,000
Costs incurred to date	6,400,000	6,400,000
Percentage of completion	64%	53%

Rivet's other two projects are proceeding as planned.

**A-40. Disclosure.** As a result of the discovery of unusual subsoil conditions at the site of Project A, estimated contract completion costs have been revised upward by \$2 million. [Due to uncertainties inherent

in the estimation process,<sup>19]</sup> it is at least reasonably possible that completion costs for Project A will be further revised in the near-term [by up to an additional \$2.7 million].<sup>20</sup>

**A-41. Discussion.** In addition to any disclosures regarding the change in estimates that might be required by APB Opinion 20,<sup>21</sup> the disclosure requirements of this SOP focus on the effects of possible near-term changes in estimates. Disclosure is required under this SOP because it is at least reasonably possible that the estimated cost of completing Project A will change in the near term and that the change will be material to the financial statements.

**A-42.** Disclosure of the potential for changes in other estimates used in determining amounts reported for Rivet's long-term contracts is not required because, given Rivet's history of making similar estimates, it is not considered at least reasonably possible that they will change in the near term by amounts that would be material to the financial statements.

### ***Illustrative Disclosure H—Realizability of a Deferred Tax Asset***

**A-43. Scenario.** XYZ Corporation develops, manufactures, and markets limited-use vaccines. The company has a dominant share of the narrow market it serves. As of December 31, 19X4, the company has no temporary differences and has aggregate loss carryforwards of \$12 million that originated in prior years and that expire in varying amounts between 19X5 and 19X7. As of December 31, 19X4, the company has a deferred tax asset of \$4.8 million that represents the benefit of the remaining \$12 million in loss carryforwards, and it has concluded at that date that a valuation allowance is unnecessary. The loss carryforwards arose during the company's development stage when it incurred high levels of research and development expenses prior to commencing sales. While the company has earned, on average, \$6 million income before tax (taxable income before carryforwards) in each of the last five years, future profitability in this competitive industry depends on continually developing new products. The company has a number of promising new vaccines under development, but it is aware that other companies recently began testing vaccines that would compete with the vaccines being developed by the company as well as products that will compete with the vaccines that are currently generating the company's profits. Rapid introduction of competing products or failure of the company's development efforts could reduce estimates of future profitability in the near term, which could affect the company's ability to fully utilize its loss carryforward.

**A-44. Disclosure.**<sup>22</sup> The company has recorded a deferred tax asset of \$4.8 million reflecting the benefit of \$12 million in loss carryforwards, which expire in varying amounts between 19X5 and 19X7. Realization is dependent on generating sufficient taxable income prior to expiration of the loss carryforwards. Although realization is not assured, management believes it is more likely than not that all of

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<sup>19</sup> This is an example of voluntary disclosure that is encouraged by paragraph .14.

<sup>20</sup> As this contract is still expected to be profitable, the estimate does not involve a loss contingency covered by FASB Statement No. 5. Accordingly, disclosure of an estimate of the range of the possible change in estimate is not required.

<sup>21</sup> APB Opinion 20, *Accounting Changes*, paragraph 33, requires or recommends, depending on the estimates involved, disclosure of the effect of significant revisions of estimates if the effect is material.

<sup>22</sup> In addition to other disclosures, information as to the amount of loss carryforwards and their expiration dates and the amount of any valuation allowance with respect to the recorded deferred tax asset is required under FASB Statement No. 109, *Accounting for Income Taxes*.

the deferred tax asset will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

**A-45. Discussion.** This disclosure informs users that (a) realization of the deferred tax asset depends on achieving a certain minimum level of future taxable income within the next three years and (b) although management currently believes that achievement of the required future taxable income is more likely than not, it is at least reasonably possible that this belief could change in the near term, resulting in establishment of a valuation allowance.

### **Illustrative Disclosure I—Litigation**

**A-46. Scenario.** ABC Company is the defendant in litigation involving a major competitor claiming patent infringement. The suit claims damages of \$200 million. Discovery has been completed, and ABC is engaged in settlement discussions with the plaintiff. ABC has made an offer of \$5 million to settle the case, which offer was rejected by the plaintiff; the plaintiff has made an offer of \$35 million to settle the case, which offer was rejected by ABC. Based on the expressed willingness of the plaintiff to settle the case along with information revealed during discovery and the likely cost and risk to both sides of litigating, the company believes that it is probable the case will not come to trial. Accordingly, the company has determined that it is probable that it has some liability. The company's reasonable estimate of this liability is a range between \$10 million and \$35 million, with no amount within that range a better estimate than any other amount; accordingly, \$10 million was accrued.

**A-47. Disclosure.** On March 15, 19X1, the DEF Company filed a suit against the company claiming patent infringement. While the company believes it has meritorious defenses against the suit, the ultimate resolution of the matter, which is expected to occur within one year, could result in a loss of up to \$25 million in excess of the amount accrued.<sup>23</sup>

**A-48. Discussion.** FASB Statement No. 5 requires accrual of a loss contingency and disclosure of the nature of the contingency, the exposure to loss in excess of the amount accrued, and, depending on the circumstances, the amount accrued. This SOP requires disclosure of an indication that it is at least reasonably possible that a change in the company's estimate of its probable liability could occur in the near term.

### **Current Vulnerability Due to Certain Concentrations**

*Note: The following are illustrations of the disclosures required by paragraph .21 of this SOP. Some of the concentrations described may fall into more than one of the categories of concentrations given in paragraph .22, a through d.*

### **Illustrative Disclosure A—Supplier/Sources of Supply**

**A-49. Scenario.** Hi-Tech Corp. is a manufacturer of electronic equipment in which integrated circuits are an important component. Substantially all of Hi-Tech's customers require that only those vendors that meet quality criteria be used as sources for integrated circuits. Hi-Tech currently buys all of its integrated circuits from one manufacturer in the Far East, and no long-term sup-

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<sup>23</sup> See footnote 17 of this Appendix.



ply contract exists. There are only a limited number of manufacturers of these particular integrated circuits, and a change of supplier could significantly disrupt the business due to the time it would take to locate and qualify a new vendor.

**A-50. Disclosure.** The company currently buys all of its integrated circuits, an important component of its products, from one supplier. Although there are a limited number of manufacturers of the particular integrated circuits, management believes that other suppliers could provide similar integrated circuits on comparable terms. A change in suppliers, however, could cause a delay in manufacturing and a possible loss of sales, which would affect operating results adversely.

**A-51. Discussion.** Although other sources of supply of this particular kind of integrated circuit are currently available, the limited number of such sources and the time it takes to qualify new vendors makes Hi-Tech currently vulnerable to the risk of a near-term severe impact.

**A-52.** Disclosure is required because it is considered at least reasonably possible, based on information known to management prior to issuance of the financial statements, that the events that could cause the severe impact will occur.

### ***Illustrative Disclosure B—Supplier/Sources of Supply***

**A-53. Scenario.** Minnesota Company manufactures various products in which wheat is an important raw material. It currently buys 80 percent of its wheat from one supplier, but numerous alternate sources of supply are readily available on comparable terms.

**A-54. Disclosure.** (No disclosure is required.)

**A-55. Discussion.** The concentration exists at the date of the financial statements, and an inability to obtain wheat could result in a near-term severe impact. No disclosure is required, however, because numerous alternative suppliers are available and, therefore, it is not considered at least reasonably possible that events that could cause a near-term severe impact will occur.

### ***Illustrative Disclosure C—Patent***

**A-56. Scenario.** Felt Pharmaceutical Company is a national pharmaceutical manufacturer headquartered in Atlanta, Georgia. The company markets a wide range of pharmaceutical products. One of its better-known name-brand products, a significant source of profits and cash flow, is an antibiotic on which there is a patent that will expire in six months. Competitors are preparing to enter the market with generic alternatives when Felt's patent expires, and the concentration therefore has the potential for a severe impact.

**A-57. Disclosure.** Felt Pharmaceutical Company is a national pharmaceutical manufacturer with sales throughout the United States. The patent on one of its major products expires next year. This product accounts for approximately one-third [or "a significant portion"] of the company's revenues and a higher percentage of its gross profit.

**A-58. Discussion.** The disclosure focuses on the nature of the business and on Felt's current vulnerability due to a concentration of its patented products. Disclosure is required because the concentration exists at the date of the finan-

cial statements, because the effect on the company's cash flows and profitability of competitors entering the market when the patent expires could be a severe impact, and because it is considered at least reasonably possible that the events that could cause the severe impact will occur in the near term.

**A-59.** Because the risk is evident from the description of the concentration, no further explanation of the risk is necessary.

### ***Illustrative Disclosure D—Source of Supply of Labor***

**A-60. Scenario.** Team Company is a manufacturer of industrial hardware. The contract with the union representing Team's labor force is due to expire in the coming year. Over the past thirty years, Team has, in rare instances, been affected by work stoppages in the course of contract negotiations; they have always been of short duration, and none has had a significant effect on Team's financial statements. Although management expects that there will initially be some differences between its offer to the union and union demands, based on preliminary discussions with union leaders, management believes it is very unlikely that those differences will result in a protracted conflict.

**A-61. Disclosure.** (No disclosure is required.)

**A-62. Discussion.** Although the concentration of labor exists at the date of the financial statements and it could result in a severe impact in the near term due to the potential of a protracted work stoppage, no disclosure is required because it is not considered at least reasonably possible in the light of past experience and current conditions that a protracted work stoppage will take place.

### ***Illustrative Disclosure E—Contributor***

**A-63. Scenario.** Zebra Zoo, a not-for-profit organization, is supported by contributions from the public. In the current year, two contributors provided 35 percent of the organization's combined revenues.

**A-64. Disclosure.** Approximately 35 percent of the organization's combined revenues were provided by two contributors.

**A-65. Discussion.** Disclosure is required because the two contributors provided a significant portion of the organization's revenues. As noted in paragraph .22, it is always considered reasonably possible that a customer, grantor, or contributor will be lost in the near term.

### ***Illustrative Disclosure F—Geographic Area of Operations***

**A-66. Scenario.** Offshore Productions, Inc. (Offshore), a Delaware corporation, designs and manufactures optical lenses, which it markets throughout the United States. Substantially all of its manufacturing operations are carried out in a single facility, which is located in Switzerland and which is owned by Offshore's subsidiary. Offshore does not carry insurance for risks of loss. Offshore's consolidated balance sheet includes \$20 million representing the net assets of those operations.

**A-67. Disclosure.** Included in the company's consolidated balance sheet at December 31, 19X4, are the net assets of the company's manufacturing operations, all of which are located in a single facility in Switzerland and which total approximately \$20 million.<sup>24</sup>

<sup>24</sup> The disclosures required by this SOP for this scenario may have been met, or partly met, by satisfying the requirements of Accounting Research Bulletin (ARB) 43, chapter 12, "Foreign Operations and Foreign Exchange." Furthermore, for public companies, the disclosures required by this SOP for this scenario may also have been met, in part, by satisfying the requirements of FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*.

**A-68. Discussion.** All of Offshore's specialized manufacturing capacity is concentrated in a single facility. As noted in paragraph .22, it is always considered at least reasonably possible that the use of a facility located outside of an entity's home country could be disrupted in the near term. Due to the specialized nature of the assets, it would not be possible to find replacement capacity quickly. Accordingly, loss of the facility could produce a near-term severe impact to Offshore. This disclosure informs financial statement users of that concentration of operations in a particular geographic area and informs them of the risks and uncertainties associated with the concentration. Because the concentration is one of operations located outside of Offshore's home country, the disclosure also sets forth the carrying amount of the net assets, as required by paragraph .24 of this SOP.

## Appendix B

### Background Information and Basis for Conclusions

**B-1.** FASB Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, states that financial reporting should “provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions” (paragraph 34). To support that decision-making process, financial reports should help such users “assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise” (paragraph 37) by providing “information about the economic resources of an enterprise, the claims to those resources...and the effects of transactions, events, and circumstances that change resources and claims to those resources” (paragraph 40). Without additional disclosure in financial reports about significant risks and uncertainties, these objectives may not be fully met in today’s environment.

**B-2.** Recognizing that a riskier business and economic climate equates to a riskier investment and lending climate, users increasingly are asking that financial statements include more information to help them assess the risks and uncertainties concerning a reporting entity’s future cash flows and results of operations. These requests are underscored in calls for an “early warning system” expressed in the financial press and in congressional hearings.

**B-3.** No system of reporting can provide early warnings of all future detrimental events. Indeed, management may be unaware, and reasonably so, of some significant risks and uncertainties. And, clearly, financial statements should not be burdened in an attempt to describe every possible risk and uncertainty facing the reporting entity.

**B-4.** But such limitations should not prevent users from receiving improved disclosures concerning significant risks and uncertainties. Their existence merely means that any new disclosure requirements must focus on what is important. New disclosure requirements should effectively separate the significant matters that warrant reporting from the host of lesser risks and uncertainties that do not.<sup>25</sup> AcSEC believes that the requirements in this SOP meet those objectives.

**B-5.** In reaching the conclusions in this SOP, AcSEC considered and evaluated users’ reliance on financial information, sources of financial information, current accounting and disclosure requirements, current SEC requirements, and users’ perceptions of the kinds of information that should be presented in financial statements.

### Users’ Reliance on Financial Information

**B-6.** Information in financial statements, shaped by generally accepted accounting principles (GAAP) and, for SEC registrants, by the additional regulatory requirements of the Commission, is considered important to users in making investment and lending decisions. Financial statements provide information about certain current conditions and trends that help users in pre-

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<sup>25</sup> This SOP does not prohibit disclosure of matters it does not require to be disclosed either because they do not meet the specified screening criteria or because they relate to risks and uncertainties that are outside the scope of this SOP.

dicting reporting entities' future cash flows and results of operations. The quality of users' predictions depends to a significant degree on their assessment of the risks and uncertainties inherent in entities' operations and of the information about those operations that financial reporting provides.

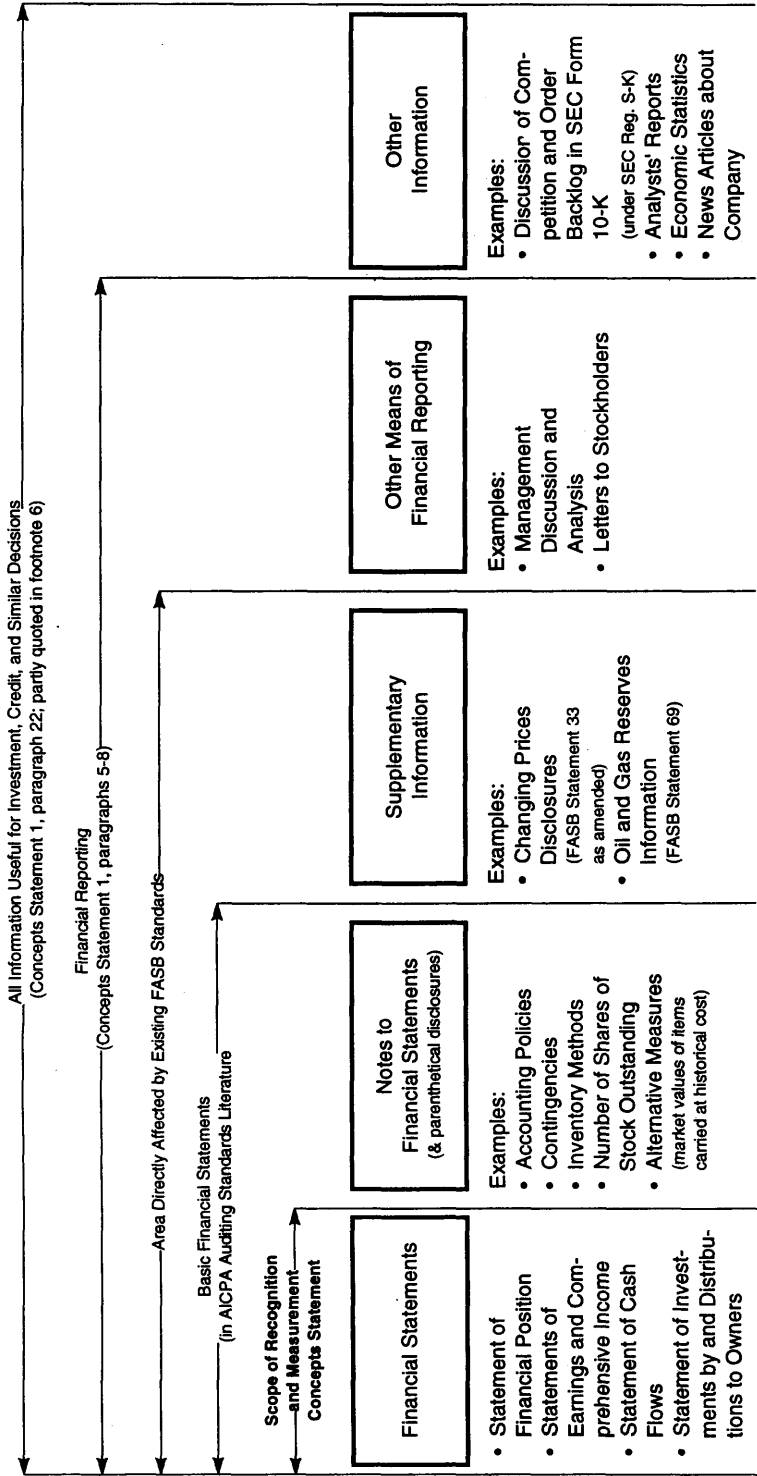
**B-7.** Financial reporting largely reflects the effects of past transactions and other events that have already affected a reporting entity. Such information can help users in assessing the future. But that does not mean the future can be predicted merely by extrapolating past trends or relationships. Indeed, volatility in the economic environment almost always means that simply extrapolating past trends and relationships will lead to inaccurate predictions. Users need to assess all currently available information to form their own expectations about the future and its relation to the past. Forming expectations—making predictions—is a vital part of the decision process. But it is a function of financial analysis, not of financial reporting. Furthermore, financial reporting is only one source of information required for making investment and credit decisions.

**B-8.** Reporting entities and those who have economic interests in them are affected by many factors that interact in complex ways. Those who use financial information for business and economic decisions need to combine information provided by financial reports with pertinent information from other sources, including additional information provided by issuers, financial analysts' reports, business and trade publications, and reports of macroeconomic and other local, national, and international events.

## Sources of Financial Information

**B-9.** Financial reporting encompasses the financial statements and notes, required information supplementary to the financial statements, and other information, such as that included in Management's Discussion and Analysis (MD&A), which the SEC requires publicly held business enterprises to provide in their annual and quarterly reports. Additional sources of information include company releases, current information filings of publicly held business enterprises, investment advisory services, analysts' reports, the financial press, general economic statistics, and general news reports.

**B-10.** The major sources of financial information and their relationships for business and not-for-profit entities are illustrated in the following diagram, taken from FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.



[Source: FASB Concepts Statement No. 5, p. 5]

## Current Accounting Requirements

**B-11.** Disclosing information to help users assess major risks and uncertainties is consistent with the established objectives of financial reporting, and some such information is already presented in financial statements. Such information includes, for example, information about financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk, related party disclosures and information about receivables, leases, pensions, postretirement benefits, and commitments and contingencies. In addition, publicly held business enterprises are required to disclose in their financial statements segment information and information about foreign operations, export sales, and major customers, which, among other things, helps users to assess risks and uncertainties. This SOP, however, is intended to extend disclosures beyond those currently required and to help users discern those risks that are of particular importance.

### *Nature of Operations*

**B-12.** Current GAAP (FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*) requires a public business enterprise to disclose the major types of products and services that generate revenues, that is, the nature of its businesses, as part of segment information in its financial statements, even if the business enterprise operates in only one industry.<sup>26</sup> Information presented includes a description of the types of goods or services provided, operating revenues, operating income or loss, net income or loss, net working capital, and total assets for each segment. But other reporting entities are not required to disclose such information.<sup>27</sup> Thus, financial statement users now sometimes cannot discern the nature of the operations of such other entities from information presented in their financial statements.

**B-13.** Information about the nature of operations is helpful because the various kinds of businesses in which reporting entities operate have diverse degrees and kinds of risks. Certain of these risks are inherent to the business in which an entity is engaged. Simply by knowing the nature of an entity's business and the principal markets for its products or services, a financial statement user is alerted, indirectly, about the risks common to that business.

**B-14.** Some have expressed concerns about whether this SOP conflicts with FASB Statement No. 21, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*. AcSEC believes that, while the information that this SOP requires to be disclosed concerning the nature of a reporting entity's operations overlaps in certain respects the information public business enterprises are required to report under FASB Statement No. 14, it is significantly different in other respects. Accordingly, AcSEC does not believe this SOP conflicts with Statement No. 21.

**B-15.** Further, AcSEC notes that, for public business enterprises that already disclose information about the nature of their operations pursuant to FASB Statement No. 14, this SOP requires disclosure of additional information about the nature of their operations.

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<sup>26</sup> The FASB currently has on its agenda a project on disaggregated disclosures, which is reconsidering issues related to FASB Statement No. 14.

<sup>27</sup> FASB Statement No. 21, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*, suspended the segment information reporting requirements of FASB Statement No. 14 for nonpublic enterprises.

**B-16.** The disclosure required by paragraph .10 of this SOP focuses on the entity's principal markets, including their locations. Current segment information for business enterprises, in contrast, focuses on the nature of the segments' operations and their identifiable assets and the geographic location of assets outside the enterprise's home location. Disclosure of the locations of a business or not-for-profit entity's principal markets provides information useful in assessing risks and uncertainties related to the environments in which the entity operates. The risks and the uncertainties associated with selling products and services in various regions in the United States may differ significantly. And they do differ significantly from the risks and the uncertainties in selling products and services outside the United States. Knowing those environments in which an entity sells its products or provides services helps users of financial reports to assess certain risks based on day-to-day national and world events.

**B-17.** The following table compares and contrasts the information required of public companies by FASB Statement No. 14 with paragraph .10.

**Comparison of Disclosure Requirements:  
FASB Statement No. 14 (Segment Reporting) Versus  
Paragraph .10 of this SOP**

<i>Disclosure</i>	<i>FASB Statement No. 14</i>	<i>Paragraph .10</i>
Description of the types of products or services sold	X	X
Revenue, profitability, identifiable assets, and other related disclosures for each reportable segment	X	*
Revenue, profitability, identifiable assets for foreign operations, by geographic area	X	†
Export sales by domestic operations, by geographic area	X	
Significant sales to single customer, foreign government, or domestic governmental agency	X	‡
Identification of principal markets		X
Description of location of principal markets		X

\* Paragraph .10 requires an indication of the relative importance of operations in each business.

† This SOP requires disclosure of current vulnerability due to concentrations in the market or geographic area in which an entity conducts its operations if the criteria in paragraph .21 are met.

‡ This SOP requires disclosure of current vulnerability due to concentrations of customers if the criteria in paragraph .21 are met.

**B-18.** AcSEC considered whether disclosure of an entity's principal operating locations would be informative to financial statement users and should, therefore, be included in paragraph .10. AcSEC concluded that, although in certain circumstances such information would be relevant, generally it would not be. In addition, disclosure of an entity's principal operating locations would be required under paragraph .21 (current vulnerability due to certain concen-



trations) in circumstances where operating in that particular environment created substantive near-term risk to the entity. Knowing, however, that a manufacturing plant is located in Dallas, Texas, for example, was not considered particularly relevant information. In contrast, knowing where a residential housing construction contractor's principal market is located was considered to be highly relevant. As a result, disclosure of the location of principal markets was chosen by AcSEC for inclusion in paragraph .10, while disclosure of the location of principal operating units was considered unnecessary.

### ***Use of Estimates in the Preparation of Financial Statements***

**B-19.** Auditors are required under generally accepted auditing standards (GAAS)<sup>28</sup> to acknowledge in their standard reports the use of estimates in the preparation of financial statements. AcSEC has concluded, however, that an explanation that the preparation of financial information requires the use of estimates and assumptions should be included in the financial statements by the reporting entity to inform users of the nature and limitations of those financial statements. AcSEC acknowledges that the disclosure would usually be standardized. AcSEC nevertheless believes it would help users make sounder use of financial statements.

**B-20.** There is a need to communicate explicitly to users of financial reports that the inescapable use of estimates in the preparation of financial information, including the estimation of fair and, in some cases, market values for assets carried at such bases, results in the presentation of a number of approximate rather than exact amounts. If users understand better the inherent limitations on precision in financial statements, they will be better able to make decisions.

**B-21.** Estimates inherent in the current financial reporting process inevitably involve assumptions about future events. For example, accruing income for the current period under a long-term contract requires an estimate of the total profit to be earned on the contract. For another example, carrying inventories at the lower of cost or market is based on an assumption that there will be sufficient demand for that product in the future to be able to sell the quantity on hand without incurring losses on the sales or, if market is used, that it can be estimated. Making reliable estimates for such matters is often difficult even in periods of economic stability; it is more so in periods of economic volatility. Although many users of financial reports are aware of that aspect of financial reporting, others often assume an unwarranted degree of reliability in financial statements. The disclosure required by this SOP should help dispel any such erroneous assumptions.

**B-22.** A number of publicly held business enterprises now include management reports in annual reports to stockholders. Many such reports and letters state that estimates and assumptions are required to prepare financial statements in conformity with GAAP. AcSEC acknowledges that development, but it believes the disclosure should be mandated and included in the notes to financial statements.

### ***Certain Significant Estimates***

**B-23.** FASB Statement No. 5 requires reporting entities to disclose certain loss contingencies, as follows:

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<sup>28</sup> SAS No. 58, *Reports on Audited Financial Statements*, requires auditors to include in their standard reports a statement that an audit includes "assessing . . . significant estimates made by management."

If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.<sup>6</sup> The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. [Emphasis added.] [FASB Statement No. 5, paragraph 10]

Footnote 6 to Statement No. 5 states:

For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(a) but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 8(b)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(a)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset has been impaired or a liability had been incurred at the date of the financial statements. [Emphasis in original.]

FASB Statement No. 5 defines loss contingencies as:

an existing condition, situation, or set of circumstances involving uncertainty as to possible . . . loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability. [paragraph 1]

The recognition and disclosure requirements of Statement No. 5 are further clarified in FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*. This SOP does not change the requirements of FASB Statement No. 5 or FASB Interpretation No. 14; the requirements of this SOP supplement those requirements. For example, if a loss contingency meets the criteria for disclosure under both Statement No. 5 and paragraph 13 of this SOP, this SOP requires disclosure that it is at least reasonably possible that future events confirming the fact of the loss or the change in the estimated amount of the loss will occur in the near term.

**B-24.** This SOP also requires disclosure of matters that may not be deemed to be contingencies requiring disclosure under current GAAP. FASB Statement No. 5 distinguishes loss contingencies from other uncertainties inherent in making accounting estimates, as follows:

Not all uncertainties inherent in the accounting process give rise to contingencies as that term is used in this Statement. Estimates are required in financial statements for many on-going and recurring activities of an enterprise. The mere fact that an estimate is involved does not of itself constitute the type of uncertainty referred to in the definition [of a contingency] in paragraph 1. For example, the fact that estimates are used to allocate the known cost of a depreciable asset over the period of use by an enterprise does not make depreciation a contingency; the eventual expiration of the utility of the asset is not uncertain. Thus, depreciation of assets is not a contingency as defined in paragraph 1, nor are such matters as recurring repairs, maintenance, and overhauls, which interrelate with depreciation. Also, amounts owed for services received, such as advertising and utilities, are not contingencies even though the accrued amounts may have been estimated; there is nothing uncertain about the fact that those obligations have been incurred. [paragraph 2]

FASB Statement No. 5 acknowledges, however, that the distinction between uncertainties inherent in making accounting estimates and uncertainties that give rise to a contingency is not always clear:

A question has been raised whether uncollectibility of receivables and product warranties constitute contingencies within the scope of this Statement. The Board recognizes that uncertainties associated with uncollectibility of some receivables and some product warranties are likely to be, in part, inherent in making accounting estimates (described in paragraph 2) as well as, in part, the type of uncertainties that give rise to a contingency (described in paragraph 1). The Board believes that no useful purpose would be served by attempting to distinguish between those two types of uncertainties for purposes of establishing conditions for accrual of uncollectible receivables and product warranties. Consequently, those matters are deemed to be contingencies within the definition of paragraph 1 and should be accounted for pursuant to the provisions of this Statement. [paragraph 58]

**B-25.** AcSEC believes that requiring disclosure of certain estimates not deemed to be covered by current GAAP, for example, some amounts reported for long-term contracts, would enhance the usefulness of financial statements in assessing risks and uncertainties.

**B-26.** Among the matters specifically excluded from the scope of FASB Statement No. 5 is the write-down of operating assets. Paragraph 31 of Statement No. 5 states:

In some cases, the carrying amount of an operating asset not intended for disposal may exceed the amount expected to be recoverable through future use of that asset even though there has been no physical loss or damage of the asset or threat of such loss or damage. For example, changed economic conditions may have made recovery of the carrying amount of a productive facility doubtful. The question of whether, in those cases, it is appropriate to write down the carrying amount of the asset to an amount expected to be recoverable through future operations is not covered by this Statement.

The requirements of paragraph .13 of this SOP are applicable to long-lived assets whose value may become impaired in the near term.

**B-27.** On November 29, 1993, the FASB issued an exposure draft of a Proposed Statement of Financial Accounting Standards, *Accounting for the Impairment of Long-Lived Assets*. That exposure draft is expected to result ultimately in the promulgation of authoritative guidance on recognition, measurement, and disclosure requirements for long-lived assets whose carrying amounts may not be recoverable. Paragraphs 102 and 103 of the exposure draft state:

In 1985, the AICPA established a task force to consider the need for improved disclosures about risks and uncertainties that affect companies and the manner in which they do business. In July 1987, the task force published *Report of the Task Force on Risks and Uncertainties*, which concluded that companies should be making early warning disclosures as part of their financial statements. In March 1993, AcSEC issued an exposure draft of a proposed Statement of Position, *Disclosure of Certain Significant Risks and Uncertainties and Financial Flexibility*. That proposed SOP would require entities to include in their financial statements disclosures about (a) the nature of their operations, (b) the use of estimates in the preparation of their financial statements, (c) certain significant estimates, (d) current vulnerability due to concentrations, and (e) financial flexibility.

Board members observed that for some impairments early warning disclosures would be useful. However, they were in general agreement, based on comment letters and testimony, that it would not be possible to adequately describe those situations and develop adequate disclosure requirements. Some Board members also believed that the proposed SOP is a much broader disclosure requirement that could have implications in several other Board projects. Board members therefore concluded not to require early warning disclosures in this Statement.

AcSEC notes that, while the exposure draft would not require early warning disclosures concerning impairment of long-lived assets, it acknowledges the usefulness of such disclosures and recognizes that the disclosure requirement of this SOP is a much broader requirement than the FASB considered.

### **Current Vulnerability Due to Certain Concentrations**

**B-28.** Current GAAP requires disclosure of certain concentrations (for example, credit concentrations under FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and information about major customers under FASB Statement No. 14 for public enterprises) but does not specifically address disclosures of concentrations on a comprehensive basis. This SOP addresses known concentrations more comprehensively but stops short of requiring disclosure of all concentrations.

**B-29.** Some believe that disclosure of economic dependency is required under current literature. A requirement to disclose economic dependency was included in SAS No. 6, *Related Party Transactions*. But, partly in response to the issuance of FASB Statement No. 57, *Related Party Transactions*, the AICPA superseded SAS No. 6 in August 1983 with the issuance of SAS No. 43, *Omnibus Statement on Auditing Standards—1983*, which, among other things, “remov[ed] guidance on accounting considerations and disclosure standards . . . provided in FASB Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*.” Statement No. 57 states, in turn, that it “does not address the issues pertaining to economic dependency.”

**B-30.** The FASB observed in Statement No. 21, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*, which was issued in April 1978 and which eliminated the requirement for nonpublic enterprises to disclose information about major customers, that FASB Statement No. 21 “does not affect the disclosure of information about economic dependency when such disclosure may be necessary for a fair presentation.” That observation, however, refers to the now-superseded SAS No. 6.

**B-31.** AcSEC believes that disclosure in the notes to financial statements about current vulnerability due to concentrations of customers, grantors, and contributors is necessary for a fair presentation when the criteria in paragraph .21 of this SOP are met. Assessing the likelihood of loss of relationships with these parties would often present difficulties, however. Accordingly, for purposes of this SOP, it is always considered at least reasonably possible that any of these relationships will be lost in the near term. Similarly, because of the difficulty in assessing the political and economic risks associated with operations located outside an entity’s home country, for purposes of this SOP, it is always considered at least reasonably possible that those operations might be disrupted in the near term. This SOP does not, however, prohibit entities from also stating in disclosures of concentrations related to customers, grantors, or contributors or operations located outside the entity’s home country that the entity does not expect that the business relationship will be lost or does not expect that the foreign operations will be disrupted if such is the case.

**B-32.** AcSEC considered whether it would be useful to establish quantitative criteria for disclosure of concentrations, either in place of or in addition to the qualitative criteria provided. AcSEC believes that a quantitative approach might not provide meaningful information about an enterprise (for example, a critical supplier is not necessarily a major supplier). Any potential simplification in implementing the disclosure requirements that might result from a quantitative approach would be outweighed by deterioration in the quality of information provided.

### Current SEC Requirements

**B-33.** The SEC requirement for information to be included in MD&A expands the information that financial reporting otherwise provides to include certain specific kinds of information related to liquidity, capital resources, and results of operations. It further expands the information to include management analysis of trends and other factors. Thus, management's subjective analysis is a significant part of the information users obtain from financial reporting of publicly held business enterprises as the data for their decisions.

**B-34.** The FASB's Concepts Statements present the view that such analysis is helpful to users. For example, in Concepts Statement No. 1, the FASB observes that financial reporting should include explanations and interpretations and cites as an example management's explanation of the information as a significant aid to users.

**B-35.** Under SEC requirements relating to MD&A, publicly held business enterprises are required to describe, among other things, "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations" (Regulation S-K, Item 303(a)(3)(ii)). SEC Financial Reporting Release (FRR) No. 36 clarifies that disclosure is required unless management determines that the trend or uncertainty is not reasonably likely to occur or that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur. Publicly held business enterprises are encouraged but not required to include forward-looking information relevant to a full understanding of their past and anticipated operations.

**B-36.** The disclosure of current vulnerability due to certain concentrations required by paragraph .21 of this SOP differs from the MD&A requirement in two important respects. First, the MD&A rules apply broadly to "any known trends or uncertainties," whereas paragraph .21 applies only to certain known concentrations. Second, this SOP requires disclosure only if the effect would cause a severe impact in the near term—a higher threshold than "material" used for MD&A purposes. AcSEC believes a higher threshold is needed for these disclosures to avoid required disclosure of lengthy lists of risks related to concentrations that are reasonably possible in today's environment and at the same time still meet the objective of providing an early warning of the potential for a disruptive set of events occurring in the near term.

**B-37.** The SEC also requires registrants, "where appropriate," to include in prospectuses offering securities to the public "a discussion of the principal factors that make the offering speculative or one of high risk." Among the factors cited are "the financial position of the registrant" and "the nature of the business in which the registrant is engaged or proposes to engage" (Regulation S-K, Item 503(c)).

**B-38.** This information required by the SEC is not now required for entities not subject to SEC regulation. However, expanding the scope of financial statements to include some of such information is compatible with the objectives of financial reporting. This SOP requires disclosure in the notes to financial statements of some of the information now reported in MD&A or as risk factors but might also require disclosure of certain information not currently required in either place.

## Comments Received on Exposure Draft

**B-39.** An exposure draft of a proposed Statement of Position, *Disclosure of Certain Significant Risks and Uncertainties and Financial Flexibility*, was issued for public comment on March 31, 1993, and distributed to approximately 20,000 interested parties to encourage comment by those who would be affected by the proposal. Over 300 comment letters were received in response to the exposure draft. Substantially all of the responses expressed reservations regarding the exposure draft's required disclosures of certain significant estimates, current vulnerability due to concentrations, and financial flexibility, while relatively few respondents expressed concerns regarding the disclosure of the nature of the reporting entity's operations or the use of estimates in the preparation of financial statements.

**B-40.** The most significant and pervasive concerns can be summarized in three areas:

- a. The cost of determining the necessity of the disclosures will exceed the benefit received from providing them, particularly for small, privately owned entities, and particularly with respect to the requirements for disclosure of financial flexibility.
- b. Requiring disclosures based on information "of which management is reasonably expected to have knowledge" is too subjective and unnecessarily expands costs and liability as well as the "expectation gap."
- c. "Reasonably possible" is too low a threshold and is an insufficiently objective criterion for disclosure of a broad range of possible future events.

**B-41.** AcSEC considered the comments received on the exposure draft and took the following actions in response to them.

- a. The requirement for disclosure of financial flexibility has been eliminated from this SOP. Financial flexibility was the exposure draft's most controversial requirement, with deep concerns expressed about the cost of compliance. Other concerns were expressed regarding the overlap between the exposure draft's requirements and the requirements of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, and the ability of the exposure draft's criteria to highlight meaningful information and to differentiate among entities that have different risks.

AcSEC does, however, continue to consider financial flexibility disclosures to be relevant early warnings for financial statement users. AcSEC also believes that disclosure requirements such as those included in SAS No. 59 should be included in accounting rather than auditing standards. Therefore, AcSEC and the AICPA's Auditing

Standards Board are considering forming an interdivisional task force to develop accounting standards to provide the appropriate early warnings of possible financial difficulties and to replace disclosure requirements currently included only in auditing standards.

- b. This SOP requires disclosure of certain defined concentrations known to management rather than a wider range of concentrations based on information of which management "is reasonably expected to have knowledge." Further, because of the continuing activity of the FASB in establishing disclosure requirements related to financial instruments, none of the defined concentrations relate specifically to financial instruments. The disclosures are to be made when (a) the concentrations are known to exist at the date of the financial statements, (b) they make the enterprise vulnerable to the risk of a near-term severe impact, and (c) it is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

AcSEC considered eliminating the reasonably possible and severe-impact disclosure criteria, but decided that retention of these criteria should promote disclosures that are more significant and useful than standardized listings that might otherwise result.

- c. The requirements to disclose certain significant estimates have been clarified to make them more consistent with the requirements of FASB Statement No. 5. This SOP requires discussion of estimates when, based on known information available prior to the issuance of the financial statements, it is reasonably possible that the estimate will change in the near term and the effect of the change will be material. AcSEC responded to concerns regarding the predictive nature of this disclosure requirement by stipulating that it is the estimate of the effect of a change in a condition, situation, or set of circumstances that existed at the date of the financial statements that must be disclosed and that the evaluation should be based on known information available prior to issuance of the financial statements.

AcSEC also revised the disclosure requirements included in the exposure draft applicable to estimates not involving loss contingencies covered by FASB Statement No. 5. With respect to such estimates, this SOP does not require the disclosure of the possible loss or range of loss or the statement that such an estimate cannot be made.

### **Placement of Disclosures**

**B-42.** A significant number of commentators recommended that, because of the subjectivity associated with some of the disclosures required by this SOP, they should be presented outside the basic financial statements, either as supplemental information or in MD&A.

**B-43.** FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, distinguishes between information that should be part of the basic financial statements and that which should be provided as supplementary information. Paragraph 7 of Concepts Statement No. 5 emphasizes that information disclosed as part of the basic financial state-

ments amplifies or explains information recognized in financial statements and is essential to understanding that information. FASB Statement No. 107, however, points out in paragraph 75 a need for disclosure about “many important items . . . not recognized as assets and liabilities in financial statements, and many transactions and other events . . . not recognized when they occur but only later when uncertainty about them is reduced sufficiently so that their effects are clear.”

**B-44.** The disclosures required by this SOP build on disclosures already included in the basic financial statements and, like them, serve one of the major purposes of disclosure summarized in Appendix D of FASB Statement No. 105, that is, to help in assessing risks and potentials. AcSEC also believes that the changes made in response to the comments received on the exposure draft have significantly reduced the subjectivity of the disclosures. Accordingly, AcSEC concluded that all of the disclosures now required by this SOP should be included in the basic financial statements.

### Scope

**B-45.** The exposure draft of this SOP would have applied to state and local governmental units. However, concern was expressed that inclusion of such entities unduly complicated the SOP. Further, resolving financial reporting issues unique to state and local governments that were brought up by commentators on the exposure draft—especially in the light of the other substantive changes made to the exposure draft—would have unduly delayed the issuance of this SOP. AcSEC believes the understandability of this SOP is improved by not including state and local governmental units in its scope.<sup>29</sup>

**B-46.** Many commentators on the exposure draft recommended that other reporting entities, especially smaller nonpublic reporting entities, be exempted from this SOP's disclosure requirements. AcSEC considered those recommendations and concluded that the disclosures required by this SOP are no less relevant for such entities and that the changes made to the exposure draft sufficiently mitigate the concerns expressed by commentators.

**B-47.** Some commentators requested that AcSEC clarify the applicability of the SOP's requirements to financial statements prepared using an Other Comprehensive Basis of Accounting (OCBOA). AcSEC concluded that the applicability of disclosures required by GAAP to OCBOA financial statements is a pervasive issue that is beyond the scope of this SOP.

### Field Tests

**B-48.** The March 31, 1993 exposure draft *Disclosure of Certain Significant Risks and Uncertainties and Financial Flexibility* was subjected to limited field testing in which the exposure draft was applied to small and medium-size busi-

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<sup>29</sup> Under the provisions of Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, paragraph 7, proprietary activities may apply all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements. Paragraph 33 of the “Basis for Conclusions” of that Statement explains that, for proprietary activities that apply paragraph 7, an AICPA SOP that does not include governmental entities in its scope but that has been cleared by the Financial Accounting Standards Board (FASB) would be considered category (b) guidance under Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, issued by the Auditing Standards Board of the AICPA.



nesses, a not-for-profit organization, and case studies. The issues highlighted by the results of those tests were similar to the issues raised in the comment letters on the exposure draft. The results of the field tests were considered by AcSEC in its deliberations of this SOP.

## Cost/Benefit

**B-49.** AcSEC believes the disclosures required by this SOP will improve financial reporting by providing, in a number of situations, information that will assist financial statement users in assessing certain risks and uncertainties inherent in financial reporting. AcSEC also believes the changes made to the exposure draft, which are discussed in paragraph B-41, are reasonably responsive to concerns expressed by commentators about the cost of determining the need for and making those disclosures.

**B-50.** FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, states in paragraph 142 that:

The costs and benefits of a standard are both direct and indirect, immediate and deferred. They may be affected by a change in circumstances not foreseen when the standard was promulgated. There are wide variations in the estimates that different people make about the dollar values involved and the rate of discount to be used in reducing them to a present value . . . [It has been observed that] "the merits of any Standard, or of the Standards as a whole, can be decided finally only by judgments that are largely subjective. They cannot be decided by scientific test."

**B-51.** While a reliable evaluation of costs versus benefits is not possible, AcSEC believes that the benefits of the disclosures required by this SOP will outweigh their costs.

## AICPA Special Committee on Financial Reporting

**B-52.** In the Spring of 1991, the AICPA's Board of Directors formed a Special Committee on Financial Reporting to address increasing concerns about the relevance and usefulness of financial reporting. The committee's charge is to recommend to standards setters and regulators (1) the nature and extent of information that should be made available to others by management and (2) the extent to which auditors should report on the various elements of that information. The focus of the Special Committee's work is on the information needs of investors and creditors, and its recommendations will be responsive to those needs.

**B-53.** In its November 1993 report on the information needs of today's users of financial reporting, *The Information Needs of Investors and Creditors*, the Special Committee stated:

Users want operating opportunities and risks identified based on the company and its segments rather than on an industry-wide basis. They also want information about opportunities and risks resulting from concentrations in assets, customers and suppliers.

**B-54.** AcSEC considered the Special Committee's preliminary findings in developing this SOP, and AcSEC may reconsider the guidance in this SOP in the light of the Special Committee's recommendations, if and when the conclusions are implemented by standards-setting bodies.

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## Section 10,650

# **Statement of Position 95-1 Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises**

January 18, 1995

### **NOTE**

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## **Introduction and Background**

.01 Most mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies (hereafter collectively referred to as *mutual life insurance enterprises*) issue financial statements prepared in conformity with statutory accounting practices. Practice, however, has been to consider statutory accounting practices as generally accepted accounting principles (GAAP), and mutual life insurance enterprises' statutory financial statements have been described as being in accordance with GAAP.

.02 In April 1993, the FASB issued Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, which concludes that financial statements based on statutory accounting practices can no longer be described as prepared in conformity with GAAP. FASB Interpretation No. 40, as amended by FASB Statement of Financial Accounting Standards No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, is effective for financial statements issued for fiscal years beginning after December 15, 1995. (FASB Statement No. 120 does not change the disclosure and other transition provisions of Interpretation No. 40.) Accordingly, mutual life insurance enterprises that wish to prepare GAAP financial statements in 1996 and beyond will have to apply pertinent authoritative accounting pronouncements, such as FASB Statements and Interpretations, Accounting Principles Board Opinions, and AICPA Statements of Position, that do not explicitly exempt mutual life insurance companies.

.03 When FASB Interpretation No. 40 was issued, FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, exempted mutual life insurance companies from their provisions. Furthermore, the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies* does not apply to mutual life insurance companies.<sup>1</sup> Accordingly, there was no authoritative guidance that explicitly addressed how to account for certain insurance activities of mutual life insurance enterprises. Recognizing the lack of authoritative guidance, the FASB urged the AICPA to take on a project to address accounting and reporting by mutual life insurance enterprises for their insurance activities. This SOP was prepared in response to that request. Furthermore, concurrent with the issuance of this SOP, the FASB has issued Statement No. 120, which removes the exemption for mutual life insurance enterprises from FASB Statement Nos. 60, 97, and 113 and recognizes that participating life insurance contracts that meet the conditions in paragraph .05 of this SOP should be accounted for under this SOP.

## Applicability and Scope

.04 This SOP applies to all mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies. This SOP also applies to stock life insurance subsidiaries of mutual life insurance enterprises.

.05 This SOP applies to life insurance contracts that have both of the following characteristics:

- a. They are long-duration participating contracts that are expected to pay **dividends to policyholders**<sup>2</sup> based on actual experience of the insurance enterprise.
- b. **Annual policyholder dividends** are paid in a manner that identifies divisible surplus and distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus (commonly referred to in actuarial literature as the *contribution principle*).

.06 FASB Statement No. 97 should be applied to investment contracts, limited-payment contracts that do not have the characteristics described in paragraph .05, and universal life-type contracts as defined in FASB Statement No. 97. FASB Statement No. 60 should be applied to short-duration contracts with fixed and variable terms and to long-duration contracts that do not have the characteristics described in paragraph .05 and are not covered by FASB Statement No. 97. FASB Statement No. 113 should be applied to reinsurance contracts.

## Accounting and Reporting Models

.07 The accounting and reporting model for long-duration insurance contracts issued by insurance enterprises other than mutual life insurance enter-

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<sup>1</sup> The AICPA plans to issue an exposure draft of a revised life and health insurance enterprises audit guide, which will apply to mutual life insurance enterprises. This SOP will be incorporated into the revised guide.

<sup>2</sup> Terms defined in the Glossary [paragraph .65] are in **boldface type** the first time they appear in this SOP.

prises was established in FASB Statement Nos. 60 and 97. FASB Statement No. 60 addresses long-duration contracts, such as whole-life, guaranteed-renewable term-life, and annuity contracts that are expected to remain in force for an extended period and that are characterized by fixed and guaranteed terms. FASB Statement No. 97 addresses other long-duration contracts such as universal life-type insurance contracts—that are characterized by flexibility and discretion granted to one or both parties to the contract, limited payment contracts, and investment contracts.

## FASB Statement No. 60

.08 Under FASB Statement No. 60, premiums for long-duration insurance contracts are recognized as revenue when due from policyholders. A liability for future policy benefits is accrued when premium revenue is recognized. The liability—which represents both the present value of estimated future policy benefits to be paid to or on behalf of policyholders, and related expenses less the present value of estimated future net premiums<sup>3</sup> to be collected from policyholders is based on a uniform percentage of anticipated premiums and on estimates of expected **investment yields**, mortality, morbidity, terminations, and expenses applicable at the time the insurance contracts are made. FASB Statement No. 60 also requires a provision for the risk of adverse deviation. Original assumptions ordinarily continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits (referred to as *lock-in*), unless a premium deficiency exists. Costs that vary with, and are primarily related to, the acquisition of new and renewal insurance contracts (**acquisition costs**) are capitalized and charged to expense in proportion to premium revenue recognized.

## FASB Statement No. 97

.09 FASB Statement No. 97 requires that a retrospective deposit method be used to account for universal life-type insurance contracts. That accounting method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder. Premiums are not reported as revenues. Rather, revenues from those contracts represent amounts assessed against policyholders and are reported in the period that the amounts are assessed, unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period. FASB Statement No. 97 also requires that capitalized acquisition costs associated with universal life-type contracts be amortized, based on a constant percentage of the present value of estimated gross profit amounts. Estimates of gross profits should be evaluated regularly, and the total amortization recorded to date is adjusted if actual experience or other evidence suggests earlier estimates should be revised.

## Participating Contracts

.10 FASB Statement No. 60 addresses accounting for traditional forms of participating contracts issued, but does not address the participating contracts issued by mutual life insurance enterprises, which are covered by this SOP.

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<sup>3</sup> FASB Statement No. 60 defines *gross premium* as “the premium charged to a policyholder for an insurance contract.” That Statement defines *net premium* as “the portion of the gross premium required to provide for all benefits and expenses.”

Furthermore, FASB Statement No. 97 addresses those participating contracts with contract terms that suggest that they are, in substance, universal life-type contracts.

## Conclusions on Financial Reporting

.11 The following conclusions should be applied to insurance contracts described in paragraph .05 of this SOP and should be read in conjunction with "Background Information and Basis for Conclusions," beginning in paragraph .26 of this SOP. Furthermore, AICPA Practice Bulletin 8, *Application of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, to Insurance Enterprises* [section 12,080], provides interpretative guidance that, if applicable, should be followed for the contracts covered by this SOP.

### Revenue Recognition

.12 Premiums from participating insurance contracts should be reported as revenue in the statement of earnings when due from policyholders.

### Benefits Recognition

.13 Death and surrender benefits incurred should be reported as expenses in the statement of earnings.

### Dividends

.14 Annual policyholder dividends should be reported separately as an expense in the statement of earnings, and should be based on estimates of amounts incurred for the policies in effect during the period. For example, if a policy has an anniversary date of June 30, at which time annual dividends are paid, at December 31, 19X1, dividends should be accrued for the period July 1, 19X1, through December 31, 19X1, and should be reported separately on the balance sheet. (See paragraph .17 for information on accounting for terminal dividends as part of the liability for future policyholder benefits.)

### Liability for Future Policy Benefits

.15 A liability for future policy benefits relating to participating life insurance contracts should be equal to the sum of—

- a. The **net level premium reserve** for death and endowment policy benefits.
- b. The liability for **terminal dividends**.
- c. Any probable loss (premium deficiency) as described in paragraphs 35 to 37 of FASB Statement No. 60.

.16 The net level premium reserve should be calculated based on the **dividend fund interest rate**, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the contract. If the dividend fund interest rate is not determinable, the **guaranteed interest rate** used in calculating cash surrender values described in the contract should be used. If the dividend fund interest rate is not determinable and there is no guaranteed interest rate, the interest rate used in determining guaranteed nonforfeiture values should be used. Finally, if none of the above rates exists,

then the interest rate used to determine minimum cash surrender values—as set by the National Association of Insurance Commissioners' (NAIC) model standard nonforfeiture law—for the year of issue of the contract should be used. Regardless of the rate used, net premiums should be calculated as a constant percentage of the gross premiums.

**.17 Terminal dividends** should be accrued in the liability for future policy benefits if the following conditions are both met:<sup>4</sup>

- a. Payment of the dividend is probable.
- b. The amount can be reasonably estimated.

If the two conditions are met (and they ordinarily will be), the terminal dividends should be recognized as an expense over the life of a book of participating life insurance contracts, at a constant rate based on the present value of the estimated gross margin amounts expected to be realized over the life of the book of contracts. The present value of estimated gross margins should be computed using the expected investment yield (net of related investment expenses). If significant negative gross margins are expected in any period, then the present value of gross margins before annual dividends, estimated gross premiums, or the balance of insurance in force should be substituted as the base for computing the expense amount to be recognized. (The base substituted in this calculation should be the same one substituted in the amortization of deferred acquisition costs discussed in paragraph .20.)

**.18** Increases in the liability for future policy benefits should be reported as an expense in the statement of earnings.

## Acquisition Costs

**.19** This SOP uses the definition of *acquisition costs* contained in FASB Statement No. 60,<sup>5</sup> and in the following sentence describes those that are ineligible for capitalization under this SOP. Acquisition costs (such as premium taxes) that vary in a constant relationship to premiums or insurance in force, that are recurring in nature, or that tend to be incurred in a level amount from period to period, should be charged to expense in the period incurred.

**.20** Capitalized acquisition costs should be amortized over the life of a book of participating life insurance contracts at a constant rate, based on the present value of the estimated gross margin amounts expected to be realized over the life of the book of contracts. The present value of estimated gross margins should be computed using the expected investment yield. If significant negative gross margins are expected in any period, then the present value of gross margins before annual dividends, estimated gross premiums, or the balance of insurance in force should be substituted as the base for computing amortization.

**.21** In computing amortization, interest should accrue to the unamortized balance of capitalized acquisition costs at the rate used to discount expected gross margins. Estimates of expected gross margins used as a basis for amortization should be evaluated regularly, and the total amortization recorded to date should be adjusted by a charge or credit to the statement of earnings if actual experience or other evidence suggests that earlier estimates should be

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<sup>4</sup> These conditions should be used in the same sense that they are used in FASB Statement No. 5, *Accounting for Contingencies*.

<sup>5</sup> Acquisition costs are addressed in paragraphs 28 to 31 of FASB Statement No. 60.

revised. The interest rate used to compute the present value of revised estimates of expected gross margins should be either the rate in effect at the inception of the book of contracts or the latest revised rate applied to the remaining benefit period. The approach selected to compute the present value of revised estimates should be applied consistently in subsequent revisions to computations of expected gross margins.

### **Estimated Gross Margins**

**.22** *Estimated gross margin*, as the term is used in this SOP, should include estimates of the following:

- a. Amounts expected to be received from premiums, plus
- b. Amounts expected to be earned from investment of policyholder balances (that is, the net level premium reserve described in paragraph .15a), less
- c. All benefit claims expected to be paid, less
- d. Costs expected to be incurred for contract administration (including acquisition costs not included in capitalized acquisition costs), less
- e. Expected change in the net level premium reserve for death and endowment benefits, less
- f. Expected annual policyholder dividends, plus or less
- g. Other expected assessments and credits, however characterized

Estimated gross margins should be determined on a best estimate basis, without provision for adverse deviation.

**.23** Several dividend options may be available to the policyholder, in which instances the options generally can be changed during the life of the contract. In estimating gross margins, insurance enterprises should use the best estimate of the dividend options that policyholders will elect.

### **Disclosures**

**.24** The following should be disclosed in the financial statements with respect to participating contracts:

- a. The methods and assumptions used in estimating the liability for future policy benefits
- b. The average rate of assumed investment yields used in estimating expected gross margins
- c. The nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period

### **Effective Date and Transition**

**.25** This SOP is effective for financial statements for fiscal years beginning after December 15, 1995. Earlier application is encouraged. The effect of initially applying this SOP should be reported retroactively through restatement of all previously issued annual financial statements presented for comparative purposes for fiscal years beginning after December 15, 1992. Previously issued financial statements for any number of consecutive periods preceding that date may be restated to conform to the provisions of this SOP. The cumulative effect of adopting this SOP should be included in the earliest year restated.



## Background Information and Basis for Conclusions

.26 The AICPA Accounting Standards Executive Committee's (AcSEC's) conclusions about accounting and reporting for participating life insurance contracts covered by this SOP are based on how the economic substance of those contracts differs fundamentally from nonparticipating contracts (traditional and universal life-type contracts) and from participating contracts that do not have the characteristics described in paragraph .05 of this SOP. The following sections (a) describe the factors differentiating the contracts covered by this SOP from those other contracts, (b) discuss AcSEC's reasons for concluding that neither FASB Statement No. 60 nor FASB Statement No. 97 in its entirety is appropriate for the contracts covered by this SOP, and (c) discuss other considerations deemed significant by AcSEC in reaching its conclusions.

### Participating Contracts

.27 Participating life insurance contracts are issued for a gross premium that provides policyholders with certain guaranteed benefits as well as with dividends. Generally, the gross premium is calculated with sufficient margin so that each class of contracts is self-supporting. Annual policyholder dividends paid generally reflect the company's experience and performance in investment activity, mortality experience, and contract administration for each class of contracts. It is the dividend determination and distribution that distinguishes participating life insurance from nonparticipating life insurance.

.28 The nature of the annual dividend determination varies from company to company but is generally a two-step process. The first step is to determine divisible surplus, which is a determination each company makes based on its financial results. The second step is to distribute divisible surplus to policyholders in an equitable manner. Actuarial standards require divisible surplus to be distributed among contracts in the same proportion as the contracts contributed to divisible surplus.

### Applicability and Scope

.29 AcSEC's charge was to address, as much as possible, the accounting and reporting of mutual life insurance enterprises' insurance activities within the framework established in FASB Statement Nos. 60 and 97. In reaching the conclusions in this SOP, AcSEC believes the contracts covered by this SOP are transactions between mutual life insurance enterprises and their customers. After reviewing the nature of a variety of mutual life insurance enterprise contracts, AcSEC concluded that this SOP should address the accounting only for life insurance contracts with the characteristics described in paragraph .05 of this SOP. The dividend scales on such contracts are often referred to as *actively managed*, because dividends paid are based on actual experience; that is, dividend scales are adjusted to reflect significant changes on a reasonably timely basis. FASB Statement No. 120 requires that other insurance contracts of mutual life insurance enterprises, such as annuity contracts, group insurance contracts, disability contracts, universal life-type contracts, and pension guarantee contracts, should be accounted for under FASB Statement Nos. 60 and 97.

.30 AcSEC concluded that separate consideration of the participating life insurance contracts covered by this SOP is justified by the differences between

those contracts and both traditional nonparticipating life insurance contracts, covered by FASB Statement No. 60, and universal life-type contracts, covered by FASB Statement No. 97. Participating life insurance contracts covered under this SOP have attributes of the contracts covered by FASB Statement Nos. 60 and 97. AcSEC concluded, therefore, that contracts covered by this SOP were not sufficiently similar to those covered by either FASB Statement to warrant applying either of them in its entirety.

.31 Participating life insurance contracts covered by this SOP are similar to the conventional life contracts contemplated by FASB Statement No. 60 in the following respects:

- a. Permanent participating life insurance is based on the traditional concept of level premiums over the life of the contract.
- b. The individual contract functions related to interest, mortality, and expenses are not separately displayed to policyholders and are not explicitly stated in the policy.
- c. The pattern of premium payments is specified in the contract and cannot normally be varied after issue.
- d. There is no explicit account balance for each policyholder.

.32 Despite those similarities in form to FASB Statement No. 60 contracts, the dividend feature introduces a variable that affects the substance of the earnings flow to the company. The dividend feature causes the contracts covered by this SOP to more closely resemble contracts in which the earnings emerge in relation to margins rather than contracts in which earnings emerge proportional to the level of premiums received in that year. Participating policies covered by this SOP share in the results of investment activity, mortality experience, and contract administration costs through dividends, which are not fixed or guaranteed by contract terms. As a result, earnings on these products, after annual policyholder dividends, tend to emerge as the margin recognized on investments, mortality, and expenses.

.33 AcSEC concluded that because the earnings after annual policyholder dividends from the contracts covered by this SOP tend to evolve in a manner similar to universal life-type contracts, most of the provisions of FASB Statement No. 97 should be applied to the contracts covered by this SOP. Nevertheless, AcSEC concluded that because the contracts covered by this SOP have terms similar to the terms of conventional life products, it was not feasible or appropriate to apply FASB Statement No. 97 in its entirety.

.34 The recommendations in this SOP differ from the accounting in FASB Statement No. 97 for universal life-type contracts in two significant respects:

- a. Whereas under FASB Statement No. 97 premiums are not reported as revenue and benefit payments representing a return of policyholder balances are not reported as expenses in the statement of earnings, under this SOP premiums should be recognized as revenue and benefit payments charged to expense.
- b. Whereas FASB Statement No. 97 does not address dividends, under this SOP dividends should be charged to expense.

.35 AcSEC recognizes that the FASB chose to exclude traditional participating life insurance contracts issued by stock life insurance companies from the scope of FASB Statement No. 97. However, AcSEC notes that in making that decision, the FASB did not consider participating policies of mutual life

insurance enterprises, which AcSEC believes differ substantively from many of the participating policies issued by stock life insurance companies. Furthermore, the FASB's consideration of participating policies may have been influenced by the fact that participating policies are generally a less significant portion of stock life insurance companies' business than of mutual life insurance enterprises' business.

## Revenue Recognition

.36 AcSEC recognizes that reporting premiums as revenues may appear inconsistent with the accounting model set forth in this SOP. AcSEC believes, however, that recognizing premiums as revenue for the contracts covered by this SOP is justified for two reasons, both of which are based on the economic substance of the relationship between the issuer and the policyholder.

.37 First, premiums received under participating contracts fit the definition of *revenues* in FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*. AcSEC believes the fact that premiums generally are level, fixed, and payable at predetermined points in return for a guaranteed death benefit and cash surrender value is significant. Furthermore, unlike the purchaser of a universal life-type insurance contract, the purchaser of a participating life insurance contract generally cannot vary the amount and timing of premium payments, and no account balance information is communicated to the policyholder. In addition, premiums are not credited to a policyholder account balance. Accordingly, AcSEC believes reporting premiums as revenues is consistent with the FASB Concepts Statement No. 6 definition of *revenues* as inflows from delivering services that constitute an entity's ongoing major or central operations.

.38 Second, for many mutual life insurance enterprises it would not be practicable or meaningful to report premiums received as deposits. AcSEC considered how mutual life insurance companies would report premiums as such and concluded that mortality, expense, and surrender charges would be reported as revenues. For those amounts to be relevant, the elements of dividends related to each would have to be determined. AcSEC believes that making such allocations would be arbitrary. AcSEC further believes the costs of making such allocations would far exceed the benefits derived from reporting the amounts separately. Furthermore, the lack of an explicit policyholder balance or separate assessments or charges for contract services and credits for interest—which exist for universal life-type contracts—makes separate measurement of the advance funding and contract service functions impractical.

## Benefit Recognition

.39 AcSEC concluded that to be consistent with the reporting of premiums as revenues when due from the policyholder, actual death and surrender benefits incurred during the accounting period should be reported as expenses.

## Dividends

.40 FASB Statement No. 97 does not explicitly address the treatment of dividends for participating contracts accounted for as universal life-type contracts. Some may believe that under that model, annual policyholder dividends would be allocated among interest credited, death benefits or mortality charges, and expenses, rather than reported as an expense. Others may believe that the entire annual policyholder dividend is one of the "other assessments and cre-

dividends" described in paragraph 23 of FASB Statement No. 97. AcSEC concluded that, especially because this SOP recommends premiums should be reported as revenues when due from the policyholder, actual dividends incurred during the accounting period should always be reported as an expense; dividends should not be charged directly to equity in any circumstance.

.41 Furthermore, FASB Statement No. 60 defines two alternative accounting treatments for policyholder dividends based on whether the contracts included restrictions on the net income amount that may be distributed to stockholders. For participating contracts that have no net income restrictions, and that use life insurance dividend scales unrelated to actual net income, policyholder dividend liabilities should be accrued over the premium-paying period of the contracts (1) based on dividends anticipated in determining gross premiums, or (2) as shown in published dividend illustrations at the date insurance contracts are made. For contracts limiting the amount of net income that may be distributed to stockholders, the net income amount that cannot be distributed to shareholders is excluded from stockholders' equity by a charge to operations and a credit to a liability, a method similar to the accounting for net income applicable to minority interests. However, for either type of participating contract, dividends are reported as expenses in the statement of earnings as "dividends to policyholders" or "provision for policyholders' share of earnings on participating business."

.42 Annual policyholder dividends of participating contracts covered by this SOP are based on actual company performance. Accordingly, AcSEC believes dividends on participating contracts covered by this SOP are not similar to either of the types of dividends discussed in FASB Statement No. 60. While AcSEC acknowledges that segregating undistributed accumulated earnings on participating contracts in a manner similar to minority interests may be meaningful in a stock life insurance company, it is not meaningful for a mutual life insurance enterprise, because the objective of such presentation is to identify amounts that are not distributable to stockholders.

## Capital Gains and Losses

.43 The guidance in FASB Statement No. 97, as amended by FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, on capital gains and losses, which also is incorporated in FASB Statement No. 60, applies to the contracts covered in this SOP. Paragraph 28 of FASB Statement No. 97, as amended, states:

Realized gains and losses on all investments (except investments that are classified as trading securities and those that are accounted for as hedges as described in FASB Statements No. 52, *Foreign Currency Translation*, and No. 80, *Accounting for Futures Contracts*) shall be reported in the statement of earnings as a component of other income, on a pretax basis. Realized gains and losses shall be presented as a separate item in the statement of earnings or disclosed in the notes to the financial statements. Realized gains and losses shall not be deferred, either directly or indirectly.

Furthermore, in paragraph 77 in appendix A of FASB Statement No. 97, the FASB addressed the issue of whether certain realized gains and losses should be deferred and recognized over the remaining life of the insurance contracts with the following:

The Board notes that generally accepted accounting principles require that realized investment gains and losses be reflected in the period in which they

occur. The Board acknowledges that some contracts with policyholders may entitle policyholders to an amount equal to a portion of specific investment performance. The recording of liabilities to reflect amounts to which those policyholders are entitled is appropriate, but the deferral of realized gains and losses is not justified.

## **Liability for Future Policy Benefits**

### ***Proxy for Account Balance***

.44 Under FASB Statement No. 97, the liability for future policy benefits includes the policyholder's account balance as of the balance sheet date. However, because participating contracts usually lack a stated account balance, a proxy for account balance had to be determined. AcSEC considered six possible proxies:

- a. **Dividend fund**
- b. Net level premium reserve, using statutory valuation mortality and interest
- c. Commissioners reserve valuation method (CRVM) reserves
- d. Cash surrender value
- e. Net level premium reserve, using guaranteed mortality and interest
- f. Net level premium reserve, using the guaranteed mortality and dividend fund interest

.45 After considering all the above possible account balances, AcSEC concluded that the net level premium reserve using the guaranteed mortality and dividend fund interest generally should be used as the proxy for account balance. Furthermore, AcSEC notes that there may be policies that do not meet normal underwriting standards for which additional amounts may be included in the net level premium reserve.

.46 If experience is more favorable than what was anticipated in determining the dividends guaranteed in the policy, a mutual life insurance enterprise's objective is to distribute the favorable experience as dividends. If experience is less favorable than what was anticipated in determining the dividends guaranteed, the company must at least provide the guaranteed values. Therefore, if there is an unfavorable experience, a premium deficiency may result, which would be recognized under paragraph .15c of this SOP. Accordingly, the liability determined, based on guaranteed benefits, provides an appropriate measure of the liability to policyholders because, to the extent experience is more favorable than the guarantees, the company pays the difference to policyholders in dividends. This estimate of the liability is consistent with the view that the mutual life insurance enterprise is liable for the guaranteed provisions of the policies it sells and for paying dividends related to favorable experience. AcSEC believes that for many participating policies the net level premium reserve for guaranteed benefits will best reflect the amount that has accrued to the benefit of policyholders for participating contracts. AcSEC therefore concluded that the net level premium reserve is consistent with FASB Statement No. 97's description of the liability as "the balance that accrues to the benefit of individual policyholders [that] represents the minimum measure of an insurance enterprise's liability . . . ."

.47 Nevertheless, this SOP recommends that a mutual life insurance enterprise with a determinable dividend fund interest rate should calculate the

net level premium reserve for guaranteed benefits based on the dividend fund interest rate rather than on the rate used in determining guaranteed cash surrender values. AcSEC believes that in practice the dividend fund interest rate and the interest rate guaranteed in computing cash surrender values often will be the same. If those interest rates differ, the calculation based on the dividend fund interest rate usually reflects the pattern of anticipated annual policyholder dividends more accurately.

.48 Some mutual life insurance enterprises have a dividend fund for participating policies. Though that dividend fund generally is not disclosed to the policyholder, it is the amount specified by management at contract inception to which interest is credited and from which mortality and expense charges are assessed in the dividend determination mechanism. Accordingly, many believe the dividend fund is the economic equivalent of the account balance of universal life-type contracts. Though most companies with dividend funds define the dividend fund account balance in their dividend resolutions, there are a variety of ways in which a dividend fund is defined but no consistent practices for company management to apply in defining the amount. Furthermore, not all mutual life insurance enterprises have a dividend fund. Accordingly, AcSEC concluded that the dividend fund lacked the objectivity and comparability necessary to be an appropriate proxy for the account balance.

.49 AcSEC also rejected the statutory net level premium reserve and the statutory CRVM as proxies for account balance, because the assumptions used in determining such amounts are based on statutory requirements, which are not necessarily related to either policy nonforfeiture guarantees or the dividend calculation.

.50 AcSEC also rejected the cash surrender values as the proxy for account balance, because AcSEC believes the amount does not reflect the amount that accrues to a continuing policyholder's benefit. AcSEC believes the decision not to use cash surrender values as the proxy for account balance is consistent with FASB Statement No. 97, which requires the use of an account balance instead of the cash surrender value when both exist. Though participating policies lack an explicit account balance, AcSEC believes the net level premium reserve determined under this SOP is an appropriate proxy for the account balance. AcSEC notes that cash surrender values generally will be less than the liability for future policy benefits calculated under this SOP. Cash surrender values are frequently developed using methods similar to those used to compute the liability for future policy benefits calculated under this SOP, but are net of an implicit surrender charge.

### ***Terminal Dividends***

.51 AcSEC believes the rights to terminal dividends accumulate to policyholders over a policy's life. Accordingly, the event that creates the liability is the continuance of the contract by the policyholder, not the termination of the policy. If the payment of terminal dividends is probable and the amount can be reasonably estimated, the liability should be recognized. Furthermore, AcSEC believes terminal dividends are similar to amounts previously assessed against policyholders that are refundable on the contract's termination under paragraph 17c of FASB Statement No. 97.

### ***Adverse Deviation***

.52 FASB Statement No. 60 requires that assumptions used in calculating the liability for future policy benefits include a provision for the risk of ad-

verse deviation. The notion of adverse deviation is (1) to include in benefit reserves the risk assumed by the insurer that actual experience will be more adverse than the basic assumptions underlying premium rates, and (2) to include the gradual release from this risk in periodic net income as actual experience emerges. However, under FASB Statement No. 97, a provision for adverse deviation is not permitted. Because the liability for future policy benefits defined in this SOP generally follows the FASB Statement No. 97 model, AcSEC concluded that provision for adverse deviation should not be made. AcSEC agrees with the FASB's reasons for rejecting adverse deviation in FASB Statement No. 97. Furthermore, for participating contracts covered by this SOP, most adverse experience could be recovered from policyholders, as it emerges, through lower future dividends.

## Acquisition Costs

.53 FASB Statement No. 97 requires that gross profit estimates used as a basis for amortizing capitalized acquisition costs be evaluated regularly, and that total amortization recorded to date be adjusted by a charge or credit to the statement of earnings if actual earnings or other evidence suggests revision of earlier estimates of expected gross profits. AcSEC concluded that the expected gross margins resulting from participating life contracts issued by mutual life insurance companies are economically similar to the expected gross profits of universal life-type contracts. Accordingly, because the conclusions in this SOP are primarily based on the conclusions in FASB Statement No. 97, AcSEC decided to retain the retrospective adjustment of deferred acquisition costs in this SOP.

## Estimated Gross Margins

.54 Under FASB Statement No. 97, the emergence of earnings for universal life-type contracts is based on gross profits. Similarly, under this SOP profits would emerge based on gross margins. However, due to the different way in which values are communicated to the policyholder and maintained by a mutual life insurance company, gross margins need to be determined differently from universal life-type contracts.

.55 Paragraph 23 of FASB Statement No. 97 defines the terms to be considered in calculating the estimated gross profits for universal life-type contracts, as follows:

- a. Amounts expected to be assessed for mortality (sometimes referred to as the *cost of insurance*) less benefit claims in excess of related policyholder balances
- b. Amounts expected to be assessed for contract administration less costs incurred for contract administration (including acquisition costs not included in capitalized acquisition costs)
- c. Amounts expected to be earned from investment of policyholder balances less interest credited to policyholder balances
- d. Amounts expected to be assessed against policyholder balances upon termination of a contract (sometimes referred to as *surrender charges*)
- e. Other assessments and credits, however characterized

.56 Those terms are presented in the form of specific margins. Participating life contracts have similar margins but the charges and credits are not

structured in the same way as in universal life-type contracts. Because of this difference, certain items used in determining gross profits for universal life-type contracts are not readily available for participating contracts. AcSEC resolved this problem by using a list of elements, which AcSEC believes develops gross margins consistent with the FASB Statement No. 97 definition of *gross profit*.

.57 The gross margin elements used in this SOP are not identical to the elements used in FASB Statement No. 97. Specifically, the following elements are included in FASB Statement No. 97 but not in this SOP:

- a. Amounts expected to be assessed for mortality
- b. Amounts expected to be assessed for contract administration
- c. Interest credited to policyholder balances

The following are elements in this SOP that are not in FASB Statement No. 97:

- a. Amounts expected to be received from premiums
- b. The expected change in the net level premium reserve for death and endowment policy benefits
- c. Expected annual policyholder dividends

.58 Those lists differ because, for participating contracts covered under this SOP, dividends, premiums, and the liability for policy benefits are not separated into the various charges, credits, and deposits. This different view of gross margins is consistent with the proposed presentation of earnings for participating contracts under this SOP.

## Interest Rates

.59 Under FASB Statement No. 97, the rate that accrues to policyholder balances (the *contract rate*) is used to accrue interest to policyholder balances, to compute the present value of estimated gross profits, and to accrue interest to the unamortized balance of capitalized acquisition costs. AcSEC believes the dividend interest rate is the rate most comparable to the contract rate. However, AcSEC has concluded that using the dividend fund interest rate to determine the net level premium reserve is preferable to using the dividend interest rate, because the dividend fund interest rate is more objectively determinable. AcSEC concluded that using the investment yield to calculate the present value of estimated gross margins, and to accrete interest on the unamortized balance of capitalized acquisition costs, is preferable to using the dividend interest rate because the investment yield is more objectively determinable and would result in approximately the same income pattern as if the dividend fund interest rate were used.

## Other Methods Considered

.60 AcSEC considered, and rejected, a modified FASB Statement No. 60 approach whereby the earnings from mutual life participating insurance contracts would emerge in relation to premiums and not in relation to expected gross margins. This consideration was prompted by a concern that reporting premiums as revenues, but having profits emerge based upon gross margins,



may produce incongruous results. In addition, the lack of an explicit policyholder's account balance, and the lack of a predominant function or service representative of the pooling of the aggregation of services, are characteristics of insurance contracts as defined under FASB Statement No. 60. FASB Statement No. 60 requires that expenses should be recorded (and therefore earnings would emerge) in relation to premiums.

**.61** A modification to FASB Statement No. 60 was discussed, however, to provide for mutual life insurance contracts in which dividend scales are actively managed. Each change in the dividend scale represents, in essence, a repricing and the establishment of new expectations. Therefore, the emergence of earnings based upon the original pricing assumptions no longer would be relevant to financial measurements.

**.62** In applying FASB Statement No. 60 to mutual life insurance contracts in which the dividend scales are actively managed, each change in the dividend scale would result in an unlocking of the previously used assumptions. The new assumptions would be used in subsequent accounting periods, until the dividend scales are changed again. The unlocking of assumptions would be prospective in nature and would provide stability to the matching of benefits and expenses with revenue.

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Appendix A

Illustration of Computation of Gross Margins

Schedule 1—Computation of Estimated Gross Margins

<i>Year</i>	<i>Premium</i>	<i>Interest on NLPR</i>	<i>Interest on Current Activity</i>	<i>Death Benefits Incurred</i>	<i>Surrender Benefits Incurred</i>
	(a)	(b)	(c)	(d)	(e)
1	\$ 210,000	\$ 0	\$ 16,244	\$ (9,000)	\$ 0
2	184,611	10,719	14,280	(10,549)	0
3	169,621	19,994	13,120	(13,731)	(7,148)
4	155,763	27,955	12,048	(14,835)	(14,984)
5	142,990	34,735	11,060	(15,661)	(21,760)
6	131,222	40,440	10,150	(15,622)	(17,237)
7	124,333	46,665	9,617	(16,578)	(20,989)
8	117,768	52,317	9,109	(16,824)	(24,427)
9	111,526	57,417	8,627	(17,526)	(27,566)
10	105,582	61,982	8,167	(18,603)	(30,406)
11–20	779,517	760,283	60,296	(311,112)	(398,831)
21–55	589,392	1,222,685	45,589	(1,187,632)	(686,079)
Total	<u>\$2,822,325</u>	<u>\$2,335,192</u>	<u>\$218,307</u>	<u>\$(1,647,673)</u>	<u>\$(1,249,427)</u>

Present values at earned rate of 8.5%:  
(continued)

- (a) Gross premiums.
- (b) Interest, at the 8.5% earned rate, on net level premium reserve (NLPR) at the end of the previous year. The NLPR is based on guaranteed mortality and the dividend fund interest rate.
- (c) Interest, at the 8.5% earned rate, on current-year cash flow. This illustration assumes premiums are received, and all expenses incurred, at the start of the year. This illustration assumes death benefits, surrender benefits, and dividends are all at the end of the year.
- (d) Death benefits, not reduced by related NLPR.
- (e) Surrender benefits, not reduced by related NLPR.
- (f) Recurring expenses not included in capitalized acquisition costs.
- (g) Net decrease (increase) in aggregate NLPR in the year.
- (h) Policyholder dividends for the year.
- (i) Sum of (a) through (h) inclusive.

<i>Recurring Expenses Incurred</i>	<i>(Increase) Decrease in NLPR</i>	<i>Dividends Incurred</i>	<i>Post- dividend Gross Margins</i>	<i>Revised Gross Margins at Year 2</i>
<i>(f)</i>	<i>(g)</i>	<i>(h)</i>	<i>(i)</i>	
\$ (18,900)	\$(126,103)	\$ (18,857)	\$ 53,384	\$ 53,384
(16,615)	(109,116)	(21,399)	51,931	50,546
(15,266)	(93,669)	(24,230)	48,691	47,419
(14,019)	(79,754)	(26,574)	45,600	44,432
(12,869)	(67,117)	(28,509)	42,869	41,797
(11,810)	(73,236)	(30,043)	33,864	32,880
(11,190)	(66,499)	(32,301)	33,058	32,126
(10,599)	(60,005)	(34,367)	32,972	32,089
(10,037)	(53,706)	(36,230)	32,505	31,669
(9,502)	(47,485)	(37,915)	31,820	31,028
(70,157)	(162,077)	(424,092)	233,827	227,980
(53,041)	938,767	(669,668)	200,013	195,591
<u>\$(254,005)</u>	<u>\$ (0)</u>	<u>\$(1,384,185)</u>	<u>\$840,534</u>	<u>\$820,941</u>
			<u>\$371,261</u>	<u>\$362,945</u>

Schedule 2—Computation of Amortization Rate

		<i>Original Estimate</i>	<i>Revised Estimate</i>
Present value of estimated gross margins, years 1-55, evaluated at issue (from Schedule 1)	(a)	<u>\$371,261</u>	<u>\$362,945</u>
Present value of capitalized acquisition costs, years 1-55, evaluated at issue	(b)	<u>\$263,309</u>	<u>\$263,309</u>
Amortization rate = (b) / (a)	(c)	<u>70.923%</u>	<u>72.548%</u>

Schedule 3—Illustration of Amortization

Capitalized costs, year 1		\$241,500	\$241,500
Interest accrual at 8.5%	(d)	20,528	20,528
Amortization, year 1			
Gross margin of 53,384 (from Schedule 1) at rate (c) above	(e)	<u>(37,862)</u>	<u>(38,729)</u>
Balance, end of year 1	(f)	224,166	223,299
Additional capitalized costs, year 2		<u>9,231</u>	<u>9,231</u>
		233,397	232,530
Interest accrual at 8.5%	(g)	19,839	19,765
Amortization, year 2			
Gross margin of 50,546 (from Schedule 1, revised column) at revised rate (c) above	(h)	<u>(36,670)</u>	<u>(36,670)</u>
Balance, end of year 2		<u>\$216,566</u>	<u>\$215,625</u>
Balance based on original estimate		\$216,566	
Balance based on revised estimate		<u>215,625</u>	
Adjustment required		<u>\$ (941)</u>	
Net amortization recognized:			
In year 1 (d + e)		<u>\$ 17,334</u>	
In year 2 (g + h based on revised estimates + difference between f at original esti- mate and at revised estimate)		<u>\$ 17,772</u>	

## Appendix B

### Discussion of Comments Received on Exposure Draft

An exposure draft of a proposed statement of position, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, was issued on March 24, 1994, and distributed to a variety of interested parties to encourage comment by those who would be affected by the proposal. Thirty-five comment letters were received on the exposure draft. The most significant and pervasive comments received were in the following five areas: (a) the FASB Statement No. 60 approach, (b) limited-payment contracts, (c) dividend utilization in estimated gross margin calculations, (d) retrospective adjustment of deferred acquisition costs balances, and (e) effective date.

### FASB Statement No. 60 Approach

Several respondents preferred a modified FASB Statement No. 60 approach whereby the earnings from mutual life participating insurance contracts would emerge in relation to premiums and not in relation to expected gross margins. AcSEC considered most of the arguments in favor of the modified FASB Statement No. 60 approach in the comment letters during the process leading up to the exposure draft, and continues to support the approach recommended in this SOP.

### Limited-Payment Contracts

The exposure draft would have required revenue recognition for limited-payment contracts to be in a constant relationship to insurance in force to the extent that gross premiums exceed net premiums. Many respondents asked AcSEC to reconsider that accounting, because it is inconsistent with the fundamental premise of the SOP that income should be recognized in relation to gross margins. AcSEC believes that for limited-payment contracts with actively managed dividend scales those arguments are persuasive. Accordingly, AcSEC was convinced that the accounting model in the SOP would preclude inappropriate front-end recognition of income on most limited-payment contracts, and eliminated the special accounting requirement for limited-payment contracts.

### Dividend Utilization in Estimated Gross Margin Calculations

A variety of dividend options are available to policyholders, including receiving the dividends in cash and purchasing additional paid-up insurance. The exposure draft would have required, in many instances, mutual life insurance enterprises to assume that annual policyholder dividends are paid in cash in estimating gross margins, regardless of the options actually used. Many respondents noted that, for many mutual life insurance enterprises, dividends are more often used to purchase additional paid-up insurance, and that reliable estimates of the effects of dividend options can be made. In response to that information, AcSEC changed paragraph .23 of this SOP to require mutual life insurance enterprises to make the best estimate of the dividend options that policyholders will elect.

### **Retrospective Adjustment of Deferred Acquisition Costs Balances**

Many respondents from the mutual life insurance industry objected to the retrospective adjustment of deferred acquisition costs. They believe that because dividends are actively managed and will be used to prospectively recover or pay out differences that result from changes in expectations, the accounting for such changes should also be prospective. Furthermore, they note that retrospective calculations are much more complicated and difficult to understand than prospective calculations. However, AcSEC continues to believe that retrospective adjustment of deferred acquisition costs, consistent with the provisions of FASB Statement No. 97, is appropriate for policies covered by this SOP for the reasons discussed in paragraph .53.

### **Effective Date**

In the exposure draft the effective date was for financial statements issued for fiscal years beginning after December 15, 1994, consistent with the effective date of FASB Interpretation No. 40. A majority of respondents considered that effective date unreasonable, given the magnitude and significance of the changes that mutual life insurance enterprises will have to make to prepare financial statements in accordance with GAAP. AcSEC agreed and extended the effective date by one year, and urged the FASB to extend the effective date of Interpretation No. 40 similarly. The FASB subsequently issued FASB Statement No. 120, which amends FASB Interpretation No. 40, to be effective for financial statements issued for fiscal years beginning after December 15, 1995.

## Glossary

**Acquisition costs.** Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include costs that vary with, and are primarily related to, the acquisition of insurance contracts (for example, agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees).

**Annual policyholder dividends.** Amount of dividends to policyholders calculated and paid each year, representing the policyholders' share of divisible surplus.

**Dividend fund.** The amount specified by management at contract inception to which interest is credited and from which mortality and expense charges are assessed in the dividend determination mechanism.

**Dividend fund interest rate.** The interest rate determined at policy issuance used to determine the amount of the dividend fund. It is the rate used to credit interest to the dividend fund, and against which experience is measured to determine the amount of the interest portion of dividends paid to individual policyholders.

**Dividend interest rate.** The total interest rate the company pays on its dividend fund.

**Dividends to policyholders.** Nonguaranteed amounts distributable to policyholders of participating insurance contracts and based on actual performance of the insurance enterprise. Under various state insurance laws, dividends are apportioned to policyholders on an equitable basis. Dividends to policyholders include annual policyholder dividends and terminal dividends.

**Guaranteed interest rate.** The interest rate guaranteed in a policy's cash surrender value or nonforfeiture value calculation.

**Investment yield.** The interest rate the company expects to earn on the assets supporting the policies, net of investment expense.

**Net level premium reserve.** The excess, if any, of the present value of future guaranteed death and endowment benefits over the present value of future net premiums.

**Net premiums.** A constant ratio of guaranteed maximum gross premiums. The ratio is calculated at issue, so that the present value of all guaranteed death and endowment benefits is equal to the present value of all net premiums.

**Terminal dividends.** Dividends to policyholders calculated and paid upon termination of a contract, such as on death, surrender, or maturity.

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## Section 10,660

# Statement of Position 95-2

## Financial Reporting by Nonpublic Investment Partnerships

May 19, 1995

## NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## Introduction

.01 Investment partnerships are identified as a type of investment company in the AICPA's Audit and Accounting Guide *Audits of Investment Companies* (the Guide). The Guide uses the term *investment company* to mean "generally . . . an entity that pools shareholders' funds to provide the shareholders with professional investment management (paragraph 1.01)" [emphasis added]. The Guide states that it uses the term to refer to an entity with the attributes described in chapter 1 rather than to conform with the legal definition of an investment company in the federal securities laws.

.02 The Guide refers to investment partnerships in chapter 1 (paragraph 1.03):

Several types of investment companies exist: management investment companies, unit investment trusts, . . . investment partnerships . . .

.03 The Guide also states:

The accounting principles and auditing procedures discussed in this guide generally apply to all investment companies, though the guide has been written primarily for auditors of mutual funds and closed-end companies registered with the Securities and Exchange Commission (SEC) under the 1940 Act (paragraph 1.04) [emphasis added].

To comply with SEC rules and regulations, registered investment companies must make certain disclosures in addition to those required by generally accepted accounting principles. Those additional requirements are not presented in illustrative financial statements because they are not otherwise required by generally accepted accounting principles (paragraph 5.46).

**.04** The illustrative financial statements of management investment companies in the Guide contain a detailed schedule of investments.

## Scope

**.05** This SOP applies to investment partnerships that are exempt from SEC registration under the Investment Company Act of 1940 and defined as investment companies in paragraph 1.01 of the Guide, except for the following:

- a. Investment partnerships that are brokers and dealers in securities subject to regulation under the Securities Exchange Act of 1934 (registered broker-dealers) and that manage funds only for those who are officers, directors, or employees of the general partner
- b. Investment partnerships that are commodity pools subject to regulation under the Commodity Exchange Act of 1974

Investment partnerships identified above as being exempt from the scope of this SOP should comply with the financial reporting requirements in the AICPA audit and accounting guides applicable to such entities.<sup>1</sup> Investment partnerships that are SEC registrants must comply with the financial statement reporting requirements as set forth in the Guide and as required by Articles 6 and 12 of the SEC's Regulation S-X.

## Background

**.06** There has been diversity in practice in the application of certain provisions of the Guide—specifically, the requirement for a schedule of investments, the format of the statement of operations, and the reporting of management fees.

**.07** *Schedule of Investments.* The Guide requires investment companies to list all of their individual securities in the statement of net assets or in an accompanying schedule of investments. Many nonpublic investment partnerships do not present such a list in their financial statements.

**.08** *Statement of Operations.* Investment companies present their results of operations in a statement of operations as specified in the Guide. The Guide requires separate disclosure of dividends and interest income and of realized and unrealized gains (losses) on securities. Some investment partnerships combine these items and present them as one income-statement caption with no separate disclosure.

**.09** *Management Fees and Allocations.* Investment companies normally enter into an investment advisory agreement under which they receive investment management. The fee for that service is usually based on a specified per-

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<sup>1</sup> *Audits of Brokers and Dealers in Securities* currently specifies requirements for broker-dealers and commodity pools. A revised draft of that Guide has been exposed for comment. In addition, a new Guide that will apply to futures commission merchants and commodity pools is being prepared for comment.

centage of average assets being managed. Some agreements may provide for a performance fee or allocation, which includes the normal fee plus a bonus (or less a penalty) if the company's performance exceeds (or fails to exceed) a preestablished benchmark. Many investment companies reflect such fees, including the bonus portion, as an expense in the statement of operations. If an investment company is organized as a limited partnership, however, the payment may take the form of an allocation of earnings based on a predetermined formula specified in the partnership agreement. In such cases, some investment partnerships reflect this allocation of partnership income through a reallocation of partners' net income from the limited partners to the general partner within the equity section of the statement of assets and liabilities rather than as an expense.

## Conclusions

**.10 *Schedule of Investments.*** The financial statements of an investment partnership, when prepared in conformity with GAAP, should, at a minimum, include a condensed schedule of investments in securities owned by the partnership at the close of the most recent period. Such a schedule should do the following.

a. Categorize investments by the following:

- (1) Type (such as common stocks, preferred stocks, convertible securities, fixed-income securities, government securities, options purchased, options written, warrants, futures, loan participations, short sales, other investment companies, and so forth)
- (2) Country or geographic region
- (3) Industry.

Report (i) the percent of net assets that each such category represents and (ii) the total value and cost for each category in (1) and (2).

b. Disclose the name, shares or principal amount, value, and type of the following:

- (1) Each investment (including short sales) constituting more than 5 percent of net assets
- (2) All investments in any one issuer aggregating more than 5 percent of net assets.

In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

c. Aggregate other investments (each of which is 5 percent or less of net assets) without specifically identifying the issuers of such investments, and categorize them as required by paragraph .10a above.

**.11** Investments in other investment companies (investees), such as investment partnerships and limited liability investment companies, should be considered investments in securities for the purpose of applying paragraphs .10a and .10b, above. If the reporting partnership's proportional share of any security owned by any individual investee exceeds 5 percent of the reporting partnership's net assets at the reporting date, each such security should be named as required in paragraph .10b above, and categorized as required in paragraph .10a above. If information about the investee's portfolio is not avail-

able, that fact shall be disclosed. These investee disclosures should be made either in the condensed schedule of investments (as components of the investment in the investee) or in a note to that schedule.

**.12 *Statement of Operations.*** Investment partnerships should present their statements of operations in conformity with the requirements for statements of operations of management investment companies in paragraphs 5.24 through 5.35 of the Guide, which include, among other things, separate disclosure of dividend income and interest income and realized and unrealized gains (losses) on securities for the period.

**.13 *Management Fees and Allocations.*** Investment companies organized as limited partnerships typically receive advisory services from the general partner. For such services, a number of partnerships pay fees chargeable as expenses to the partnership, whereas others allocate net income from the limited partners' capital accounts to the general partner's capital account, and still others employ a combination of the two methods. The amounts of any such payments or allocations should be presented in either the statement of operations or the statement of changes in partners' capital, and the method of computing such payments or allocations should be described in the notes to the financial statements.

## Effective Date

**.14** This SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994. Earlier application is encouraged but not required.

## Basis for Conclusions

**.15** This section discusses considerations that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

**.16** Practice is diverse in applying the Guide's requirements to investment partnerships. Nevertheless, AcSEC believes that the Guide should apply, except for the requirement to present a detailed schedule of investments, to investment partnerships of all kinds, including hedge funds, limited liability companies, and limited duration companies. The Guide includes investment partnerships in its definition of investment companies. Paragraph 1.04 indicates that its principles and procedures "... *generally* apply to all investment companies, though the guide has been written *primarily* for auditors of mutual funds ... under the 1940 Act" [*emphasis added*]. AcSEC agrees that some of the SEC Regulation S-X and 1940 Act requirements may not apply to nonpublic investment partnerships. AcSEC believes that the disclosure of material information, such as condensed information about the investment portfolio, dividend income, interest income, realized and unrealized gains or losses, and activities in partners' capital accounts, should be required for a fair presentation of financial statements of investment partnerships.

**.17 *Schedule of Investments.*** Disclosure should provide financial statement users with information that aids decision making. FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, states in paragraph 40 that, "the benefits of information may

be increased by making it more understandable and, hence, useful to a wider circle of users.” The Guide requires a complete listing of investments consistent with the SEC’s disclosure requirements. This SOP requires nonpublic investment partnerships to present at least a condensed schedule of investments in which investments are organized by type, focusing on geographic and industry concentrations, and requires that material investments (more than 5 percent of net assets) in any one investee be disclosed separately.<sup>2</sup> AcSEC concluded that a complete list of all investments that individually represents an immaterial portion of the investment portfolio would present little additional information that is of value to users of nonpublic investment partnerships’ financial statements. The condensed disclosures required by this SOP of the types of investments, the geographical and industry concentrations, and the significant investees are informative to users without burdening them with unnecessary details. AcSEC believes this presentation will enable users to make their decisions focusing on the risk and opportunities associated with the type of investment, a geographical area, and industry by investee.

.18 The Investment Company Act of 1940 and the Internal Revenue Code define investment portfolio diversification to exclude, for certain purposes, securities whose values represent more than 5 percent of the total value of an investment company’s assets. The implication of those definitions is that investment concentration above 5 percent impose a level of risk that requires special consideration. After reviewing the comments to the exposure draft, AcSEC concluded that a 5 percent of net assets criterion should be included as a requirement of this SOP. Net assets (instead of total assets) was chosen because net asset value is the focus of investment company financial reporting.

.19 AcSEC recognizes that the 5 percent of net assets criterion for reporting separate investments is arbitrary. Accounting, however, contains many arbitrary disclosure criteria.

.20 *Statement of Operations.* Because the operations of public (SEC registered) investment companies and nonpublic investment partnerships are similar (they both invest in securities to generate dividend income, interest income, and realized or unrealized gains), AcSEC concluded that investment partnerships’ statements of operations should be presented in conformity with the Guide as required by paragraph .12 above.

.21 *Management Fees and Allocations.* A number of partnerships record an expense for fees due the general partner, a number allocate net income from the limited partners’ capital accounts to the general partner’s capital account, and others combine the two methods. Typically, accounting for such arrangements is based on the partnership agreement that specifies the fee or allocation arrangement. In a typical limited investment partnership agreement, the general partner is entitled to a fixed advisory or management fee (such as one percent of net assets), plus an allocation of profits (such as 20 percent of net realized and unrealized gains). Public investment companies or public partnerships normally do not have incentive arrangements, but if they do, they are generally limited to an amount that does not exceed one percent of net assets. The relatively material allocation of profits provided for in nonpublic partnership agreements may be considered either a disproportionate partnership income allocation, based on the fact that the general partner has incurred mat-

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<sup>2</sup> AcSEC has not reconsidered the Guide’s disclosure requirements for public investment partnerships. Further, AcSEC does not have the authority to amend SEC requirements concerning disclosures in filings with the SEC.

erial cost and effort in organizing the partnership, managing the partnership, and incurred disproportionate risk as the general partner (that is, unlimited personal liability), or a compensation arrangement. Although AcSEC recognizes that issuing definitive standards is desirable, it believes that this SOP cannot provide definitive guidance on accounting for payments to general partners because such guidance would have to result from deliberation of broader partnership issues. AcSEC therefore concluded that the accounting should conform to the structure of the partnership agreement, with the financial statement disclosures set forth in paragraph .13 of this SOP.

.22

## Appendix A

### Condensed Schedule of Investments

The following is an illustration of how to apply the SOP.\* However, it does not address all possible circumstances that may arise in applying the SOP.

**ABC Associates, Ltd.**  
**Condensed Schedule of Investments**  
**December 31, 199X**

<u>Shares</u>	<u>Value</u>
COMMON STOCKS (54.9%)	
United States (33.8%)	
53,125 Airlines (7.2%)	
Flight Airlines, Inc. (3.6%) <sup>†</sup>	\$1,811,297
Other (3.6%)	<u>1,819,074</u>
	3,630,371
Banks (1.9%)	937,099
Financial Services (2.9%)	1,433,210
106,607 Foods (7.1%)	
Andrews Midlands Co. (5.7%)	2,825,078
Other (1.4%)	<u>702,824</u>
	3,527,902
100,404 Hospital Supplies and Services (5.6%)	
Chelsea Clinics Inc.	2,811,297
Technology (4.1%)	2,039,578
Utilities (5.0%)	<u>2,480,556</u>
Total United States (cost \$16,850,954)	16,860,013
Hong Kong (5.7%)	
Drugs (0.6%)	330,741
Retail (4.0%)	1,984,445
Utility—Telephone (1.1%)	<u>552,235</u>
Total Hong Kong (cost \$2,756,959)	2,867,421
Italy (5.6%)	
Airlines (0.2%)	110,247
Financial Services (1.8%)	881,975
Leisure Related (3.5%)	1,763,951
Office Supplies (0.1%)	<u>55,123</u>
Total Italy (cost \$2,912,465)	2,811,296
Spain (5.4%)	
Banks (2.4%)	1,212,716
Oil (1.7%)	826,852
Railroads (1.3%)	<u>661,482</u>
Total Spain (cost \$2,643,197)	2,701,050
United Kingdom (4.4%)	
Financial Services (2.3%)	1,157,593
Technology (2.1%)	<u>1,047,346</u>
Total United Kingdom (cost \$2,145,246)	2,204,939
TOTAL COMMON STOCKS (cost \$27,308,821)	<u>27,444,719</u>

The accompanying notes are an integral part of these financial statements.

\* Percent of net assets is shown for each category; net assets are assumed to be \$50,000,000 for this illustration.

<sup>†</sup> Securities of Flight Airlines, Inc., aggregate 5.6 percent of net assets of ABC Associates, Ltd.

**ABC Associates, Ltd.**  
**Condensed Schedule of Investments**  
**December 31, 199X**  
*(continued)*

<u>Shares or Principal Amount</u>		<u>Value</u>
	<b>LONG-TERM DEBT</b>	
	<b>SECURITIES (41.3%)</b>	
	United States (21.4%)	
	Airlines (2.0%)	
\$ 1,000,000	Flight Airlines, Inc. 12%, 1998 <sup>†</sup>	\$ 1,000,000
	Government (19.4%)	
\$ 3,000,000	U.S. Treasury Bonds, 7.875%, 2021	3,031,791
\$ 6,600,000	U.S. Treasury Bonds, 6.875%–8.125% 1999–2021	<u>6,686,175</u>
		<u>9,717,966</u>
	Total United States (cost \$15,015,200)	10,717,966
	Spain (19.8%)	
\$10,000,000	Spanish Treasury Bonds 4.50%–5.125%, 1994–1997 (cost \$10,000,000)	<u>9,922,224</u>
	<b>TOTAL LONG-TERM DEBT</b>	
	<b>SECURITIES (cost \$25,015,200)</b>	20,640,190
	(The following investments are all in United States enterprises.)	
	<b>LONG PUT AND CALL OPTIONS (2.4%)</b>	
	(cost \$1,225,800)	1,212,716
	<b>LOAN PARTICIPATIONS (1.3%)</b>	
	(cost \$465,000)	661,482
	<b>WARRANTS (2.2%) (cost \$1,110,247)</b>	1,110,247
	<b>INTEREST IN INVESTMENT</b>	
	<b>PARTNERSHIP (10.0%) (cost \$4,000,000)</b>	<u>5,000,000</u>
	XYZ Hedge Fund, L.P. (35% owned) <sup>‡</sup>	
	(XYZ Hedge Fund L.P. owns 6,000 shares, valued at \$9,000,000 of Leisure Cruises, Inc., which is a United States company in the leisure time industry.)	
	<b>TOTAL INVESTMENTS (112.1%)</b>	
	(cost \$59,125,068)	<u>\$56,069,354</u>
	<b>SECURITIES SOLD SHORT (5.7%)</b>	
106,607	Andrews Midlands Co. (Proceeds \$2,715,000)	<u>(\$ 2,825,078)</u>

The accompanying notes are an integral part of these financial statements.

<sup>†</sup> Securities of Flight Airlines, Inc., aggregate 5.6 percent of net assets of ABC Associates, Ltd.

<sup>‡</sup> Leisure Cruises, Inc., is named because the proportionate share of ABC Associates, Ltd., equity in it is greater than 5 percent of ABC's net assets. If information about the investments of XYZ was not available, that would have been stated either parenthetically or in a note to this schedule.



## Appendix B

### Discussion of Comments Received on the Exposure Draft

**B-1.** An exposure draft of a proposed statement of position, *Financial Reporting for Investment Partnerships*, was issued for public comment in September 1993 and distributed to a variety of interested parties to encourage comments by those that would be affected by the proposal. It proposed that investment partnerships—

- Include a detailed schedule of investments in securities, as illustrated in the Guide for management investment companies, with GAAP financial statements.
- Present a statement of operations in the format illustrated in the Guide.
- Account for performance fees in accordance with partnership agreements and disclose the amounts of and how such fees are computed.

**B-2.** The exposure draft included the minority view of AcSEC that a condensed schedule of investments, which was illustrated, be required instead of a detailed schedule of investments, as required by the Guide.

**B-3.** Sixty-nine comment letters on the exposure draft were received. The most significant and pervasive comments received related to the proposed requirement that investment partnerships include a detailed schedule of investments with their financial statements. For the reasons stated in paragraphs .17 through .19 of this SOP, AcSEC agreed that the condensed schedule of investments provided more meaningful information.

#### **Schedule of Investments**

**B-4.** Most respondents to the exposure draft stated that detailed disclosures about the investment portfolio would reveal information, such as trading strategies, that is considered to be confidential. They believe that reporting either detailed or condensed information publicly could be detrimental economically to partnership investors. AcSEC noted that in the absence of any portfolio information, financial statements might merely present a single asset line item titled “investments” that would approximate total assets. Such limited disclosure would undermine the meaningfulness of financial statements.

**B-5.** Others expressed the view that basic financial statements should provide meaningful summarized information rather than a complete listing of all items included in a particular financial statement caption, such as investments in securities. They pointed out that other financial enterprises, such as banks, property and liability insurance companies, stock life insurance companies, and broker-dealers do not disclose their investments in a similar level of detail. AcSEC concluded that a condensed schedule of investments, that includes disclosures of material investments, would provide sufficient information about the composition of partnerships’ portfolios.

**B-6.** Many respondents stated that investment strategies must be kept confidential to achieve the best results for investors. They expressed concern about disclosing information that they deem to be confidential trade secrets, which might lead other investment firms to “piggyback” the reporting partnership’s positions.

**B-7.** Although AcSEC recognizes the need to balance a fair presentation with protection of proprietary information, complete confidentiality of investments is not a compelling reason for excluding information on material items from financial statements. AcSEC acknowledges that disclosure can produce certain detriments, but AcSEC believes that the need for adequate disclosure outweighs the possibility of negative results. Furthermore, as noted by several respondents, although the disclosure of investment positions may be detrimental to some funds that have material short positions outstanding at a reporting date, many such positions will have expired or will have been covered before the availability of the financial statements.

**B-8. *Investor Expectations and Needs.*** Respondents noted that investors in investment partnerships frequently are sophisticated investors with a high net worth who neither need nor expect the type of reporting required of mutual funds. Additionally, a number noted that partnership agreements provide for partner access to records, thus enabling a partner to obtain additional information if necessary, whereas others noted that partners sometimes agree not to seek such information.

**B-9.** AcSEC acknowledges that many, but not necessarily all, investment partners are sophisticated investors, but believes their need for financial information is difficult to differentiate from that of less sophisticated investors. How to assess financial statement users' needs is a pervasive issue in formulating accounting standards and is considered in AcSEC and FASB deliberations. Further, it is questionable whether investment partnerships can be distinguished from other investment companies based on the sophistication of their investors because some public investment companies registered under the 1940 Act—

- a. Can engage in similar trading strategies, such as hedging and investing in derivatives.
- b. Have sophisticated investors.
- c. Have minimum investment levels equal to or in excess of those called for by some nonpublic investment partnerships.

**B-10.** An investor's willingness to take increased risk in return for an expected higher return does not necessarily equate to a lack of desire for information about an investment company's investments. In the absence of any portfolio information, financial statements might merely present a single asset line item titled "investments" that would approximate total assets. Such limited disclosure would undermine the meaningfulness of financial statements.

**B-11. *Cost.*** A number of respondents addressed the issue of cost benefit in terms of their belief that including either a detailed or condensed schedule of investments with financial statements would jeopardize the confidentiality required to protect their trading strategies and the gains that they engender. They mentioned, as consequences, that others could mimic their strategies or even devise strategies to profit at the expense of an investment partnership, such as in a short squeeze. AcSEC acknowledges that disclosure of condensed schedules of investments may be detrimental in certain cases. Nevertheless, AcSEC believes that reporting basic information about investments is vital for a fair presentation of investment partnerships' financial statements.

**B-12.** Other respondents expressed a belief that the incremental cost to assemble, present, and audit the investment information would not be out-

weighed by the benefits of the disclosures. AcSEC believes that such costs should not be material because much of the information required appears to be readily available.

### ***Statement of Operations and Partners' Fees and Allocations***

**B-13.** Most respondents directed their comments to the proposed requirement for investment partnerships to present a schedule of investments, as discussed above. Comments on the proposed statement of operations and partners' fees and allocations were as follows:

- Most respondents who expressed opinions on the proposed statement of operations supported it, but a number objected to it because they believe that the format is appropriate for public mutual funds, but not for nonpublic investment partnerships. One commentator suggested imposing a uniform requirement for both broker-dealers and investment companies, and another suggested a different format altogether.
- A number of respondents who expressed opinions on reporting partners' fees and allocations supported the proposed reporting, and most of the remainder recommended that one or the other accounting method be required, although most did not state a preference for one method or another.

**B-14.** AcSEC has decided not to make any significant changes to those requirements proposed in the exposure draft. AcSEC believes that because both public (SEC registered) investment companies and nonpublic investment partnerships have similar operations, their statements of operations should also be similar. Although AcSEC recognizes that issuing definitive standards is desirable, it continues to believe that this SOP cannot provide definitive guidance on accounting for payments to general partners because such guidance would have to result from deliberations of broader partnership accounting issues.

### ***Regulatory Considerations***

**B-15. Broker-Dealer Requirements.** The financial statements of broker-dealers need not include a detailed or condensed schedule of investments or a separate disclosure of realized and unrealized gains (losses). In the AICPA's Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*, securities brokers and dealers are described as follows (paragraph 1.01):

Brokers, acting in an agency capacity, buy and sell securities and commodities for their customers and charge a commission. Dealers or traders, acting in a principal capacity, buy and sell for their own account and trade with customers and other dealers.

**B-16.** Representatives of the broker-dealer industry have expressed the view that investment partnerships that are registered as broker-dealers and that manage funds only for directors, officers, or employees of the partnership's general partner, should be permitted to follow broker-dealer accounting, which does not require the presentation of a schedule of investments. They point out that such investment partnerships are registered as broker-dealers to more readily obtain credit to invest on behalf of the broker-dealers' owners or employees, who are defined as "affiliated persons" by the Securities Exchange Act of 1934. Because those investment partnerships are registered broker-dealers, they are required to prepare financial statements filed with the SEC the way that broker-dealers are. Such financial statements comply with the format

for broker-dealers specified in the Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*. Were such entities required to apply the requirements in this SOP, they would have to prepare financial statements using two different formats: those in the broker-dealer Guide and those specified by this SOP.

**B-17.** AcSEC believes that investment partnerships that are registered broker-dealers and that invest funds only for directors, officers, or employees of a partnership's general partner should be exempt from the requirements of this SOP. GAAP for broker-dealers is set forth in the broker-dealer Guide, and such partners can readily obtain the information that a condensed schedule of investments and a statement of operations in the format of an investment company would afford them.

**B-18. *Commodity Pool Requirements.*** Some investment partnerships are registered with the Commodity Futures Trading Commission (CFTC) as commodity pool operators and, as such, are required by the CFTC to file financial statements that are prepared in conformity with GAAP. Commentators recommend that such entities be exempt from the scope of the SOP because—

- a. A detailed or condensed schedule of investments may not be meaningful and may even be misleading because of the volatility of most commodity portfolios.
- b. The format of the statement of operations currently in use for commodity pools is more meaningful than that proposed in the SOP.
- c. The Chief Accountant of the CFTC Division of Trading and Markets has issued an interpretation on how to report allocations of investment partnership equity or other interests to general partners in financial statements filed with the CFTC. That interpretation requires that such allocations be reported in the statement of operations immediately after net income and, as such, is consistent with the conclusions in this SOP.

**B-19.** In addition to the foregoing, AcSEC notes that an AICPA task force is drafting an audit and accounting guide that will apply to commodity pools, including investment partnerships that are commodity pools. Accordingly, AcSEC has exempted from the scope of this SOP investment partnerships that are commodity pools subject to regulation under the Commodity Exchange Act of 1974.

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## Section 10,670

# Statement of Position 95-3

## Accounting for Certain Distribution Costs of Investment Companies

July 28, 1995

## NOTE

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## Introduction and Background

.01 The Audit and Accounting Guide *Audits of Investment Companies* (the Guide) describes how to account for distribution costs of open-end investment companies that are registered under the Investment Company Act of 1940 (1940 Act), as amended, and that have adopted plans of distribution pursuant to rule 270.12b-1 of the 1940 Act. Paragraph 8.35 of the Guide states the following:

Rule 270.12b-1 of the 1940 Act permits an investment company, in compliance with specified conditions, to pay for costs incurred to distribute its shares. Payments are made pursuant to a plan, commonly known as a "12b-1 plan," adopted by the board of directors. There are many forms of such plans, and the auditor should review their provisions. Distribution expenses paid with an investment company's assets are accounted for as operating expenses. [Rule 6-07.2(f) of Regulation S-X]

.02 Open-end investment companies, referred to in this SOP as funds, are permitted to finance the distribution of their shares under a plan pursuant to rule 270.12b-1 of the 1940 Act.

Under rule 270.12b-1, a fund's board of directors is required to perform an annual review of the plan and determine whether to continue or terminate it. Under a **traditional 12b-1 plan**,<sup>1</sup> fund's **distributor** may be compensated or reimbursed for its distribution efforts or costs through one or more of the following methods:

<sup>1</sup> Words that are defined in the accompanying glossary [paragraph .23] are set in boldface the first time they appear.

- A 12b-1 fee, payable by the fund, based on an annual percentage of the fund's average net assets (a **compensation plan**) or based on an annual percentage of the fund's average net assets limited to actual costs incurred, after deducting **contingent-deferred sales loads (CDSLs)** received by the distributor (a **reimbursement plan**). Therefore, a compensation plan differs from a reimbursement plan only in that the latter provides for annual or cumulative limits, or both, on fees paid. Fees for both kinds of plans are treated as expenses in a fund's statement of operations.
- A front-end load, which is assessed on purchasing shareholders at the time fund shares are sold.
- A CDSL imposed directly on redeeming shareholders. The CDSL usually is expressed as a percentage, which declines with the passage of time, of the lesser of redemption proceeds or original cost. The CDSL normally ranges from 4 percent to 6 percent and typically is reduced by 1 percent (for example, from 6 percent to 5 percent) a year until the sales charge reaches zero percent.

.03 Rule 12b-1 plans historically have provided that a fund's board of directors may terminate the plan with no penalty to the fund. (Termination of the plan does not necessitate termination of the fund.) Redeeming shareholders still would be subject to the CDSL, which would be paid to the distributor that sold the shares to those shareholders. However, with a traditional 12b-1 plan, the 12b-1 fees normally would be discontinued on plan termination. Some traditional reimbursement 12b-1 plans provide that, when the plan is terminated, the fund's board of directors has the option, but not the requirement, to pay the distributor for any costs incurred by the distributor in excess of the cumulative CDSL and 12b-1 fees the distributor has received. Such a plan is referred to in this SOP as a **board-contingent plan**. Under traditional reimbursement 12b-1 plans, including board-contingent plans, CDSL payments by shareholders continue to be remitted to the distributor until excess costs are fully recovered, after which the CDSL payments usually are remitted to the fund instead of the distributor.

.04 With an **enhanced 12b-1 plan**, the fund is required to continue paying the 12b-1 fee after termination of the plan to the extent the distributor has **excess costs**. CDSL payments by shareholders would continue to be remitted to the distributor to further offset excess costs. Thus, the major distinction between traditional and enhanced 12b-1 plans is the requirement for the fund to continue such payments upon plan termination.

.05 The following table summarizes the 12b-1 plan attributes enumerated above.



	<i>Traditional</i>			<i>Enhanced</i>
	<i>Compensation</i>	<i>Reimbursement</i>		
		<i>Nonboard Contingent</i>	<i>Board Contingent</i>	
Annual review and approval of plan by board, with ability to terminate plan	X	X	X	X
<i>Fund Payment Terms*</i>				
Payment based on average net assets	X	X	X	X
Annual or cumulative limitation, or both, based on actual distribution costs		X	X	X
Upon termination of 12b-1 plan, board has option, but not obligation, to pay excess costs			X	
Upon termination of 12b-1 plan, fund is required to continue paying 12b-1 fee to the extent the distributor has excess costs				X

## Scope

.06 This Statement of Position (SOP) applies to annual and interim financial statements of investment companies that adopt plans that comply with rule 270.12b-1 of the Investment Company Act of 1940.

## Conclusions

.07 A liability, with a corresponding charge to expense, should be recognized by a fund with an enhanced 12b-1 plan for excess costs. The amount of the liability should be equal to the cumulative **distribution costs** incurred by the distributor less the sum of (a) cumulative 12b-1 fees paid, (b) cumulative CDSL payments, and (c) future cumulative CDSL payments by **current shareholders**, if reasonably estimable. Any future cumulative CDSL payments should be based on (a) current net asset value per share, (b) the number of shares currently outstanding and the number of years that they have been outstanding, and (c) estimated shareholder **persistence** based on historical fund data or, if historical fund data are not available, group or industry data for a similar class of shares. Changes in the liability should be recognized in the statement of operations as an expense or reduction in expense.

.08 The liability should be reported at its present value, calculated using an appropriate current interest rate, if (a) the amount and timing of cash flows are reliably determinable and (b) the distribution costs are not subject to a reasonable interest charge. If these conditions are not met, the liability should be calculated without discounting to present value.

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\* Excludes front-end and CDSL payments, which are made by shareholders and not the fund.

**.09** A liability for excess costs, computed in the same way as for an enhanced 12b-1 plan, should be recorded by a fund with a board-contingent plan when the fund's board commits to pay such costs.

**.10** For both traditional and enhanced plans, funds should disclose in their financial statements the principal terms of such plans and any plan provisions permitting or requiring payments of excess costs after plan termination. For board-contingent and enhanced plans, the aggregate amount of distribution costs subject to recovery through future payments by the fund pursuant to the plan and through future CDSL payments by current shareholders should be disclosed. For enhanced plans, funds should disclose the methodology used to estimate future CDSL payments by current shareholders.

**.11** An excess of cumulative 12b-1 fees and CDSL payments to date and future CDSL payments by current shareholders over the cumulative costs incurred by the distributor should not be reported as an asset.

## Effective Date and Transition

**.12** This SOP is effective for annual financial statements for fiscal years beginning after December 15, 1995, and for interim financial statements for periods in such years. The cumulative effect of changes caused by adopting this SOP should be reflected in the calculation of net asset value on the first day of the fiscal year of adoption.<sup>2</sup> Restatement of financial statements presented for comparative purposes, including financial highlights, is not permitted. Pro forma financial information is not required. Early application is encouraged.

## Basis for Conclusions

**.13** This section discusses factors that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

**.14** For enhanced 12b-1 plans, AcSEC considered three alternatives with respect to accounting for excess costs: (1) immediate recognition of a liability when the distributor incurs excess costs; (2) recognition of a liability upon termination of the plan; and (3) no recognition of a liability.

**.15** AcSEC believes that a fund is unconditionally committed to pay excess costs at the formation of an enhanced 12b-1 plan and that a liability for such costs should be reported by the fund when the costs are incurred by the distributor. Although an enhanced 12b-1 plan requires annual board approval for its continuance, the payment for excess costs is not contingent on such approval. Termination of the plan by the fund's board would not change the obligations under the plan. Any operational difficulties, such as the daily calculation of the share net asset values, does not change the fact that the fund is liable for excess costs.

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<sup>2</sup> Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 74, *Disclosures Regarding Accounting Standards Issued But Not Yet Adopted*, expresses the SEC staff's views concerning disclosures of the impact that recently issued accounting standards will have on the financial statements when adopted in a future period. The impact of this standard should be disclosed for all investment companies, including those not subject to SAB No. 74.

.16 The amount of the liability, as calculated pursuant to paragraph .07 of this SOP, includes a reduction for the future cumulative CDSL payments by current shareholders, if reasonably estimable. That is analogous to accounting for the disposal of a segment of a business when the anticipated future cash flows that will result from an original lease and a sublease are taken into account in determining the overall gain or loss on the disposal.<sup>3</sup> In the case of a terminated 12b-1 plan, future CDSL payments on redemption by shareholders pursuant to the prospectus terms reduce the fund's obligation to the distributor, although the amount of those payments is subject to estimation.

.17 Funds account for 12b-1 fees as expenses, in accordance with Regulation S-X and the Guide. AcSEC observes that accounting for excess costs as expenses is consistent with that and the way that funds account for other costs of raising capital (such as state registration fees and legal fees). That accounting is based on the principle that raising capital is an integral part of a fund's business. Such costs are analogous to ordinary and necessary period costs in nonfinancial businesses.

.18 AcSEC believes that the liability for excess costs should be accounted for at its present value, if (a) the amount and timing of cash flows are reliably determinable and (b) the distribution costs are not subject to a reasonable interest charge. That is consistent with the consensus in Emerging Issues Task Force (EITF) Issue 93-5, *Accounting for Environmental Liabilities*.

.19 Board-contingent plans provide that on a plan's termination, the fund's board of directors has the option, but not the obligation, to pay the distributor for any excess costs incurred. AcSEC believes that a liability for excess costs, computed in the same way as for an enhanced 12b-1 plan, should be recorded for a board-contingent plan only when the fund's board commits to pay such costs and communicates its intent to do so. A commitment by the board, in effect, converts a board-contingent plan into an enhanced plan. That is, the fund is then obligated to continue to pay the 12b-1 fee after termination of the plan to the extent that the distributor has excess costs.

.20 AcSEC believes that the disclosures required for traditional and enhanced plans are necessary to provide users with adequate information regarding the assumptions used to compute the liabilities for certain distributions costs of enhanced 12b-1 plans and contingent excess costs for traditional 12b-1 plans.

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<sup>3</sup> FASB Interpretation No. 27, *Accounting for a Loss on a Sublease*, paragraph 3.

## Appendix A

### Illustration

To illustrate application of this SOP, the following assumptions are made for a fund with an enhanced 12b-1 plan:

Total distribution costs incurred	\$5,000,000
12b-1 payments	(750,000)
CDSL payments received by distributor	<u>(250,000)</u>
	4,000,000
Estimated future CDSL payments to be received by distributor from current shareholders at current asset levels*	<u>(1,000,000)</u>
	<u><u>\$3,000,000</u></u>

Assuming that the 12b-1 fee is paid at the end of the year, the following calculation would be made:

Current fund net assets	
(10 million shares at \$10.00 per share)	\$100,000,000
12b-1 fee as a percentage of net assets	<u>.0075</u>
Annual 12b-1 fee payments (75 basis points)	<u>\$ 750,000</u>
Estimated number of years to pay excess costs ( $\$3,000,000 \div \$750,000/\text{year}$ )	<u>4</u>
Present value of 12b-1 payments of \$750,000 for 4 years, discounted at an assumed rate of 8 percent (assuming discounting is appropriate)	<u><u>\$ 2,484,000</u></u>

Accordingly, upon adoption of the SOP on January 1, 19X1, the fund would recognize a liability of \$2,484,000 and a corresponding expense, which would be reported as the cumulative effect of a change in accounting principle pursuant to Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*.

The following illustrates the impact of adopting this SOP in the 19X1 Financial Statements after making the following additional assumptions:

There are no further distribution costs incurred or capital share activity during 19X1.

CDSLs received during 19X1 are \$250,000, and anticipated CDSLs with respect to current shareholders expected to be received after 19X1 are \$750,000 (that is, the assumption at the beginning of 19X1 that \$1,000,000 of CDSLs would be received still is considered valid).

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\* Assuming amounts are reasonably estimable.

**Statement of Operations**

Investment income	\$X,XXX,XXX
Expenses	
Distribution fees	—
Interest	199,000*
Other	<u>X,XXX,XXX</u>
Realized and unrealized gains	<u>X,XXX,XXX</u>
Net increase in net assets resulting from operations before cumulative effect of change in accounting principle	<u>X,XXX,XXX</u>
Cumulative effect of change in accounting principle (Note)	<u>(2,484,000)</u>
Net increase in net assets resulting from operations	<u><u>X,XXX,XXX</u></u>

The statement of changes in net assets should separately reflect the inclusion of the cumulative effect of the accounting change in a similar manner.

The liability at the end of 19X1 would be \$1,933,000 (\$2,484,000 + \$199,000 of interest amortization - \$750,000 of annual 12b-1 fees paid) and would be reflected on the statement of assets and liabilities as accrued distribution expenses payable. That amount can be proved as the present value of three consecutive payments of \$750,000, which represents the fund's undiscounted liability of \$2,250,000.

**Financial Highlights**

Net asset value—beginning of year	\$ .XX
Net investment income	.XX
Realized and unrealized gains	<u>X.XX</u>
	X.XX
Cumulative effect of adoption of accounting standard (Note)	<u>(.25)</u>
Net increase in net assets resulting from operations	<u><u>\$X.XX</u></u>

**Note**

Effective January 19X1, the fund adopted AICPA Statement of Position No. 95-3, which requires that a fund record a liability and expense for excess costs, as defined, for enhanced 12b-1 plans. Prior thereto the fund recognized an expense under its 12b-1 plan based on a percentage of the fund's net assets. Under an enhanced 12b-1 plan, the fund is obligated to reimburse the distributor for any costs it has incurred in excess of cumulative 12b-1 and CDSL payments it has received. As of January 1, 19X1, the fund has recorded a liability of \$2,484,000 for such costs, representing the cumulative effect of the change in accounting. It is equal to the \$4,000,000 of aggregate costs incurred by the distributor in excess of cumulative 12b-1 and CDSL payments through that date, less future estimated CDSL payments of \$1,000,000, discounted at 8 percent. At December 31, 19X1, the liability of \$1,933,000 represents the aggregate excess costs of \$3,000,000 less estimated future CDSL payments of \$750,000, discounted at 8 percent. Future CDSL payments were estimated based on the net asset value per share of the fund as of December 31, 19X1, the

\* \$2,484,000 at 8 percent.

number of shares currently outstanding and the number of years that they have been outstanding, and estimated shareholder persistency based on historical fund data.

### Change in Estimate

Assume that at the end of 19X1, actual CDSLs received in year one exceed those anticipated by \$250,000 and the distributor's estimate of future CDSLs after 19X1 is increased by a further \$500,000. The undiscounted liability would be reduced from \$2,250,000 to \$1,500,000; the discounted liability would be \$1,337,000. In this situation, the distribution fees included in the 19X1 statement of operations would be a contra expense of \$596,000 (interest expense would be unchanged) and not an adjustment of the cumulative effect of adoption.

If it is assumed instead that year-end CDSLs fell short by \$250,000 and the estimate of future CDSLs from current shareholders fell by another \$500,000, the undiscounted liability would increase to \$3,000,000. The discounted liability would increase to \$2,484,000, and the 19X1 statement of operations would include distribution fees of \$551,000.

In practice, the periodic remeasurement of the liability also will have to incorporate new fund share sales, additional costs incurred during the period, and the effect of changes in net asset value on the discounting process. In addition, such calculations would have to be made at each net asset value determination date.

## Appendix B

### Discussion of Comments Received on the Exposure Draft

**B-1.** An exposure draft of a proposed statement of position, *Accounting for Certain Distribution Costs for Investment Companies*, was issued for public comment in April 1994 and distributed to a variety of interested parties to encourage comments by those that would be affected by the proposal. The conclusions proposed in the exposure draft on how to account for such costs have been adopted in this SOP. A majority of commentators supported or did not object to the conclusions proposed.

**B-2.** A minority of commentators objected to the conclusion that investment companies should account for excess costs under enhanced 12b-1 plans as liabilities and expenses. One objection acknowledged that the SOP may be based on existing accounting theory, but objected to it on the grounds that it will not afford equal and fair treatment to fund shareholders. Another commentator objected because of the belief that the likelihood of the termination of a 12b-1 plan is "highly unlikely, remote," as defined in FASB Statement No. 5, *Accounting for Contingencies*.

**B-3.** As to the first objection, AcSEC observes that Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, in discussing the concept of neutrality, states: "Neutrality means that either in formulating or implementing standards, the primary concern should be the relevance and reliability of the information that results, not the effect that the new rule may have on a particular interest."

**B-4.** The second objection fails to recognize that the promise made at the inception of an enhanced 12b-1 plan to pay unconditionally any distribution costs creates a liability. That liability is measured by the amount of excess costs. Terminating an enhanced 12b-1 plan only determines when the existing liability is to be paid.

**B-5.** A further objection to reporting enhanced 12b-1 excess costs as expenses is that doing so may cause a violation of regulatory limitations on 12b-1 fees. This objector argues that, if excess costs are accounted for as liabilities, a portion of those costs should be recorded as an asset to recognize the future economic benefits of increased fund assets. In considering this objection, AcSEC relied on the concept of neutrality cited above and notes that items are frequently treated differently for GAAP and regulatory purposes. Further, AcSEC believes that the benefits cited—lower expenses (on a pro rata per share basis) and increased cash flows that enhance investment strategy—do not meet the essential characteristic of an asset in paragraph 26 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, that, "(a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows."

## Glossary

**Board-contingent plan.** A reimbursement 12b-1 plan that provides that, on the plan's termination, a fund's board of directors has the option, but not the requirement, to pay the distributor for any excess costs incurred by the distributor.

**Compensation plan.** A plan that provides for a 12b-1 fee, payable by the fund, based on a percentage of the fund's average net assets. The 12b-1 fee may be more or less than the costs incurred by the distributor.

**Contingent-deferred sales load (CDSL or back-end load).** A sales charge imposed directly on redeeming shareholders based on a percentage of the lesser of the redemption proceeds or original cost. The percentage may decrease or be eliminated based on the duration of share ownership (frequently decreases by one percent a year).

**Current shareholders.** Shareholders of a fund, or a class of shares of a fund, at an evaluation or measurement date. Amounts attributable to current shareholders are based on shares outstanding at that date and do not include estimates of future reinvestments or other share purchases.

**Distribution costs.** Costs, as defined in a distribution agreement between a distributor and a fund, incurred by a distributor in distributing a fund's shares. Such costs may include commission payments to sales representatives, promotional materials, overhead allocations, and interest.

**Distributor.** Usually the principal underwriter that sells the fund's capital shares by acting as an agent (intermediary between the fund and an independent dealer or the public) or as a principal, buying capital shares from the fund at net asset value and selling shares through dealers or to the public (see definition of *underwriter* in section 2(a)(40) of the Investment Company Act of 1940).

**Enhanced 12b-1 plan.** A reimbursement 12b-1 plan that provides that, on termination of the plan, the fund is required to continue paying the 12b-1 fee to the extent the distributor has excess costs.

**Excess costs.** The cumulative distribution costs incurred by the distributor less the sum of (a) cumulative 12b-1 fees paid, (b) cumulative CDSL payments, and (c) future cumulative CDSL payments by current shareholders, if reasonably estimable.

**Persistency.** The length of time a shareholder owns shares of a particular fund or class of shares of a fund before redemption.

**Reimbursement plan.** A plan that provides for a 12b-1 fee, payable by the fund, that may not exceed the lesser of an annual percentage of the fund's average net assets or actual costs incurred by the distributor net of CDSL received by the distributor.

**Traditional 12b-1 plan.** A compensation or reimbursement plan pursuant to rule 270.12b-1 of the Investment Company Act of 1940 that permits the use of a fund's assets to pay distribution-related expenses under certain conditions. The 12b-1 fees under traditional 12b-1 plans are normally discontinued upon plan termination, but may continue to be paid after plan termination under a board-contingent plan (see above).



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[The next page is 20,201.]



**Section 10,680****Statement of Position 96-1  
Environmental Remediation Liabilities**

October 10, 1996

**NOTE**

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

**Part 1****Overview of Environmental  
Laws and Regulations**

.01 The objective of this part is to provide accountants with an overview of key environmental laws and regulations. It is intended to be a separate, nonauthoritative component of this Statement of Position (SOP).

.02 Although the remainder of this SOP focuses on environmental remediation liability issues, this part includes brief discussions of key pollution control and other environmental laws as well as a more extensive discussion of environmental remediation liability laws.

## Chapter 1

### INTRODUCTION

.03 Beginning in the early 1970s, Congress and state governments began paying increased attention to legislation designed to protect the environment. In just twenty years, these efforts have changed dramatically the manner in which business is carried out in the United States.

.04 For instance, today, new loan agreements only rarely do not contain extensive environmental representations, warranties, and indemnities. Real estate development is likewise affected by environmental considerations, such as whether the project area contains wetlands or whether past activities could have adversely affected the soil or groundwater. The possibility of becoming subject to liability for environmental **remediation**<sup>1</sup> costs associated with past waste **disposal** practices based on strict liability can affect transactions involving the acquisition or merger of enterprises or the purchase of land. In sum, the explosion of federal and state environmental laws and regulations has affected all manner of business transactions.

.05 Although this SOP focuses on both state and federal United States laws and regulations, environmental considerations are also important for foreign operations. Environmental laws and regulations in many countries are similar to United States laws. The legal and regulatory climates in other countries are evolving. Regardless of whether the host countries' environmental laws are as stringent as those in the United States, entities can often be held liable for environmental damages under a variety of nonenvironmental statutes and broad legal theories.

.06 Environmental laws may be thought of as being of two kinds. First, there are laws that impose liability for remediation of environmental pollution arising from some past act. Second, there are pollution control and pollution prevention laws. Some environmental laws cover both categories. This SOP focuses principally on federal laws, but many states have enacted analogous statutes.

.07 The first kind of environmental law, environmental remediation liability laws, includes individual statutes as well as response provisions in other statutes. The most important of these are the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), as amended by the Superfund Amendments and Reauthorization Act of 1986 (SARA), which together are referred to as Superfund, and the **corrective action** provisions of the Resource Conservation and Recovery Act of 1976 (RCRA). Under Superfund's current broad liability provisions, the U.S. Environmental Protection Agency (EPA) may order liable parties to remediate sites or use Superfund money to remediate them and then seek to recover its costs and additional damages. Similarly, under the corrective action provisions of RCRA, the EPA may order "facilities that treat, store, or dispose of **hazardous waste**" to clean up **releases of hazardous waste constituents** associated with past or ongoing practices.

.08 Environmental laws of the second kind, laws intended to control or prevent pollution, are directed at identifying or regulating pollution sources or

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<sup>1</sup> Terms defined in the glossary [paragraph .178] are in **boldface** type the first time they appear in this SOP.

reducing emissions or discharges of pollutants. Myriad statutes regulate sources of pollution, including the pollution control provisions of RCRA (solid and hazardous wastes), the Clean Water Act (discharge of pollutants into the waters of the United States and to publicly owned treatment works, or POTWs), and the Clean Air Act (emission of pollutants into the atmosphere). Other examples are the Emergency Planning and Community-Right-to-Know Act (EPCRA) and the Pollution Prevention Act of 1990. Pursuant to EPCRA, facilities that store chemicals over threshold amounts must submit certain information to local, state, and federal environmental and emergency response authorities. EPCRA also includes requirements for reporting of episodic releases of toxic chemicals, as well as annual reporting of toxic chemical releases that occur as a result of normal business operations for specified manufacturing and other activities. The Pollution Prevention Act, among other things, requires facilities subject to EPCRA's reporting requirements to also report pollution source reduction and recycling activities.

.09 Before discussing key statutes in more detail, it is worth mentioning two legal concepts that are expressly or implicitly incorporated into Superfund: strict liability, and joint and several liability. Strict liability statutes, such as CERCLA, impose liability without regard to the liable party's fault. Thus, a waste generator that disposed of its waste at approved facilities, in accordance with all then-current requirements, having exercised "due care," would nevertheless be liable. Where liability is joint and several, any party deemed liable is potentially responsible for all of the associated costs. Under CERCLA, for instance, a waste generator that is responsible for a small percentage of the total amount of waste at a site may be held liable for the entire cost of remediating the site.

.10 Also noteworthy is that wastes need not be hazardous wastes for there to be environmental remediation liability. If the waste generator "arranged for disposal" of wastes containing **hazardous substances** (at any concentration level and regardless of whether the substances were defined as, or known to be, hazardous at the time of disposal), and a "release" of hazardous substances has or could occur, the waste generator could be subject to environmental remediation liability.

## Chapter 2

### ENVIRONMENTAL REMEDIATION LAWS

.11 The vast majority of federal environmental remediation provisions are contained in the Superfund laws, the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the Superfund Amendments and Reauthorization Act (SARA), and in the corrective action provisions of the Resource Conservation and Recovery Act of 1976 (RCRA). Typically, the United States Environmental Protection Agency (EPA) utilizes Superfund to clean up facilities that are abandoned or inactive or whose owners are insolvent; however, Superfund can be and is also applied to sites still in operation. RCRA provisions apply to hazardous waste treatment, storage, and disposal facilities that are still in operation or have closed recently.

#### Superfund

.12 Congress enacted CERCLA in 1980 to facilitate the remediation of abandoned waste sites. CERCLA established a program to identify sites where hazardous substances have been or might be released into the environment; to ensure that they are remediated by responsible parties or the government; to compensate the United States, states, municipalities, and tribes for damages to natural resources; and to create a procedure for claims against responsible parties by parties who have cleaned up sites or spent money to restore natural resources. The act also created a \$1.6 billion trust fund to cover the costs associated with **orphan sites** and costs incurred while the EPA seeks reimbursement from **potentially responsible parties (PRPs)**. In 1986, SARA increased the amount of the trust fund to \$8.5 billion, broadened the provisions of Superfund, provided more detailed standards for remediation and settlement provisions, and broadened criminal sanctions. The increase in the trust fund is supported by increased taxes on the petroleum industry and a tax on corporate alternative minimum taxable income. At the time of this writing, Superfund is again in the process of reauthorization, and there is a potential for further changes to the law as part of this process.

.13 Superfund places liability on the following four distinct classes of responsible parties:

- a. Current owners or operators of sites at which hazardous substances have been disposed of or abandoned
- b. Previous owners or operators of sites at the time of disposal of hazardous substances
- c. Parties that "arranged for disposal" of hazardous substances found at the sites
- d. Parties that transported hazardous substances to a site, having selected the site for treatment or disposal

This liability is imposed regardless of whether a party was negligent, whether the site was in compliance with environmental laws at the time of the disposal, or whether the party participated in or benefitted from the deposit of the haz-

ardous substance. Parties that disposed of hazardous substances many years ago—including the years preceding CERCLA's enactment—at sites where there is, was, or may be a release into the environment, may be liable for remediation costs.

.14 *Hazardous substance* is a much broader term than *hazardous waste*. It includes any substance identified by the EPA by regulation, pursuant to a number of federal statutes. Covered, for example, are substances considered to be *toxic pollutants* under the Clean Water Act or *hazardous air pollutants* under the Clean Air Act. The various lists of hazardous substances identified by the EPA contain more than one thousand chemicals and chemical compounds.

.15 Petroleum and any derivative or fraction that is not specifically listed or designated as a hazardous substance are specifically excluded from the federal definition of a hazardous substance contained in Superfund. Also excluded are natural gas, natural gas liquids, liquefied natural gas, and synthetic gas of pipeline quality. (Discharges of petroleum into the surface waters or shorelines of the United States are covered under several other federal laws.) The protection afforded by this petroleum exclusion is narrow, however. For example, lead (a hazardous substance) that is added to gasoline would not be covered by the petroleum exclusion because it is not an indigenous constituent of petroleum. Further, many state laws that are analogous to Superfund do not provide for a petroleum exclusion.

.16 Hazardous substances are often integral components of materials that are not hazardous wastes. And, although a threshold quantity of a hazardous substance must be released in order to create a reporting obligation, there is no threshold quantity that gives rise to liability. Thus, discarding industrial equipment on which there is leaded paint may not trigger a reporting obligation, but if that equipment is discovered at a Superfund site, it may be sufficient to identify the disposer as a PRP.

.17 The courts have interpreted CERCLA to impose strict liability. In other words, responsible parties are liable regardless of fault. Moreover, through EPA-initiated legal action, liability under CERCLA may be joint and several. If a PRP can prove, however, that the harm is divisible and there is a reasonable basis for apportionment of costs, the PRP may ultimately be responsible only for its portion of the costs. This scheme of liability means that any responsible party can potentially be liable for the entire cost of remediating a site, notwithstanding that the party is responsible for only a small amount of the total hazardous substances or waste at the site and did nothing improper.

.18 Statutory defenses to CERCLA liability are limited. Essentially, they are an act of God; an act of war (but not a response to an act of war, such as the manufacturing of munitions); and, in limited circumstances, an act or omission of a third party. There is an additional defense available to owners of property affected by hazardous substances known as the *innocent landowner* defense, which applies to landowners that acquired properties after hazardous substances were disposed of on them and that did not know or have reason to know about the existence of the hazardous substances. In order to use this defense, however, a landowner must establish that it made "all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice." What constitutes "all appropriate inquiry" has been the subject of substantial litigation. It can be said, however, that a landowner that gains such actual knowledge and subsequently transfers the property without disclosure forfeits this defense.

.19 In order to mitigate the potentially harsh effects of the strict, joint and several, and retroactive liability scheme, however, Superfund does permit responsible parties to sue other responsible parties to make them contribute to the cost of the remediation or to recover money spent on remediation.

.20 The EPA has several potent enforcement tools available to it under Superfund. Most significant is the EPA's power to issue a **unilateral administrative order** to responsible parties requiring them to take a **response action** at a site where there is "an imminent and substantial endangerment to the public health or welfare or the environment because of an actual or threatened release [of a hazardous substance] from a facility." A respondent who fails to perform the response action or fails to report as required under CERCLA is potentially subject to \$25,000 per day in penalties. In addition, if the EPA performs the action, it may recover up to four times its costs in damages and penalties (that is, actual costs plus treble damages). Judicial review of an EPA administrative order is not available until after the remedy is implemented, money is spent, and the EPA commences an enforcement action for cost recovery. Thus, even a party with a reasonably good defense to liability takes great risk in not complying with an EPA order.

.21 Costs to a PRP may include cleanup costs (**containment, removal, remedial action**), enforcement costs (for example, legal), government oversight costs, and natural resource damages (see the section herein entitled "Natural Resource Damages Under Superfund" in paragraphs .48 through .50). Though CERCLA does not provide for personal injury or property damage suits, suits for injury to health or property (referred to as toxic torts) may also be brought by third parties under various legal theories.

## Stages of the Superfund Remediation Process

.22 The following is a discussion of the Superfund remediation process. The stages of this process are also depicted in figure 1, "Sequence of a Typical Superfund Remediation Process," in paragraph .39. The subsequent section, "Potentially Responsible Parties Identification and Allocation" [paragraphs .40 through .47], discusses stages of PRP involvement in the remediation process.

### *Site Identification and Screening*

.23 Beginning in 1981, the EPA identified more than thirty thousand sites for scrutiny based on reports filed by companies pursuant to section 103(c) of CERCLA in which they disclosed locations where they had disposed of hazardous substances. This information formed the basis for a database called the **Comprehensive Environmental Response, Compensation, and Liability Information System (CERCLIS or CERCLA Information System)**.

.24 Each site in the CERCLIS database has undergone or will undergo a preliminary assessment of available information as a first step in determining what, if any, action is needed at the site. Based on this information, a site may be dropped from further consideration, or a site investigation or inspection may be performed. This involves a visit to the site by EPA representatives and, usually, limited sampling, which provides the information necessary to rank the site according to the Hazard Ranking System, a mathematical rating scheme that combines the potential of a release to cause harm to people or the environment with the severity or magnitude of these potential situations and the number of people that could be affected. Using the numerical scores from



this scheme, the EPA and the states prioritize sites and allocate resources for further investigation, enforcement of remediation, and remediation. Sites receiving high scores (28.5 or above) are proposed for inclusion on the **National Priorities List (NPL)** for remedial action, which generally is a long-term operation involving permanent solutions to the extent practicable.

### ***Removal Action***

.25 Some sites may be determined to require a **removal action**, which is a relatively short-term or emergency response taken where there is an imminent and substantial endangerment to the public health or welfare or the environment. In such cases, the EPA may undertake or order PRPs to undertake any appropriate removal action to prevent, abate, stabilize, minimize, mitigate, or eliminate a release or threatened release. A removal action may occur at any stage of the remediation process. Moreover, sites need not be on the NPL for the EPA to undertake or order removal actions.

### ***Remedial Investigation***

.26 The remedial investigation is a comprehensive study, usually performed by environmental engineers, that seeks to delineate the nature and extent of hazardous substances at a site, assess potential risks posed by the site, and define potential pathways for exposure. The remedial investigation usually involves extensive sampling of soil and groundwater in and around the vicinity of the site.

### ***Risk Assessment***

.27 A site-specific **baseline risk assessment** identifies hazards, assesses exposure to the hazardous substances and their toxicity, and characterizes and quantifies the potential risks posed by the site. A baseline risk assessment often is performed during the feasibility study phase.

### ***Feasibility Study***

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

- Identifies a list of potential remedial alternatives.
- Estimates the cost of each remedial alternative.
- Screens the alternatives for their ability to meet technical, public health, and environmental requirements and, if other considerations are equal, their cost-effectiveness; evaluates their ability to be implemented in a reasonable time frame given available technologies; and eliminates inferior alternatives from further evaluation.
- Completes a detailed analysis of the screened alternatives with respect to the criteria established by the EPA.

.29 The **remedial investigation and the feasibility study (RI/FS)** together generally take a minimum of two years to complete and, depending on factors such as the types of hazardous substances, soil formations, and number of parties involved, may take more than five years, and they can cost well in excess of \$1 million. The EPA oversees the progress of the RI/FS, and completion is sometimes performed in stages.

### ***Remedial Action Plan***

.30 Once the RI/FS is complete, a program must be decided on for remediation of the site.

.31 In selecting a remediation program, the EPA first decides what cleanup standards are to be applied to the site. (The remedy selected must achieve cleanup standards, standards of control, and other environmental protection requirements, criteria, or limitations, known as **applicable or relevant and appropriate requirements (ARARs)**.) It then identifies which remediation methods can achieve the standards. Finally, it is specified which of the alternative remediation methods is most cost-effective. Thus, the cleanup standards to be applied are not weighed against the cost of achieving those standards in the decision process.

### ***Public Comment and Record of Decision***

.32 The program is contained in a proposed remedial action plan (PRAP), which is made available to interested parties for public comment. After reviewing any public comments received, the EPA modifies the remedial plan, if necessary, and issues a record of decision (ROD), which specifies the remedy, as well as the time frame in which the remedy is to be implemented. The final ROD is part of a written **administrative record** documenting the basis of the EPA's remedy selection.

.33 The EPA reviews the effectiveness of the remedial action periodically and can require changes to the plan or additional measures. EPA reviews typically occur every five years (often more frequently in the early stages of the remediation) and may continue well beyond delisting of the site from the NPL.

### ***Remedial Design***

.34 Following issuance of the ROD, the site enters into the remedial design phase. This phase includes development of a complete site remediation plan, including engineering drawings and specifications for the site remediation.

### ***Remedial Action***

.35 This phase includes actual construction and implementation of the remedial design that results in site remediation as specified in the ROD.

.36 There is a general presumption that the technology specified in the ROD must be used at the site. But the EPA sometimes agrees to innovative approaches using alternative, unproven technologies because one of the objectives embodied in Superfund is the promotion of improvements in remediation technology.

### ***Operation and Maintenance (Including Postremediation Monitoring)***

.37 After Superfund site remedial action is completed, activities must be conducted at the site to ensure that the remedy is effective and operating properly. For example, after a system to pump and treat groundwater is constructed (remedial action), the system must be operated and maintained. In addition, the EPA may require postremediation monitoring. These operation and maintenance activities may continue for thirty years or longer.

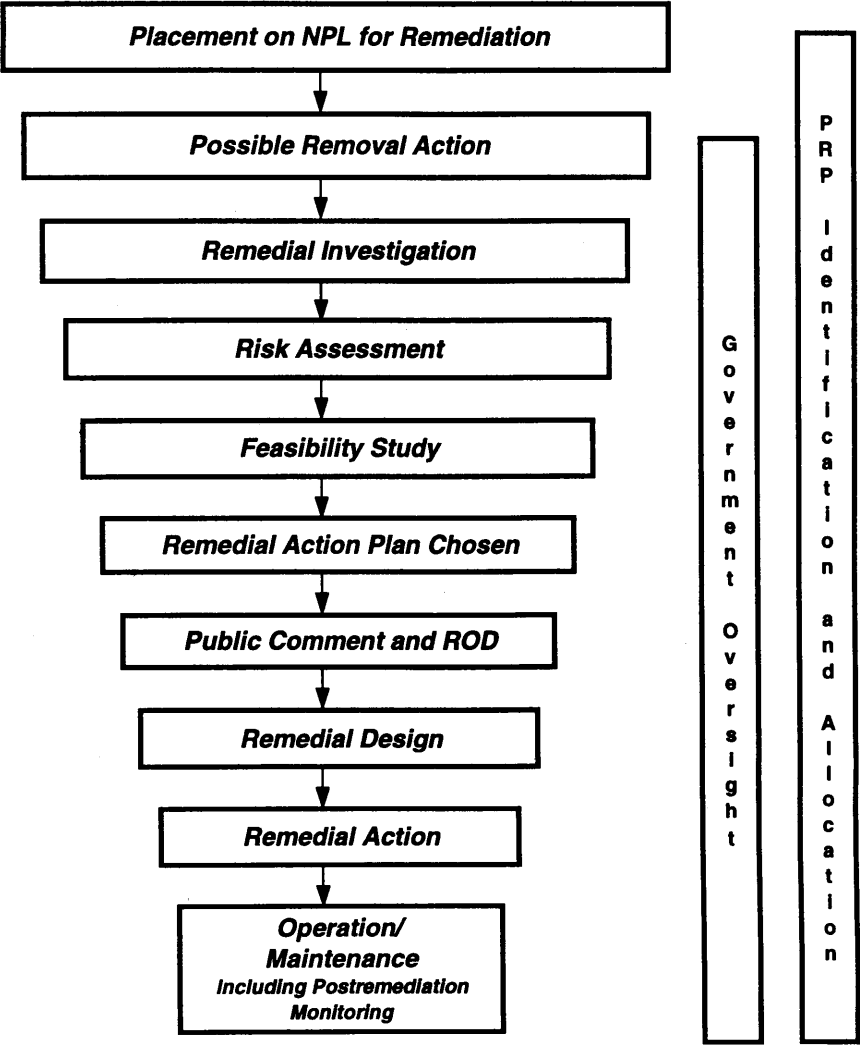
### ***Government Oversight***

.38 Under Superfund, the President of the United States has broad freedom to respond to actual or threatened releases of hazardous substances;

threatened, not actual, releases are enough to give rise to authority to act. Authority to abate the risk of harm from even threatened releases lies at the heart of the statute. The President has delegated this authority principally to the EPA for land, groundwater, and surface water. Thus, the Superfund program is controlled by the EPA throughout each step of the remediation process. This is reflected in continued agency oversight as the Superfund project unfolds.

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Figure 1  
Sequence of a Typical Superfund Remediation Process



## Potentially Responsible Parties Identification and Allocation

.40 The following is a discussion of the stages of PRP involvement in the Superfund remediation process. As depicted in figure 1 [paragraph .39], PRP identification and the allocation of costs among the PRPs is an ongoing process over the course of the remediation process; specific stages of PRP involvement do not necessarily correspond to specific stages of the remediation process.

### **Notification of Involvement**

.41 A company may first learn of potential involvement in a Superfund site through the appearance of the site on a government list such as the NPL, in the CERCLIS database, or on a state priorities list. More often, an entity learns of involvement by receiving an information request [Section 104(e) Request] from the EPA regarding the wastes it may have sent to a designated site. But full-scale Superfund involvement usually begins when a company is notified by the EPA that it may be a PRP. The EPA may do this in several ways. It may—

- Issue a Notice Letter to all PRPs. A Notice Letter is the EPA's formal notice that Superfund-related action is to be undertaken at a site for which the PRP is considered potentially responsible.
- Issue a Special Notice Letter to PRPs stating that the government intends to initiate work at the site or issue an administrative order to force the PRPs to take response actions at the site unless the PRPs commit within a specified period (typically sixty to one-hundred twenty days) to take response actions.

The Special Notice Letter provides the names and addresses of other targeted PRPs (to facilitate negotiations among the parties), and it may include a draft of a **consent decree** for each party to share in the costs or assume the responsibility for performing the RI/FS. The EPA also normally includes information about the nature of the material at the waste site and any knowledge it has obtained about the amount of waste contributed by each party.

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

.42 Theoretically, the EPA should identify all of the PRPs and send each one of them a notice or summon them to a meeting. However, depending on the evidence it has collected to that point, the EPA may not be aware of all PRPs, leaving it up to the identified PRPs to perform an investigation to find others who may be liable and then file suits for cost recovery or contribution.

.43 PRPs are generally prohibited under Superfund from obtaining immediate judicial review of EPA decisions identifying them as liable or requiring them to take response actions; such review generally is available only after the EPA decides to bring an enforcement action for cost recovery, long after the remedy has been implemented.

### **Negotiations**

.44 Once notified, the PRPs face the difficult task of organizing to negotiate with the government and perhaps assuming responsibility for carrying out the investigation or remedial work.<sup>2,3</sup> Many PRPs consider it in their best in-

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<sup>2</sup> The negotiations do not require participation by all PRPs.

<sup>3</sup> A useful source of information is the *PRP Organization Handbook*, published by the Information Network for Superfund Settlements c/o Morgan, Lewis & Bockius, 1800 M Street, NW, Washington, DC 20036.

terests to assume such responsibility; if the PRPs are unable to reach an agreement among themselves, however, the EPA has the power to clean up the site and sue for full reimbursement of the costs. The sixty- to one-hundred-twenty-day period given with the Special Notice Letter is intended to give multiple PRPs sufficient time to organize and to make a good faith offer to the government to perform a specified activity.

.45 Negotiations often take place in stages. For example, PRPs may organize and agree to perform the RI/FS and to divide the costs among themselves in a particular way while continuing to negotiate how and whether to address the remediation itself.<sup>4</sup> Such preliminary cost-sharing agreements are often based on the volume of waste contributed to a site by each party (without regard to its relative toxicity), with an understanding that the allocation may be subsequently revised as additional information about the site becomes available.

.46 The process ultimately results in one of three outcomes:

- a. *Negotiated settlement among the parties.* The parties and the EPA agree on who will clean up the site and how the cost sharing will take place. The EPA sometimes provides some assistance in this area through a *nonbinding allocation of responsibility*—a nonbinding judgment by the EPA as to who should be responsible for what share of the cost.

One or more minor participants may negotiate a de minimis settlement with the EPA in which they agree to pay their shares, usually with an agreement from the EPA that their liability is completed at the time of settlement. Such shares typically include some kind of premium over the contributors' "fair share." De minimis settlement nevertheless saves the contributor from incurring further legal fees, and it is the closest thing a PRP can get to a final cash settlement.

For the EPA to be receptive to a de minimis settlement, one of the following conditions must be met: (a) both the amount and the toxicity or hazardous properties of substances the PRP contributed are minimal in comparison to other hazardous substances at the site or (b) the PRP is a current or past owner of the site, did not allow generation, transportation, storage, treatment, or disposal of any hazardous substance at the site, did not contribute to the release or threat of release at the site, and did not purchase the property knowing that it was used for generation, transportation, storage, treatment, or disposal of any hazardous substances. Further, de minimis settlements typically occur only when a participant's "share" of the liability is less than one percent. Moreover, the EPA typically is unwilling to commit time and resources to negotiate with de minimis contributors individually. The de minimis settlement must take place as part of negotiations with the larger PRP group or with a separate group of de minimis contributors.

PRPs usually establish and contribute to a trust fund, from which an independent contractor is paid to do the RI/FS and remedial work. The contractor's work typically is overseen by a technical committee

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<sup>4</sup> Some states, however, will not enter into agreements with PRPs concerning only stages of the remediation, such as the RI/FS; they require any agreement to cover the entire remediation effort.

of the contributing PRPs and either by a finance committee of those PRPs or by a management firm hired by the trust. PRPs seldom perform the RI/FS or remedial work themselves.

- b. *Unilateral administrative order.* The EPA issues a unilateral administrative order under section 106 of CERCLA to compel a potentially responsible party (or parties) to clean up a site where there may be an “imminent and substantial endangerment” to human health or to the environment because of an actual or threatened release of a hazardous substance.
- c. *Section 107.* The EPA remediates the site and seeks recovery of its costs from PRPs under section 107. To obtain reimbursement, the EPA issues letters to PRPs demanding payment for its response costs (costs of removal, remediation, and enforcement action). If these letters do not result in settlement, the EPA can seek reimbursement in the courts by referring the case to the Department of Justice.

### **Litigation**

.47 PRPs that participate in the remediation can, and generally do, sue PRPs that did not participate in the remediation to recover costs, assuming those parties can be found and are solvent. Superfund expressly provides that any responsible party who pays Superfund response costs may sue other responsible parties to recover at least a part of such costs. In resolving such suits, courts are authorized by Superfund to apportion liability for response costs among responsible parties using “such equitable factors as the court determines are appropriate.”

### **Natural Resource Damages Under Superfund**

.48 There is a growing specter of liability for natural resource damages under the Superfund laws. CERCLA authorizes the recovery of damages for injury to, destruction of, or loss of natural resources, including reasonable costs for assessing such injury resulting from a release of a hazardous substance.

.49 Under CERCLA, natural resources are defined as land, fish, wildlife, biota, air, water, groundwater; drinking water supplies, and other such resources belonging to, managed or held in trust, or otherwise controlled by the United States, state or local governments, foreign governments, or Indian tribes.

.50 Natural resource damage claims include actual restoration costs and lost use values and may in the future include nonuse values, such as the intrinsic public value of protecting or restoring resources that may not be used but are valuable for their mere existence.

### **Reporting Releases Under Superfund Provisions**

.51 Persons in charge of facilities must report releases of hazardous substances (spills) to the environment that exceed specified *reportable quantities*.

### **Remediation Provisions of the Resource Conservation and Recovery Act**

.52 The RCRA of 1976, the pollution control provisions of which are discussed in chapter 3, provides for “cradle-to-grave” management standards

for hazardous wastes. Section 7003 of RCRA also authorizes the EPA to conduct removal actions, seek affirmative injunctive relief, and maintain cost-recovery actions where an imminent and substantial endangerment to the public health or welfare or to the environment is determined to exist. Much like under Superfund, one who has “contributed to” the disposal of waste that is causing an imminent and substantial endangerment can be required to perform or pay for associated remediation under section 7003.

.53 The 1984 Hazardous and Solid Waste Amendments to RCRA expanded owner-operator responsibility for environmental remediation liability associated with releases of hazardous wastes or hazardous waste constituents at hazardous waste **treatment, storage, or disposal facilities (TSDFs)**. As amended, RCRA requires facilities—whether they continue operating or intend to close—to remedy any such releases. These corrective action provisions of RCRA, which are separate from Superfund, apply only to facilities that are operating under RCRA permits (see chapter 3) or that have applied for such permits.<sup>5</sup> However, because the EPA generally takes the position that the facility includes all the property that is adjacent or contiguous to the TSDF, permitting of a very small TSDF can subject a much larger, unrelated part of a property to RCRA’s corrective action provisions, which apply “fencepost-to-fencepost.”

.54 RCRA corrective action may be initiated either as part of the RCRA permitting process or through an interim status corrective action order. Corrective action for releases of hazardous waste or its constituents from **solid waste management units (SWMUs)**, whether they are on- or off-site, is a condition for obtaining any operating or postclosure RCRA permit. The EPA may also order corrective action while a TSDF is in interim status (before it receives its permit) based on information that there is or has been a release to the environment from the TSDF. The EPA does not need to demonstrate imminent and substantial endangerment to human health or the environment from a real or threatened release to issue an interim status corrective action order.

.55 The RCRA corrective action process, which is depicted in figure 2 in paragraph .59, is divided into the following five stages.

.56 *RCRA Facility Assessment.* The RCRA facility assessment (RFA) identifies areas and units at the facility from which hazardous waste or hazardous waste constituents may have been released and collects all existing information regarding the releases. The RFA may be conducted by the EPA or the EPA’s contractors, or by the facility owner. There is no analogous stage in the Superfund remediation process.

.57 *RCRA Facility Investigation.* The RCRA facility investigation (RFI) is a detailed investigation to characterize releases to the environment by identifying the environmental setting, characterizing the sources of hazardous substances releases, identifying potential receptors, determining if remediation is necessary, and, if so, collecting data to support the evaluation of remediation alternatives. This stage is analogous to the Superfund remedial investigation stage.

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<sup>5</sup> Facilities that have not actively applied for a permit may be deemed to have a “permit by rule” if the owner/operator (1) holds a permit under another qualifying program and (2) complies with certain RCRA requirements specified for the owner/operator’s situation. In addition, operating a facility in a manner that was subject to permit requirements, even if an application was not submitted, triggers RCRA permit obligations, including corrective action.

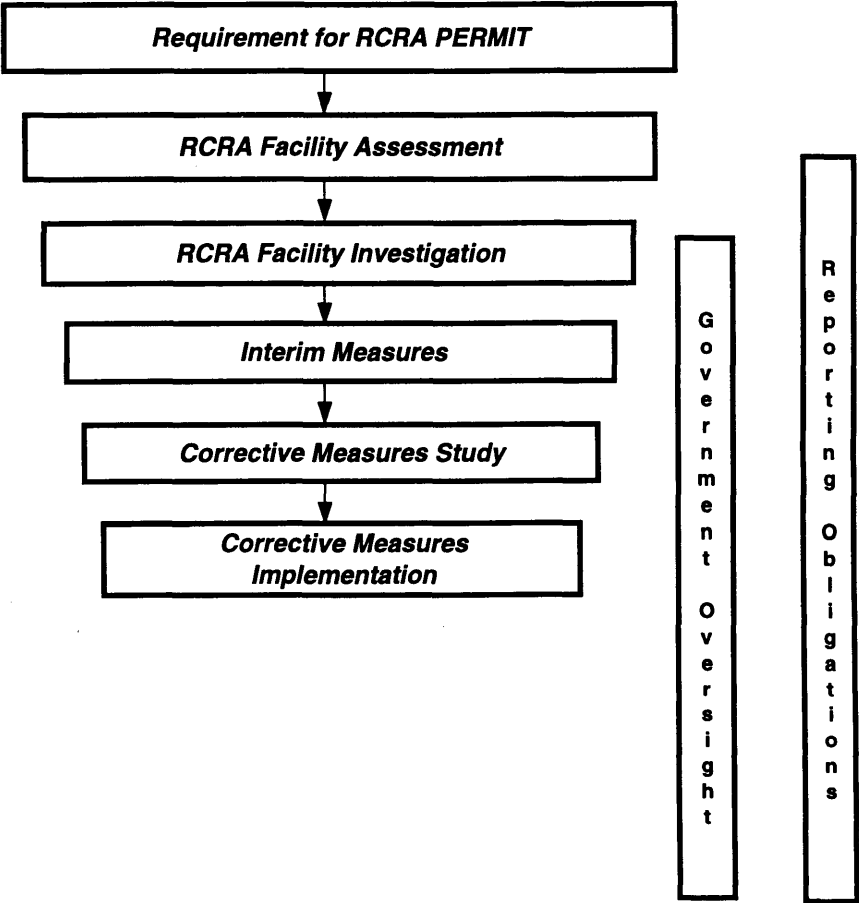


**.58 *Interim Corrective Measures.*** Interim corrective measures (ICM) are measures (typically containment) conducted at any time before selection of the final remedy by the environmental agency. This stage is analogous to a removal action under Superfund.

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Figure 2

Sequence of RCRA Corrective Action Process



**.60 *Corrective Measures Study.*** If the RFI reveals a potential need for corrective measures, the agency requires the owner to perform a corrective measures study (CMS) to identify and recommend specific measures to correct the releases. The CMS assesses possible corrective measures in terms of technical feasibility, ability to protect public health and the environment, and possible adverse environmental effects of the corrective measures. Although analogous to the Superfund feasibility-study stage, this study is usually less complicated.

**.61 *Corrective Measures Implementation.*** This stage, corrective measures implementation (CMI), includes designing, constructing, operating, maintaining, and monitoring selected corrective measures that have been approved by the regulatory agency. This stage combines activities that are often segregated under Superfund as remedial design, remedial action, and operation and maintenance.

**.62 *Owner/Operator Reporting and Government Oversight.*** Beginning with the application for a RCRA permit, owner-operators are required to report to the EPA throughout the RCRA corrective action process, and the EPA oversees and controls each stage of the process.

**.63** The 1984 amendments also created the Underground Storage Tank (UST) Program, which requires, among other things, that owners or operators of existing tank systems used for storage of petroleum and petroleum-based substances and certain other designated hazardous substances upgrade in accordance with standards specified by the EPA if those tank systems do not meet new tank standards. In addition, the 1984 amendments create an environmental remediation liability for known releases from USTs.

**.64** RCRA regulations require financial assurance for closure and postclosure remediation of TSDFs and USTs.

## State and Foreign Laws

**.65** Many states have also enacted laws that are similar to the federal statutes. Furthermore, under certain federal statutes, such as RCRA, states are allowed to promulgate regulations to implement federal programs as long as the state law is at least as stringent as the federal law. In most such cases, states are free to enact more stringent provisions. Preparers and auditors of financial statements should also be aware that most developed countries and many other countries have enacted environmental laws, some of which may be similar to or more stringent than United States laws.

## Chapter 3

# POLLUTION CONTROL AND PREVENTION LAWS

## The Resource Conservation and Recovery Act

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

.67 For generators of hazardous waste, those requirements include the following:

- a. Hazardous waste determination
- b. Manifest requirements
- c. Packaging and labeling
- d. Record keeping and annual reporting
- e. Management standards

.68 Less stringent requirements under RCRA are imposed on certain small quantity generators (up to 1,000 kg of a waste per month).

.69 The key to RCRA compliance is the hazardous waste determination, in which the facility determines whether the material it handles is a hazardous waste. A step-by-step identification procedure is prescribed. Initially, one must determine whether the material is a "solid waste."<sup>6</sup> If so, one must determine whether that solid waste is hazardous. Some wastes that are specified by regulation are automatically deemed hazardous. These are the so-called "listed wastes." Other wastes must be evaluated to determine whether they exhibit any of four characteristics: toxicity, corrosivity, reactivity, or ignitability. If so, they, too, are deemed hazardous. Exclusions are provided for wastewaters regulated under the Clean Water Act and for certain types of reuse, recycling, and reclamation.

.70 With some exceptions, a waste generator that accumulates hazardous waste in excess of ninety days or treats the hazardous waste will be deemed the operator of a TSDF and be subject to the comprehensive TSDF regulations. These regulations require owners-operators to, among other things, obtain a permit.

.71 Each TSDF is also subject to specific requirements designed to prevent any release of hazardous waste into the environment and also may be required to perform groundwater monitoring to ensure proper compliance with TSDF regulations. These regulations require containers and tanks to be of sufficient integrity to contain hazardous wastes properly, and they require that, in certain cases, containers be separated or protected by dikes, berms, or walls. Surface impoundments, waste piles, and landfills must be equipped with liners to prevent any migration of wastes into soil, groundwater, or surface wa-

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<sup>6</sup> Under RCRA, a "solid waste" may be either a solid, a liquid, or a gas.

ter during the active life of the facility and must be constructed to prevent runoff or breaks. Land treatment units that treat hazardous wastes biologically must ensure that hazardous wastes are degraded, transformed, or immobilized within the treatment zone and do not reach the underlying water table.

.72 RCRA also contains provisions for **closure** of TSDFs and financial assurance requirements for closure and postclosure obligations.

.73 RCRA also requires the United States Environmental Protection Agency (EPA) to regulate underground storage tanks (USTs). Most states have enacted their own UST regulations as well. A brief summary of the federal program is presented below.

.74 The UST regulations apply only to underground tank systems containing the following regulated substances:

- a. Petroleum and petroleum-based substances<sup>7</sup>
- b. Hazardous substances designated pursuant to section 101(14) of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)

.75 The EPA's general performance standards rely heavily on detailed technical standards set forth in industry performance codes established by nationally recognized associations or independent testing laboratories.

.76 As a general rule, each new tank (or each existing tank upgraded to new tank standards) must be designed and constructed according to the standards of a nationally recognized organization or an independent testing laboratory. Like the tanks, the piping associated with a new UST system must be designed and constructed in accordance with industry codes. All tanks must also be equipped with spill and overfill prevention equipment. If existing tank systems do not currently meet the new tank standards, the owner or operator must upgrade them by December 22, 1998.

.77 As an alternative to installing new tanks or upgrading existing tanks, an owner or operator may choose to close some or all of its UST systems. The closure, however, must meet standards specified by the EPA. The regulations require that a closed tank be emptied and cleaned by removing all liquids and accumulated sludges. The tank must then be either removed from the ground or filled with an inert solid material.<sup>8</sup>

.78 The UST regulations also impose general operation and maintenance requirements on owners and operators of underground storage tank systems in the following five main areas: (a) spill and overfill control, (b) corrosion protection, (c) tank repair, (d) leak detection, and (e) record keeping. These regulations are designed to ensure that releases due to spilling, overfilling, corrosion, or poor maintenance do not occur. Record-keeping regulations require that records evidencing repairs, release detection systems, monitoring results, and corrosion and inspection reports be maintained at the plant or at a readily available alternative site.

.79 In addition, owners and operators must establish financial responsibility. The regulations specify several different methods of demonstrating fi-

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<sup>7</sup> Certain types of UST systems used for storing heating oil for consumptive use on the premises where stored are exempted.

<sup>8</sup> The regulations further require that the EPA or state agency be notified of the intent to close a tank system permanently at least thirty days before beginning the closure process.

nancial responsibility: self-insurance; guarantee; insurance or risk retention group; surety bond; letter of credit; trust funds; or state-provided financial assurance.

## The Clean Air Act

.80 The Clean Air Act provides comprehensive federal regulation of all “sources” of air pollution. Under the Clean Air Act, every area of the United States is evaluated for its compliance with the National Primary and Secondary Ambient Air Quality Standards (NAAQS). In areas where the NAAQS have not been attained, new and significantly modified sources must use the most effective pollution control equipment available that results in the lowest achievable emissions rate (LAER). This determination is made without regard to cost. The permittee must also provide emissions offsets, or greater than one-to-one reduction, for any nonattainment pollutant that the source would emit in significant amounts. These offsets must be sufficient to provide a net air quality benefit in the affected area.

.81 In areas that have attained the NAAQS for particular pollutants, new or modified stationary sources that would emit these pollutants in significant amounts must obtain permits under the Prevention of Significant Deterioration (PSD) Program. Under the PSD program, a facility emitting air pollutants must apply the best available control technology (BACT). BACT is determined on a case-by-case basis, taking into account energy, environmental, and economic factors, and other costs and benefits of reduced air pollution.

.82 The Clean Air Act also contains new source performance standards (NSPS), which are applicable to stationary sources that are modified or built after the NSPS are proposed. The NSPS program is designed to ensure that new sources are built with state-of-the-art controls and that when existing sources are modified, new controls are installed. Each NSPS establishes design or performance criteria for a specific source. There are numerous specific industrial facilities and operations for which NSPS have been developed.

.83 Section 107(a) of the Clean Air Act directs that each state “shall have the primary responsibility for assuring air quality within the entire geographic area of such state.” Toward that end, the EPA has developed regulations governing state implementation plans pursuant to which states assume Clean Air Act regulation of all facilities within their borders. The act also contains citizen suit provisions that augment government enforcement with citizen enforcement.

.84 Amendments to the Clean Air Act in the 1990s are designed to address issues such as acid rain, urban air pollution, toxic air pollutants, and ozone-depleting chemicals. The major provisions of the Clean Air Act amendments require emissions reduction in the electric utility industry, operating permits for existing facilities, an expansion of the air toxics program to regulate a large number of toxic air pollutants, and new source categories (including smaller sources, such as dry cleaners).

## The Clean Water Act

.85 The Clean Water Act provides comprehensive federal regulation of all sources of water pollution. The primary means of obtaining national water quality is through the imposition of National Pollutant Discharge Elimination System (NPDES) permits on all facilities that discharge pollutants into the wa-

ters of the United States. The Clean Water Act also utilizes ambient water quality standards to set individual permit limitations and technology-based limitations that, in varying degrees, impose the most cost-effective pollution control technology on dischargers. These include effluent limitations utilizing specified technology, compliance with performance standards, use of specified practices for facility design and operation requirements, use of specified treatment or pretreatment methods, and detailed assessments and evaluations of the impact of proposed discharges. Although technology-based effluent limitations provide minimum discharge standards, the act also requires more stringent water-quality-based limitations to maintain or protect water quality in specific bodies of water.

**.86** The Clean Water Act imposes standards on dischargers of conventional (less harmful), toxic (more harmful), and nonconventional pollutants requiring varying degrees of technology. As with the Clean Air Act, the Clean Water Act imposes more stringent standards on facilities whose construction or modification commenced after publication of applicable NSPS. In the promulgation of these standards, the EPA may consider incorporating alternative production processes, operating methods, and in-plant control procedures and other factors. Industrial facilities that discharge into publicly owned treatment works (POTWs) must also meet discharge standards, called pretreatment standards, designed to prevent pollutants from passing through treatment works without adequate treatment. The Clean Water Act also prohibits the discharge of pollutants from nonpermitted point sources. In addition, the EPA has issued regulations requiring permits for storm water discharges from industrial and municipal sources.

**.87** The act authorizes cleanup, injunctive, and cost-recovery actions where an imminent hazard is caused by pollution. It also prohibits the discharge of oil and other hazardous substances to the navigable waters of the United States, imposes a criminal penalty for failure to notify the appropriate entity of such discharges, and provides for citizen suits.

**.88** If a facility discharges pollutants into navigable waters pursuant to a Clean Water Act permit, it must file a discharge monitoring report (DMR) with the EPA or the appropriate state agency. The DMR gives notice to the authorities of any violations of the permit.

**.89** The citizen suit provision of the Clean Water Act permits any citizen to, "commence a civil action . . . against any person . . . alleged to be in violation of an effluent standard or limitation under the Act." Numerous citizen groups have used the citizen suit provision to bring suits against companies based on violations reported in their DMRs.

**.90** Most states have assumed enforcement of the act within their borders through state regulations that correspond to the federal regulations discussed above.

## Chapter 4

### OTHER ENVIRONMENTAL LAWS

.91 There are a variety of other statutes that relate to environmental matters. Two of the more significant ones, the Emergency Planning and Community Right-to-Know Act (EPCRA) and the Toxic Substances Control Act (TSCA), are discussed in this chapter.

#### The Emergency Planning and Community Right-to-Know Act

.92 EPCRA requires facilities that have certain quantities of *extremely hazardous substances* to notify their state emergency response commission that they are subject to the emergency planning requirements of the Superfund Amendments and Reauthorization Act of 1986 (SARA). They must also report releases to the local emergency planning committee.

.93 In addition, facilities that store chemicals over specified threshold amounts must submit material safety data sheets (MSDSs), or their equivalent, to the appropriate local emergency planning committee, the state emergency response commission, and the fire department with jurisdiction over the facility.

.94 Each facility subject to EPCRA reporting requirements must report the maximum amount of the hazardous chemical present at the facility and provide a description of the storage or use of the chemical and its location at the facility. This inventory report must be submitted to local and state emergency response officials annually.

.95 Section 313 of EPCRA also includes requirements for the annual reporting of releases of certain toxic chemicals that occur as a result of normal business operations (as distinguished from abnormal, emergency releases). Facilities subject to this reporting requirement are required to complete a Toxic Chemical Release Inventory Form (Form R) for specified chemicals. This form also includes source reduction and recycling information required under the Pollution Prevention Act of 1990. All the information described above is made available to the general public.

#### The Toxic Substances Control Act

.96 The TSCA regulates the manufacture, processing, and distribution in commerce of chemical substances and mixtures capable of adversely affecting health or the environment. The TSCA may require testing and may impose use restrictions, along with requirements for the reporting and retention of information on the risks of TSCA-regulated substances.

.97 The act requires that any person who manufactures, processes, or distributes in commerce a chemical substance or mixture and who obtains information that reasonably supports the conclusion that such substance or mixture presents a substantial risk of injury to health or the environment shall immediately inform the United States Environmental Protection Agency (EPA). The only excuse for not meeting this duty is actual knowledge that the EPA already has been adequately informed. The act also provides that any per-



son who manufactures, processes, or distributes in commerce any chemical substance or mixture shall maintain records of significant adverse reactions to health or the environment alleged to have been caused by the substance or mixture. Records of any adverse health reactions of employees must also be kept. In addition, records of other problems, including those stemming from consumer complaints and reports of occupational diseases or injuries to nonemployees or harm to the environment, must be maintained. Any person who manufactures, processes, or distributes in commerce a listed chemical under this section must submit to the EPA lists of health and safety studies conducted by the person, known to the person, or reasonably ascertainable. TSCA also requires notification of substantial risk to human health or the environment.

**.98** Regulations promulgated under the TSCA also govern the manufacturing, processing, and distribution in commerce of polychlorinated biphenyls (PCBs) and asbestos. The PCB regulations contain stringent requirements for the labeling, disposal, storage, and incineration of PCBs and should be reviewed carefully if PCB transformers or other PCB articles are present at a facility. Under the asbestos rules, all persons who manufacture, import, or process asbestos must report quantity, use, and exposure information to the EPA.

## Part 2

### Accounting Guidance

.99 The objective of Part 2 is to provide accounting guidance with respect to environmental remediation liabilities that relate to pollution arising from some past act, generally as a result of the provisions of Superfund, the corrective-action provisions of the Resource Conservation and Recovery Act, or analogous state and non-United States laws and regulations. The recognition and measurement guidance in this Part should be applied on a site-by-site basis.

### Scope

.100 The provisions of this SOP apply to all entities that prepare financial statements in conformity with generally accepted accounting principles applicable to nongovernmental entities.

.101 This SOP provides guidance on accounting for environmental remediation liabilities and is written in the context of operations taking place in the United States; however, the accounting guidance in this SOP is applicable to all the operations of the reporting entity. This SOP does not provide guidance on accounting for pollution control costs with respect to current operations or on accounting for costs of future site restoration or closure that are required upon the cessation of operations or sale of facilities, as such current and future costs and obligations represent a class of accounting issues different from environmental remediation liabilities.<sup>9</sup> This SOP also does not provide guidance on accounting for environmental remediation actions that are undertaken at the sole discretion of management and that are not induced by the threat, by governments or other parties, of litigation or of assertion of a claim or an assessment. Furthermore, this SOP does not provide guidance on recognizing liabilities of insurance companies for unpaid claims or address asset impairment issues.

### Effective Date and Transition

.102 The provisions of this SOP are effective for fiscal years beginning after December 15, 1996. Earlier application is encouraged. Although the effect of initially applying the provisions of this SOP will, in individual cases, have elements of a change in accounting principle and of a change in accounting estimate, those elements often will be inseparable. Consequently, the entire effect of initially applying the provisions of this SOP shall be reported as a change in accounting estimate [Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, paragraphs 31 through 33]. Restatement of previously issued financial statements is not permitted.

.103 The provisions of this SOP need not be applied to immaterial items.

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<sup>9</sup> On February 7, 1996, the Financial Accounting Standards Board (FASB) issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting for Certain Liabilities Related to Closure or Removal of Long-Lived Assets*.

## Chapter 5

### RECOGNITION OF ENVIRONMENTAL REMEDiation LIABILITIES

.104 Recognition has to do with when amounts should be reported in financial statements. This chapter addresses that issue. Measurement, which has to do with the amounts to be reported in financial statements, is addressed in chapter 6. Issues with respect to both recognition and measurement of potential recoveries are addressed in chapter 6.

### Overall Approach

.105 FASB Statement No. 5, *Accounting for Contingencies*, requires the accrual of a liability if (a) information available prior to issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and (b) the amount of the loss can be reasonably estimated.

.106 An entity's environmental remediation obligation that results in a liability generally does not become determinable as a distinct event, nor is the amount of the liability generally fixed and determinable at a specific point in time. Rather, the existence of a liability for environmental remediation costs becomes determinable and the amount of the liability becomes estimable over a continuum of events and activities that help to frame, define, and verify the liability.

.107 The underlying cause of an environmental remediation liability is the past or present ownership or operation of a site, or the contribution or transportation of waste to a site, at which remedial actions (at a minimum, investigation) must take place. For a liability to be recognized in the financial statements, this underlying cause must have occurred on or before the date of the financial statements.

### Probability That a Liability Has Been Incurred

.108 In the context of environmental remediation liabilities, FASB Statement No. 5's probability criterion consists of two elements; the criterion is met if both of the following elements are met on or before the date the financial statements are issued:

- Litigation has commenced or a claim or an assessment has been asserted, or, based on available information, commencement of litigation or assertion of a claim or an assessment is probable. In other words, it has been asserted (or it is probable that it will be asserted) that the entity is responsible for participating in a remediation process because of a past event.
- Based on available information, it is probable that the outcome of such litigation, claim, or assessment will be unfavorable. In other words, an entity will be held responsible for participating in a remediation process because of the past event.

What constitutes commencement or probable commencement of litigation or assertion or probable assertion of a claim or an assessment in relation to particular environmental laws and regulations may require legal determination.

.109 Given the legal framework within which most environmental remediation liabilities arise,<sup>10</sup> AcSEC concluded that there is a presumption that, (a) if litigation has commenced or a claim or an assessment has been asserted or if commencement of litigation or assertion of a claim or assessment is probable and (b) if the reporting entity is associated with the site—that is, if it in fact arranged for the disposal of hazardous substances found at a site or transported hazardous substances to the site or is the current or previous owner or operator of the site—the outcome of such litigation, claim, or assessment will be unfavorable.

## Ability to Reasonably Estimate the Liability

.110 Estimating environmental remediation liabilities involves an array of issues at any point in time. In the early stages of the process, cost estimates can be difficult to derive because of uncertainties about a variety of factors. For this reason, estimates developed in the early stages of remediation can vary significantly; in many cases, early estimates later require significant revision. The following are some of the factors that are integral to developing cost estimates:

- The extent and types of hazardous substances at a site
- The range of technologies that can be used for remediation
- Evolving standards of what constitutes acceptable remediation
- The number and financial condition of other potentially responsible parties (PRPs) and the extent of their responsibility for the remediation (that is, the extent and types of hazardous substances they contributed to the site)

.111 FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, concludes that the criterion for recognition of a loss contingency in paragraph 8(b) of FASB Statement No. 5—that “the amount of loss can be reasonably estimated”—is met when a range of loss can be reasonably estimated.

.112 At the early stages of the remediation process, environmental remediation liabilities are not easily quantified, due in part to the uncertainties noted previously. As a practical matter, the range of an estimated remediation liability will be defined and refined as events in the remediation process occur.

.113 An estimate of the range of an environmental remediation liability typically is derived by combining estimates of various components of the liability (such as the costs of performing particular tasks, or amounts allocable to other PRPs but that will not be paid by those other PRPs), which are themselves likely to be ranges. For some of those component ranges, there may be amounts that appear to be better estimates than any other amount within the range; for other component ranges, there may be no such best estimates.

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<sup>10</sup> See the discussion of strict liability in the “Introduction” in paragraphs .03 through .10.

Accordingly, the overall liability that is recorded may be based on amounts representing the lower end of a range of costs for some components of the liability and best estimates within ranges of costs of other components of the liability.

.114 At the early stages of the remediation process, particular components of the overall liability may not be reasonably estimable. This fact should not preclude the recognition of a liability. Rather, the components of the liability that can be reasonably estimated should be viewed as a surrogate for the minimum in the range of the overall liability. For example, a sole PRP that has confirmed that it sent waste to a Superfund site and agrees to perform a remedial investigation and feasibility study (RI/FS) may know that it will incur costs related to the RI/FS. The PRP, although aware that the total costs associated with the site will be greater than the cost of the RI/FS, may be unable to reasonably estimate the overall liability because of existing uncertainties, for example, regarding the kinds and quantities of hazardous substances present at the site and the technologies available to remediate the site. This lack of ability to quantify the total costs of the remediation effort, however, should not preclude recognition of the estimated cost of the RI/FS. In this circumstance, a liability for the best estimate (or, if no best estimate is available, the minimum amount in the range) of the cost of the RI/FS and for any other component remediation costs that can be reasonably estimated, should be recognized in the entity's financial statements.

.115 Additional complexities arise if other PRPs are involved in an identified site. The costs associated with remediation of a site ultimately will be assigned and allocated among the various PRPs. The final allocation of costs may not be known, however, until the remediation effort is substantially complete, and it may or may not be based on an entity's relative direct responsibility at a site. An entity's final obligation depends, among other things, on the willingness of the entity and other PRPs to negotiate a cost allocation, the results of the entity's negotiation efforts, and the ability of other PRPs associated with the particular site to fund the remediation effort.

.116 Uncertainties relating to the entity's *share* of an environmental remediation liability should not preclude the entity from recognizing its best estimate of its share of the liability or, if no best estimate can be made, the minimum estimate of its share of the liability, if the liability is probable and the total remediation liability associated with the site is reasonably estimable within a range. (See the section entitled "Allocation of Liability Among Potentially Responsible Parties" in paragraphs .133 through .139.)

.117 Changes in estimates of the entity's remediation liability, including revisions to the entity's estimate of its share of the liability due to negotiation or identification of other PRPs, should be accounted for as changes in estimates, in consonance with APB Opinion No. 20, *Accounting Changes*.

## Benchmarks

.118 Certain stages of a remediation effort or process and of PRP involvement (see chapter 2 for a discussion of these stages) provide benchmarks that should be considered when evaluating the probability that a loss has been incurred and the extent to which any loss is reasonably estimable. Benchmarks should not, however, be applied in a manner that would delay recognition beyond the point at which FASB Statement No. 5's recognition criteria are met.

.119 The following are recognition benchmarks for a Superfund remediation liability; analogous stages of the RCRA corrective-action process are also indicated. At a minimum, the estimate of a Superfund (or RCRA) remediation liability should be evaluated as each of these benchmarks occurs.

- *Identification and verification of an entity as a PRP.* The RCRA analogue is subjection to RCRA facility permit requirements. Receipt of notification or otherwise becoming aware that an entity may be a PRP compels the entity to action. The entity must examine its records to determine whether it is associated with the site.

If, based on a review and evaluation of its records and all other available information, the entity determines that it is associated with the site, it is probable that a liability has been incurred. If all or a portion of the liability is reasonably estimable, the liability should be recognized.

In some cases, an entity will be able to reasonably estimate a range of its liability very early in the process because the site situation is common or similar to situations at other sites with which the entity has been associated (for example, the remediation involves only the removal of underground storage tanks [USTs] in accordance with the UST program). In such cases, the criteria for recognition would be met and the liability should be recognized. In other cases, however, the entity may have insufficient information to reasonably estimate the minimum amount in the range of its liability. In these cases, the criteria for recognition would not be met at this time.

- *Receipt of unilateral administrative order.* The RCRA analogue is, generally, interim corrective measures. An entity may receive a unilateral administrative order compelling it to take a response action at a site or risk penalties of up to four times the cost of the response action. Such response actions may be relatively limited actions, such as the performance of a remedial investigation and feasibility study or performance of a removal action, or they may be broad actions such as remediating a site. Under section 106 of Superfund, the EPA must find that an "imminent and substantial endangerment" exists at the site before such an order may be issued. No preenforcement review by a court is authorized under Superfund if an entity elects to challenge a unilateral administrative order.

The ability to estimate costs resulting from unilateral administrative orders varies with factors such as site complexity and the nature and extent of the work to be performed. The benchmarks that follow should be considered in evaluating the ability to estimate such costs insofar as the actions required by the unilateral administrative order involve these benchmarks. The cost of performing the requisite work generally is estimable within a range, and recognition of an environmental remediation liability for costs of removal actions generally should not be delayed beyond this point.

- *Participation, as a PRP, in the RI/FS.* The RCRA analogue is RCRA facility investigation. At this stage, the entity and possibly others have been identified as PRPs and have agreed to pay the costs of a study that will investigate the extent of the environmental impact of the release or threatened release of hazardous substances and identify site-remediation alternatives. Further, the total cost of the RI/FS generally is estimable within a reasonable range. In addition, the iden-

tification of other PRPs and their agreement to participate in funding the RI/FS typically provides a reasonable basis for determining the entity's allocable share of the cost of the RI/FS. At this stage, additional information may be available regarding the extent of environmental impact and possible remediation alternatives. This additional information, however, may or may not be sufficient to provide a basis for reasonable estimation of the total remediation liability. At a minimum, the entity should recognize its share of the estimated total cost of the RI/FS.

As the RI/FS proceeds, the entity's estimate of its share of the total cost of the RI/FS can be refined. Further, additional information may become available based on which the entity can refine its estimates of other components of the liability or begin to estimate other components. For example, an entity may be able to estimate the extent of environmental impact at a site and to identify existing alternative remediation technologies. An entity may also be able to identify better the extent of its involvement at the site relative to other PRPs; the universe of PRPs may be identified; negotiations among PRPs and with federal and state EPA representatives may occur; and information may be obtained that materially affects the agreed-upon method of remediation.

- *Completion of feasibility study.* The RCRA analogue is corrective measures study. At substantial completion of the feasibility study, both a minimum remediation liability and the entity's allocated share generally will be reasonably estimable.

The feasibility study should be considered substantially complete no later than the point at which the PRPs recommend a proposed course of action to the EPA. If the entity had not previously concluded that it could reasonably estimate the remediation liability (the best estimate or, if no amount within an estimated range of loss was a better estimate than any other amount in the range, the minimum amount in the range), recognition should not be delayed beyond this point, even if uncertainties, for example, about allocations to individual PRPs and potential recoveries from third parties, remain.

- *Issuance of record of decision (ROD).* The RCRA analogue is approval of corrective measures study. At this point, the EPA has issued its determination specifying a preferred remedy. Normally, the entity and other PRPs have begun, or perhaps completed, negotiations, litigation (see the section, "Impact of Potential Recoveries" in paragraphs .140 and .141), or both for their allocated share of the remediation liability. Accordingly, the entity's estimate normally can be refined based on the specified preferred remedy and a preliminary allocation of the total remediation costs.
- *Remedial Design Through Operation and Maintenance, Including Postremediation Monitoring.* The RCRA analogue is corrective measures implementation. During the design phase of the remediation, engineers develop a better sense of the work to be done and are able to provide more precise estimates of the total remediation cost. Further information likely will become available at various points until the site is delisted, subject only to postremediation monitoring. The entity should continue to refine and recognize its best estimate of its final obligation as this additional information becomes available.

## Chapter 6

### MEASUREMENT OF ENVIRONMENTAL REMEDiation LIABILITIES

**.120** Measurement has to do with the amounts to be reported in financial statements. This chapter addresses that issue. Recognition, which has to do with when amounts should be reported in financial statements, is addressed in chapter 5.

#### Overall Approach

**.121** Once an entity has determined that it is probable that an environmental remediation liability has been incurred, the entity should estimate that liability based on available information. (Also see the section entitled "Ability to Reasonably Estimate the Liability" in paragraphs .110 through .117.) The estimate of the liability includes the entity's—

- a. Allocable share of the liability for a specific site.
- b. Share of amounts related to the site that will not be paid by other potentially responsible parties (PRPs) or the government.

**.122** Making the appropriate measurement of an entity's remediation liability involves the following issues:

- Costs that should be included in the measurement
- Whether the measurement should consider the effects of expected future events or developments, including discounting considerations
- How the measurement should be affected by the existence of other PRPs
- How the measurement should be affected by potential recoveries

**.123** Two kinds of costs that may be involved in environmental remediation situations are not discussed in this chapter. These costs—natural resource damages and toxic torts—are identified in paragraphs .21 and .48 through .50 in chapter 2 of this SOP. Concepts and practices with respect to natural resource damages are still evolving, and third-party suits are too case-specific for general guidance. The accounting guidance with respect to litigation [FASB Statement No. 5, especially paragraphs 33 through 39] should be considered in accounting for and the disclosure of such costs.

#### Costs to Be Included

**.124** The Accounting Standards Executive Committee (AcSEC) concluded that the costs to be included in the measurement are the following:

- a. Incremental direct costs of the remediation effort
- b. Costs of compensation and benefits for those employees who are expected to devote a significant amount of time directly to the remediation effort, to the extent of the time expected to be spent directly on the remediation effort

The remediation effort is considered on a site-by-site basis; it includes the following:



- Precleanup activities, such as the performance of a remedial investigation, risk assessment, or feasibility study and the preparation of a remedial action plan and remedial designs for a Superfund site, or the performance of a Resource Conservation and Recovery Act of 1976 (RCRA) facility assessment, RCRA facility investigation, or RCRA corrective measures studies
- Performance of remedial actions under Superfund, corrective actions under RCRA, and analogous actions under state and non-United States laws
- Government oversight and enforcement-related activities
- Operation and maintenance of the remedy, including required postremediation monitoring

.125 Examples of incremental direct costs of the remediation effort include the following:

- Fees to outside law firms for work related to determining the extent of remedial actions that are required, the type of remedial actions to be used, or the allocation of costs among PRPs
- Costs related to completing the remedial investigation/feasibility study (RI/FS)
- Fees to outside engineering and consulting firms for site investigations and the development of remedial action plans and remedial designs
- Costs of contractors performing remedial actions
- Government oversight costs and past costs; usually this is based on the cost incurred by the United States Environmental Protection Agency (EPA) or other governmental authority dealing with the site
- The cost of machinery and equipment that is dedicated to the remedial actions and that does not have an alternative use
- Assessments by a PRP group covering costs incurred by the group in dealing with a site
- Costs of operation and maintenance of the remedial action, including the costs of postremediation monitoring required by the remedial action plan

.126 Determining (a) the extent of remedial actions that are required, (b) the type of remedial actions to be used, and (c) the allocation of costs among PRPs is part of the remediation effort, and the costs of making such determinations, including legal costs, are to be included in the measurement of the remediation liability. The costs of services related to routine environmental compliance matters and litigation costs involved with potential recoveries are not part of the remediation effort. Litigation costs involved with potential recoveries should be charged to expense as incurred until realization of the claim for recovery is considered probable and an asset relating to the recovery is recognized, at which time any remaining such legal costs should be considered in the measurement of the recovery. The determination of what legal costs are for potential recoveries rather than for determining the allocation of costs among PRPs will depend on the specific facts and circumstances of each situation.

**.127** Examples of employees who may devote a significant amount of time directly to the remediation effort include the following:

- The internal legal staff that is involved with the determination of the extent of remedial actions that are required, the type of remedial action to be used, and the allocation of costs among PRPs
- Technical employees who are involved with the remediation effort

Estimates of the compensation and benefits costs to be incurred for a specific site should be made in connection with the initial recording of the remediation liability and subsequently adjusted at each reporting date to reflect the current estimate of such costs to be incurred in the future.

## Effect of Expected Future Events or Developments

**.128** The time period necessary to remediate a particular site may extend several years, and the laws governing the remediation process and the technology available to complete the remedial action may change before the remedial action is complete. Additionally, the impact of inflation and productivity improvements can change the estimates of costs to be incurred.

**.129** Existing authoritative accounting literature is inconsistent in the treatment of expected future events and developments in currently measuring assets and liabilities. AcSEC concluded that for purposes of measuring environmental remediation liabilities, the measurement should be based on enacted laws and adopted regulations and policies. No changes therein should be anticipated. The impact of changes in laws, regulations, and policies should be recognized when such changes are enacted or adopted.

**.130** Remediation technology is changing constantly, and, in many cases, new technologies have resulted in modified costs for environmental remediation. The remedial action plan that is used to develop the estimate of the liability should be based on the methodology that is expected to be approved to complete the remediation effort. Once a methodology has been approved, that methodology and the technology available therefor should be the basis for estimating the liability until it is probable that there will be formal acceptance of a revised methodology.

**.131** The measurement of environmental remediation liabilities should be based on the reporting entity's estimate of what it will cost to perform each of the elements of the remediation effort (determined in accordance with paragraphs .124, .126, .129, and .130) when those elements are expected to be performed. Although this approach is sometimes referred to in shorthand fashion as "considering inflation," it does not simply rely on an inflation index<sup>11</sup> and should take into account factors such as productivity improvements due to learning from experience with similar sites and similar remedial action plans. In situations in which it is not practicable to estimate inflation and such other factors because of uncertainty about the timing of expenditures, a current-cost estimate would be the minimum in the range of the liability to be recorded until such time as these cost effects can be reasonably estimated.

**.132** The measurement of the liability, or of a component of the liability, may be discounted to reflect the time value of money if the aggregate amount of the liability or component and the amount and timing of cash payments for

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<sup>11</sup> Cost estimates submitted to the EPA usually include a prescribed inflation factor.

the liability or component are fixed or reliably determinable. (Note that these criteria would not be met in situations in which paragraph .131 permits use of a current-cost estimate.) For this purpose, the amount of the liability or component is the reporting entity's allocable share of the undiscounted joint and several liability for the remediation effort or of a component of that liability. This conclusion is consistent with the guidance in the FASB Emerging Issues Task Force (EITF) Issue 93-5.<sup>12</sup> For entities that file with the Securities and Exchange Commission (SEC), the guidance in Staff Accounting Bulletin (SAB) No. 92 with respect to the discount rate to be used—a rate that will produce an amount at which the environmental liability theoretically could be settled in an arm's-length transaction with a third party and that should not exceed the interest rate on monetary assets that are essentially risk-free and have maturities comparable to that of the environmental liability—should be followed.

## Allocation of Liability Among Potentially Responsible Parties

.133 The environmental remediation liability recorded by an entity should be based on that entity's estimate of its allocable share of the joint and several remediation liability. The estimation of an entity's allocable share of the joint and several remediation liability for a site requires an entity to (a) identify the PRPs for the site, (b) assess the likelihood that other PRPs will pay their full allocable share of the joint and several remediation liability, and (c) determine the percentage of the liability that will be allocated to the entity.

## Identification of PRPs for a Site

.134 For purposes of estimating an entity's allocable share of the joint and several remediation liability for a site, those parties that are potentially responsible for paying the remediation liability belong to one of the following five PRP categories:

- a. **Participating PRPs.** **Participating PRPs** acknowledge their potential involvement with respect to a site. Some may participate in the various administrative, negotiation, monitoring, and remediation activities related to the site. Others may adopt a passive stance and simply monitor the activities and decisions of the more involved PRPs. This passive stance could result from a variety of factors such as the entity's lack of experience, limited internal resources, or relative involvement at a site. This category of PRPs (both active and passive) is also referred to as *players*.
- b. **Recalcitrant PRPs.** **Recalcitrant PRPs** adopt a recalcitrant attitude toward the entire remediation effort even though evidence exists

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<sup>12</sup> In developing this and certain other guidance in this SOP, AcSEC considered the guidance in EITF Issue 93-5, *Accounting for Environmental Liabilities*. By incorporating the guidance in EITF Issue 93-5 into this SOP and subjecting that guidance to the due process afforded SOPs, including public comment, the conclusions in that EITF consensus are effectively superseded. That guidance, now incorporated in this SOP, occupies a higher position in the hierarchy of sources of generally accepted accounting principles (GAAP) set forth in Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report* than essentially the same guidance as it is presented in EITF Issue 93-5.

that points to their involvement at a site. Some may adopt this attitude out of ignorance of the law; others may do so in the hope that they will be considered a nuisance and therefore ignored. Typically, parties in this category must be sued in order to collect their allocable share of the remediation liability; however, it may be that it is not economical to bring such suits because the parties' assets are limited. This category of PRPs is also referred to as nonparticipating PRPs.

- c. *Unproven PRPs.* **Unproven PRPs** have been identified as PRPs by the EPA but do not acknowledge their potential involvement because there is currently no substantive evidence to link them to the site. Some ultimately may be dropped from the PRP list because no substantive evidence is found to link them to the site. For others, substantive evidence eventually may be found that points to their liability. The presentation of that evidence to the entity would result in a reclassification of the party from this category of PRPs (sometimes referred to as "hiding in the weeds") to either the participating PRP or recalcitrant PRP category.
- d. *Parties that have not yet been identified as PRPs.* At early stages of the remediation process, the list of PRPs may be limited to a handful of entities that either were significant contributors of waste to the site or were easy to identify, for example, because of their proximity to the site or because of labeled material found at the site. As further investigation of the site occurs and as remediation activities take place, additional PRPs may be identified. Once identified, the additional PRPs would be reclassified from this category to either the participating PRP or recalcitrant PRP category. The total number of parties in this category and their aggregate allocable share of the remediation liability varies by site and cannot be reliably determined prior to the specific identification of individual PRPs. This category of PRPs is sometimes referred to as **unknown PRPs**.
- e. *Parties that are PRPs but cannot be located or have no assets.* Some of these parties may be identified by the EPA; others may be identified as the site is investigated or as the remediation is performed. However, no contributions will ever be made by these parties. This category of PRPs is sometimes referred to as the **orphan share**.

Over the duration of a remediation project, individual entities may move from one PRP category to another.

## Allocation Process

**.135** In estimating its allocable share of the joint and several remediation liability for a site, there is a rebuttable presumption that costs will be allocated only among participating PRPs, as that category exists at the date of issuance of the financial statements.

**.136** There are numerous ways to allocate liabilities among PRPs. The four principal factors considered in a typical allocation process are the following:

- a. *Elements of fair share.* Examples are the amount of waste based on volume; the amount of waste based on mass, type of waste, toxicity of waste; the length of time the site was used.
- b. *Classification of PRP.* Examples are site owner, site operator, transporter of waste, generator of waste.

- c. *Limitations on payments.* This characteristic includes any statutory or regulatory limitations on contributions that may be applicable to a PRP. For example, in the reauthorization of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), it has been proposed that the statute limit the contribution of a municipality to 10 percent of the total remediation liability, irrespective of the municipality's allocable share.
- d. *Degree of care.* This refers to the degree of care exercised in selecting the site or in selecting a transporter.

.137 PRPs may reach an agreement among themselves as to the allocation method and percentages to be used, they may hire an allocation consultant whose conclusions may or may not be binding, or they may request a nonbinding allocation of responsibility from the EPA. The allocation method or percentages used may change as the remediation project moves forward. An agreement to reallocate the preliminarily allocated liability at the end of the remediation project may exist, or the allocation percentages may be adjusted during the project to reflect prior allocations that subsequently are agreed to have been inequitable.

.138 An entity should determine its allocable share of the joint and several remediation liability for a site based on its estimate of the allocation method and percentage that ultimately will be used for the entire remediation effort. The primary sources for this estimate should be the allocation method and percentages that (a) the PRPs have agreed to (whether that agreement applies to the entire remediation effort or to the costs incurred in the current phase of the remediation process), (b) has been assigned by a consultant, or (c) has been determined by the EPA. If the entity's estimate of the ultimate allocation method and percentage differs significantly from the method or percentage from these primary sources, the entity's estimate should be based on objective, verifiable information. Examples of objective, verifiable information include existing data about the kinds and quantities of waste at the site, experience with allocation approaches in comparable situations, reports of environmental specialists (internal or external), and internal data refuting EPA allegations about the entity's contribution of waste (kind, volume, and so forth) to the site.

.139 An entity should assess the likelihood that each PRP will pay its allocable share of the joint and several remediation liability. That assessment should be based primarily on the financial condition of the participating PRP. This assessment requires the entity to gain an understanding of the financial condition of the other participating PRPs and to update and monitor this information as the remediation progresses. The entity should include in its liability its share of amounts related to the site that will not be paid by other PRPs or the government.

## Impact of Potential Recoveries

.140 Potential recoveries of amounts expended for environmental remediation are distinguishable from the allocation of costs subject to joint and several liability, which is discussed in the preceding section, "Allocation of Liability Among Potentially Responsible Parties," in paragraphs .133 through .139. Potential recoveries may be claimed from a number of different parties or sources, including insurers, PRPs other than participating PRPs (see the section

entitled "Identification of PRPs for a Site" in paragraph .134), and governmental or third-party funds. The amount of an environmental remediation liability should be determined independently from any potential claim for recovery, and an asset relating to the recovery should be recognized only when realization of the claim for recovery is deemed probable.<sup>13</sup> If the claim is the subject of litigation, a rebuttable presumption exists that realization of the claim is not probable.

.141 Fair value should be used to measure the amount of a potential recovery. The concept of fair value requires consideration of both transaction costs related to the receipt of the recovery (see paragraph .126) and the time value of money. However, the time value of money should not be considered in the determination of the recorded amount of a potential recovery if (a) the liability is not discounted and (b) the timing of the recovery is dependent on the timing of the payment of the liability. In most circumstances, the point in time at which a liability for environmental remediation is both probable and reasonably estimable will precede the point in time at which any related recovery is probable of realization.

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<sup>13</sup> The term *probable* is used in this SOP with the specific technical meaning in FASB Statement No. 5, paragraph 3.

## Chapter 7

### DISPLAY AND DISCLOSURE

.142 This chapter addresses display and disclosure of environmental remediation-related matters in the context of financial statements prepared in conformity with GAAP. Entities subject to the rules and regulations of the SEC must also adhere to various SEC guidance that applies to environmental matters, particularly SAB No. 92; Regulation S-K Rules 101, 103, and 303; and Financial Reporting Release No. 36.

.143 Display issues are discussed in the context of: (a) the balance sheet and (b) the income statement. Disclosure issues are discussed in the context of: (a) accounting principles, (b) environmental remediation loss contingencies, (c) environmental remediation costs recognized currently, and (d) conclusions on loss contingencies and other matters. The disclosures discussed in these contexts are two-tiered: (a) disclosures that are required and (b) disclosures that are encouraged, but not required. This SOP does not discourage entities from disclosing additional information that they believe will further users' understanding of the entity's financial statements.

### Balance Sheet Display

.144 An entity's balance sheet may include several assets that relate to an environmental remediation obligation. Among them are the following:

- Receivables from other PRPs that are not providing initial funding
- Anticipated recoveries from insurers
- Anticipated recoveries from prior owners as a result of indemnification agreements

.145 Chapter 6 addresses an entity's recognition and measurement of potential recoveries related to its environmental remediation liabilities (see the section entitled "Impact of Potential Recoveries" in paragraphs .140 through .141). FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, addresses the issue of offsetting environmental liabilities and related recoveries in the balance sheet. FASB Interpretation No. 39 states that a right of setoff exists only when all of the following conditions are met.

- Each of *two* parties owes the other determinable amounts.
- The reporting party has the right to set off the amounts owed with the amount owed the other party.
- The reporting party intends to set off.
- The right of setoff is enforceable at law.

.146 A debtor that has a right of setoff that meets all of these conditions may offset the related asset and liability and report the net amount. It would be rare, if ever, that the facts and circumstances surrounding environmental remediation liabilities and related receivables and potential recoveries would meet all of these conditions.

## Income Statement Display

.147 Recording an environmental remediation liability usually results in a corresponding charge to income, and the guidance herein with respect to the income statement refers to such charges. In certain situations, such as those described in FASB EITF Issues 90-8 and 89-13 (see reprints of these EITF Issues in appendix A [paragraph .173]), it may be appropriate to capitalize environmental remediation costs. Also, in conjunction with the initial recording of a purchase business combination or the final estimate of a preacquisition contingency at the end of the allocation period following the guidance in APB Opinion No. 16, *Business Combinations*, and FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*, the environmental remediation liability is considered in the determination and allocation of the purchase price. By analogy to the accounting for a purchase business combination, the recording of an environmental remediation liability in conjunction with the acquisition of property would affect the amount recorded as an asset. Finally, the recording of the receipt of property as a contribution received following the guidance in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, should include the effect of any environmental remediation liability that is recorded in conjunction with the contribution.

.148 APB Opinion 30, *Reporting the Results of Operations*, sets forth the criteria for reporting extraordinary items. The incurrence of environmental remediation obligations is not an event that is unusual in nature. As such, the related costs and recoveries do not meet the criteria for classification as extraordinary.

.149 Furthermore, it is particularly difficult to substantiate the classification of environmental remediation costs as a component of nonoperating expenses. Because the events underlying the incurrence of the obligation relate to an entity's operations, remediation costs should be charged against operations. Although charging the costs of remediating past environmental impacts against current operations may appear debatable because of the time between the contribution or transportation of waste materials containing hazardous substances to a site and the subsequent incurrence of remediation costs, environmental remediation-related expenses have become a regular cost of conducting economic activity. Accordingly, environmental remediation-related expenses should be reported as a component of operating income in income statements that classify items as operating or nonoperating. Credits arising from recoveries of environmental losses from other parties should be reflected in the same income statement line. Any earnings on assets that are reflected on the entity's financial statements and are earmarked for funding its environmental liabilities should be reported as investment income.

.150 Environmental remediation-related expenses and related recoveries attributable to discontinued operations that were accounted for as such in accordance with APB Opinion 30 should be classified as discontinued operations.

## Disclosure of Accounting Principles

.151 APB Opinion 22, *Disclosure of Accounting Policies*, provides guidance regarding accounting principles that should be described in the account-



ing policies note to the financial statements. APB Opinion 22, paragraph 12, indicates that entities should disclose those accounting principles that “materially affect the determination of financial position or results of operations.” Particularly, entities should disclose accounting principles and the methods of applying those principles where alternatives exist.

**.152** With respect to environmental remediation obligations, financial statements should disclose whether the accrual for environmental remediation liabilities is measured on a discounted basis. If an entity utilizes present-value measurement techniques, additional disclosures are appropriate, and are discussed further in the section entitled “Recognized Losses and Recoveries of Losses, and Reasonably Possible Loss Exposures” in paragraphs .160 through .164.

**.153** Because environmental remediation costs have become increasingly significant, and because the accounting for many environmental loss contingencies often involves subjective judgments, disclosure of accrual benchmarks for remediation obligations is useful to further users’ understanding of the entity’s financial statements. Accordingly, entities are encouraged, but not required, to disclose the event, situation, or set of circumstances that generally triggers recognition of loss contingencies that arise out of the entity’s environmental remediation-related obligations (for example, during or upon completion of the feasibility study).<sup>14</sup> Also, entities are encouraged to disclose their policy concerning the timing of recognition of recoveries.

**.154** An illustration of an accounting policies note disclosure for environmental remediation-related costs follows (information that is italicized and enclosed in brackets is not required):

*Environmental Remediation Costs—[Enterprise A accrues for losses associated with environmental remediation obligations when such losses are probable and reasonably estimable. Accruals for estimated losses from environmental remediation obligations generally are recognized no later than completion of the remedial feasibility study.]*

*Such accruals are adjusted as further information develops or circumstances change.] Costs of future expenditures for environmental remediation obligations are not discounted to their present value. [Recoveries of environmental remediation costs from other parties are recorded as assets when their receipt is deemed probable.]*

## Disclosures for Environmental Remediation Loss Contingencies

**.155** FASB Statement No. 5 provides the primary guidance applicable to disclosures of environmental remediation loss contingencies. Paragraphs 9 and 10 of FASB Statement No. 5 state:

9. Disclosure of the nature of an accrual made pursuant to the provisions of paragraph 8 [of Statement No. 5], and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of

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<sup>14</sup> An accrual benchmark cannot operate in a manner that would delay the accrual of a loss contingency beyond the point required by the provisions of FASB Statement No. 5, *Accounting for Contingencies*.

the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable. [footnotes omitted]

**.156** The disclosure requirements of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640], also apply to environmental remediation liabilities. SOP 94-6, paragraphs 12 through 14 [section 10,640.12 through .14] state in part:

12. In addition to disclosures required by FASB Statement No. 5 and other accounting pronouncements, this SOP requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or disclosure of gain or loss contingencies, as described below.

13. Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that *both* of the following criteria are met:

- It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
- The effect of the change would be material to the financial statements.

14. The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure should also include an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.

**.157** This SOP incorporates the disclosure requirements set forth in EITF Issue 93-5 concerning discounting of environmental remediation liabilities and of assets that are recognized relating to recovery of a portion or all of such a liability.

**.158** Uncertainties associated with environmental remediation loss contingencies are pervasive, and they often result in wide ranges of reasonably possible losses with respect to such contingencies. Further, resolution of the uncertainties and the cash-flow effects of the loss contingencies often occur over a span of many years. Accordingly, this SOP encourages, but does not require, additional specific disclosures<sup>15</sup> with respect to environmental remediation loss contingencies that would be useful to further users' understanding of the entity's financial statements.

**.159** Paragraphs 9 and 10 of FASB Statement No. 5 provide for disclosures related to three different aspects of loss contingencies: (a) recognized los-

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<sup>15</sup> Nothing in this SOP eliminates disclosures that are required by FASB Statement No. 5 or SOP 94-6 [section 10,640].

ses and reasonably possible (additional) loss exposures, (b) probable but not reasonably estimable losses, and (c) unasserted claims. Following are the disclosures that are required or encouraged by Statement No. 5, SOP 94-6 [section 10,640], and this SOP for each aspect.

### **Recognized Losses and Recoveries of Losses, and Reasonably Possible Loss Exposures**

**.160** If the FASB Statement No. 5 criteria of remote, reasonably possible, and probable were mapped onto a range of likelihood of the existence of a loss spanning from zero to 100 percent, the reasonably possible portion would span a significant breadth of the range starting from remote and ending with probable. The potential outcomes of environmental remediation loss contingencies often span a range of possibilities. If a loss is deemed probable and it is reasonably estimable, it is recognized; however, beyond the recognized losses, there may be additional exposure to loss that is reasonably possible. This often happens in situations in which a range of possible outcomes is identified and, in accordance with FASB Interpretation No. 14, the entity records either a best estimate within the range or the minimum amount in the range, thus leaving unrecorded amounts of additional possible loss for the higher cost outcomes.<sup>16</sup> In other situations, no loss may be probable, but a loss is reasonably possible. There may also be situations where a loss is probable, but no amount that would be material to the entity is reasonably estimable (see the subsequent section entitled "Probable But Not Reasonably Estimable Losses" in paragraphs .165 through .167).

**.161** With respect to recorded accruals for environmental remediation loss contingencies and assets for third-party recoveries related to environmental remediation obligations, financial statements should disclose the following:

- a. The nature of the accruals, if such disclosure is necessary for the financial statements not to be misleading, and, in situations where disclosure of the nature of the accruals is necessary, the total amount accrued for the remediation obligation, if such disclosure is also necessary for the financial statements not to be misleading
- b. If any portion of the accrued obligation is discounted, the undiscounted amount of the obligation and the discount rate used in the present-value determinations
- c. If the criteria of SOP 94-6 [section 10,640] are met with respect to the accrued obligation or to any recognized asset for third-party recoveries, an indication that it is at least reasonably possible that a change in the estimate of the obligation or of the asset will occur in the near term

**.162** With respect to reasonably possible loss contingencies, including reasonably possible loss exposures in excess of the amount accrued, financial statements should disclose the following:

- a. The nature of the reasonably possible loss contingency, that is, a description of the reasonably possible remediation obligation, and an estimate of the possible loss exposure or the fact that such an estimate cannot be made

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<sup>16</sup> When an overall liability is estimated by combining estimates of various components of the liability, additional possible losses present in the component estimates must be considered in determining an overall additional possible loss.

- b. If the criteria of SOP 94-6 [section 10,640] are met with respect to estimated loss (or gain) contingencies, an indication that it is at least reasonably possible that a change in the estimate will occur in the near term
- .163** Entities also are encouraged, but not required, to disclose the following:
- a. The estimated time frame of disbursements for recorded amounts if expenditures are expected to continue over the long term
  - b. The estimated time frame for realization of recognized probable recoveries, if realization is not expected in the near term
  - c. If the criteria of SOP 94-6 [section 10,640] are met with respect to the accrued obligation, to any recognized asset for third-party recoveries, or to reasonably possible loss exposures or disclosed gain contingencies, the factors that cause the estimate to be sensitive to change
  - d. If an estimate of the probable or reasonably possible loss or range of loss cannot be made, the reasons why it cannot be made
  - e. If information about the reasonably possible loss or the recognized and additional reasonably possible loss for an environmental remediation obligation related to an individual site is relevant to an understanding of the financial position, cash flows, or results of operations of the entity, the following with respect to the site:
    - The total amount accrued for the site
    - The nature of any reasonably possible loss contingency or additional loss, and an estimate of the possible loss or the fact that an estimate cannot be made and the reasons why it cannot be made
    - Whether other PRPs are involved and the entity's estimated share of the obligation
    - The status of regulatory proceedings
    - The estimated time frame for resolution of the contingency
- .164** The following is an illustration of disclosure for a situation in which—
- a. An entity is involved in a single environmental site at which a number of potential outcomes may occur.
  - b. There is a probable, reasonably estimable recovery from a third party.
  - c. The entity has accrued for the most likely outcome within a range of possible outcomes for each component.
  - d. The nature of the amounts accrued for remediation and the related probable recovery are necessary to be disclosed in order for the financial statements not to be misleading.
  - e. There is a reasonably possible loss exposure in excess of the amount accrued that is material and it is reasonably possible that a change in estimate that would be material to the financial statements will occur in the near term.

Information that is not required is italicized and enclosed in brackets.

Enterprise A has been notified by the United States Environmental Protection Agency (EPA) that it is a potentially responsible party (PRP) under Superfund

legislation [with respect to XYZ site in Sometown, USA, a disposal site previously used in its chemical-fertilizer business. The EPA has also identified ten other PRPs for XYZ. A remedial investigation and feasibility study has been completed, and the results of that study have been forwarded to the EPA. The study indicates a range of viable remedial approaches, but agreement has not yet been reached with the EPA on the final remediation approach. The PRP group has preliminarily agreed to an allocation that sets Enterprise A's share of the cost of remediating XYZ site at 6 percent.] Enterprise A has accrued its best estimate of its obligation with respect to the site at December 31, 199X, [which is \$10 million and which is included in long-term liabilities and is expected to be disbursed over the next ten years. If certain of the PRPs are ultimately not able to fund their allocated shares or the EPA insists on a more expensive remediation approach,] Enterprise A could incur additional obligations of up to \$7 million. It is reasonably possible that Enterprise A's recorded estimate of its obligation may change in the near term.

With respect to the environmental obligation discussed above, the site was acquired in 1982, and, in connection with that acquisition, the former owner partially indemnified Enterprise A for environmental impacts occurring prior to the acquisition. [Based on existing documentation indicating the years in which the business shipped wastes to XYZ and the terms of the indemnification in the acquisition agreement,] Enterprise A [believes it is probable that it will recover from the prior owners 50 percent of its allocated remediation costs for XYZ and, accordingly,] has recorded a receivable of \$5 million at December 31, 199X.

## Probable But Not Reasonably Estimable Losses

.165 An entity often is able to determine early in the remediation process that it is probable it has an obligation, even though the determination of a reasonable estimate of the total cost of that obligation may take additional time (for example, due to the necessity of organizing a PRP group, studying and evaluating the site, or negotiating the scope of the remediation required with the regulatory authorities and other constituencies). In situations in which a probable obligation exists, FASB Statement No. 5 and Interpretation No. 14 require that the best estimate of the loss be recorded or, if the reasonable estimate of the loss is a range and there is no best estimate within the range, that the minimum amount in the range be recorded. However, it may be that there is no best estimate and the minimum amount in the range of the overall liability is not a material amount.

.166 Even though an entity may not be able to establish a reasonable estimate of a material loss or a range of reasonably estimable material loss exposure that must be recorded, in many cases it can determine early in the investigation whether the costs of environmental remediation, in fact, may be material (that is, the upper end of the range of the reasonable estimate of the loss is material). If an entity's probable but not reasonably estimable environmental remediation obligations may be material, the financial statements should disclose the nature of the probable contingency, that is, a description of the remediation obligation, and the fact that a reasonable estimate cannot currently be made. Entities also are encouraged, but not required, to disclose the estimated time frame for resolution of the uncertainty as to the amount of the loss.

.167 An illustration of disclosure of a probable but not yet reasonably estimable environmental remediation loss contingency follows (information that is italicized and enclosed in brackets is not required):

Enterprise A has been notified by the U.S. Environmental Protection Agency (EPA) that it is a potentially responsible party (PRP) with respect to environmental impacts *[identified at the XYZ site in Sometown, USA. Several meetings have been held with the EPA and the other identified PRPs, and a remedial investigation has recently commenced.]* Although a loss is probable, it is not possible at this time to reasonably estimate the amount of any obligation for remediation *[of XYZ site]* that would be material to Enterprise A's financial statements *[because the extent of environmental impact, allocation among the PRPs, remediation alternatives (which could involve no or minimal efforts), and concurrence of the regulatory authorities have not yet advanced to the stage where a reasonable estimate of any loss that would be material to the enterprise can be made].* *[A reasonable estimate of a material obligation, if any, is expected to be possible in 199X.]*

## Unasserted Claims

.168 Whether notification by regulatory authorities in relation to particular environmental laws and regulations constitutes the assertion of a claim is a matter of legal determination. If an entity concludes that it has no current legal obligation to remediate a situation of probable or possible environmental impact, then in accordance with paragraph 10 of FASB Statement No. 5, no disclosure is required. Similarly, future actions of an entity, when they occur, may create a legal obligation to perform environmental remediation; however, no obligation exists currently (for example, if the obligation arises only when and if an entity ceases to operate a facility).<sup>17</sup> However, if an entity is required by existing laws and regulations to report the release of hazardous substances and to begin a remediation study or if assertion of a claim is deemed probable, the matter would represent a loss contingency subject to the disclosure provisions of Statement No. 5, paragraph 10, regardless of a lack of involvement by a regulatory agency.

## Other Considerations

.169 For SEC registrants, other financial statement disclosure considerations related to environmental loss exposures are set forth in the SEC's SAB No. 92, Topic 5-Y, Question 5 (see reprint of SAB No. 92 in appendix A [paragraph .173]). Also, Question 7 of the SAB discusses disclosures for site-restoration costs or other environmental exit costs.

## Environmental Remediation Costs Recognized Currently

.170 Entities are encouraged but not required to disclose the amount of environmental remediation costs recognized in the income statement in the following detail:

- The amount recognized for environmental remediation loss contingencies in each period
- The amount of any recovery from third parties that is credited to environmental remediation costs in each period

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<sup>17</sup> This SOP does not provide guidance on accounting for pollution control costs with respect to current operations or on accounting for costs of future site restoration or closure that are required upon the cessation of operations or sale of facilities.

- The income statement caption in which environmental remediation costs and credits are included

## Conclusions on Loss Contingencies and Other Matters

.171 Financial statements may include a *contingency conclusion* that addresses the estimated total unrecognized exposure to environmental remediation and other loss contingencies. Such contingency conclusions may state, for example, that “management believes that the outcome of these uncertainties should not have (or “may have”) a material adverse effect on the financial condition, cash flows, or operating results of the enterprise.” Alternatively, the disclosure may indicate that the adverse effect could be material to a particular financial statement or to results and cash flows of a quarterly or annual reporting period. Although potentially useful information, these conclusions are not a substitute for the required disclosures of this SOP and of FASB Statement No. 5, such as their requirement to disclose the amounts of material reasonably possible additional losses or to state that such an estimate cannot be made. Also, the assertion that the outcome should not have a material adverse effect must be supportable. If the entity is unable to estimate the maximum end of the range of possible outcomes, it may be difficult to support an assertion that the outcome should not have a material adverse effect.

.172 Entities may wish to provide a description of the general applicability and impact of environmental laws and regulations upon their business and how the existence of such laws and regulations may give rise to loss contingencies for future environmental remediation. Such disclosures often acknowledge the uncertainty of the effect of possible future changes to environmental laws and their application, and they are frequently made on an aggregated basis, considering the entity’s total exposures for all its environmental sites.

## Appendix A

### Current Authoritative Literature

#### **FASB Statement No. 5, *Accounting for Contingencies*, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss—An Interpretation of FASB Statement No. 5***

**A-1.** FASB Statement No. 5, *Accounting for Contingencies*, states in paragraph 8 that—

An estimated loss from a loss contingency [paragraph reference omitted] shall be accrued by a charge to income [footnote omitted] if both of the following conditions are met:

- a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- b. The amount of loss can be reasonably estimated.

**A-2.** Although environmental remediation liabilities is not one of the examples discussed in FASB Statement No. 5, environmental remediation liabilities are loss contingencies, and the discussion in paragraphs 33 through 39 of “litigation, claims, and assessments” can be useful in understanding the requirements of FASB Statement No. 5 as they relate to environmental remediation liabilities.

**A-3.** FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, points out in paragraph 2 that the condition in FASB Statement No. 5 that “the amount of loss can be reasonably estimated” does not delay accrual of a loss until only a single amount can be reasonably estimated.

**A-4.** Paragraph 3 of the Interpretation provides the following guidance concerning accrual of loss contingencies when the reasonable estimate of the loss is a range of amounts.

- When some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount (the best estimate) shall be accrued.
- When no amount within the range is a better estimate than any other amount (within the range), however, the minimum amount in the range shall be accrued.

**A-5.** Paragraphs 9 and 10 of FASB Statement No. 5 state the following.

9. Disclosure of the nature of an accrual [footnote omitted] made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility



that a loss or an additional loss may have been incurred.<sup>6</sup> The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

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<sup>6</sup> For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(a) but that is not accrued because the amount of the loss can not be reasonably estimated (paragraph 8(b)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(a)—namely, those contingencies for which there is a *reasonable possibility* that a loss may have been incurred even though information may not indicate that it is *probable* that an asset has been impaired or a liability has been incurred at the date of the financial statements.

The disclosure requirements of FASB Statement No. 5 are emphasized in FASB Interpretation No. 14.

### **FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts***

**A-6.** FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, defines a *right of setoff* as

a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. [footnote omitted] A right of setoff exists when all of the following conditions are met:

- a. Each of *two* parties owes the other determinable amounts.
- b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
- c. The reporting party intends to set off.
- d. The right of setoff is enforceable at law.

A debtor having a valid right of setoff may offset the related asset and liability and report the net amount. [footnote omitted]

### **APB Opinion 20, *Accounting Changes***

**A-7.** APB Opinion No. 20, *Accounting Changes*, states in paragraph 31 that

the effect of a change in accounting estimate should be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

**A-8.** APB Opinion No. 20, paragraph 32, states in part:

A change in accounting estimate that is recognized in whole or in part by a change in accounting principle should be reported as a change in an estimate because the cumulative effect attributable to the change in accounting principle cannot be separated from the current or future effects of the change in estimate . . . .

**A-9.** APB Opinion No. 20, paragraph 33, also requires or recommends, depending on the estimates involved, disclosure of the effect of significant revisions of estimates if the effect is material.

### **AICPA SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties***

**A-10.** SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640], requires disclosure regarding an estimate when known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

- It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
- The effect of the change would be material to the financial statements.

**A-11.** The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a material change in the estimate will occur in the near term. If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure should also include an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to material change is encouraged but not required.

### **EITF Issue 93-5, *Accounting for Environmental Liabilities***

**A-12.** The guidance in FASB EITF Issue 93-5, *Accounting for Environmental Liabilities*, has been incorporated into this SOP. Therefore, EITF Issue 93-5 is not reproduced herein.

### **EITF Issue 90-8, *Capitalization of Costs to Treat Environmental Contamination***

**A-13.** EITF Issue 90-8, *Capitalization of Costs to Treat Environmental Contamination*, addresses whether "environmental contamination treatment costs" should be capitalized or charged to expense. Issue 90-8 is reprinted below in its entirety.

**Dates Discussed:** May 31, 1990; July 12, 1990

**Reference:** FASB Concepts Statement No. 6, *Elements of Financial Statements*

#### **ISSUE**

A company incurs costs to remove, contain, neutralize, or prevent existing or future environmental contamination (environmental contamination treatment costs). These costs may be incurred voluntarily or as required by law. They may include a wide range of expenditures, including costs of removal of contamination, such as that caused by leakage from underground storage tanks, costs to acquire tangible property, such as air pollution control equipment, costs of environmental studies, and costs of fines levied under environmental laws.

This Issue does not address (1) when to recognize liabilities related to environmental contamination treatment costs, (2) the measurement of those liabilities, or (3) whether environmental contamination treatment costs that are charged to expense should be reported as an unusual or extraordinary item.

The issue is whether environmental contamination treatment costs should be capitalized or charged to expense.

### **EITF DISCUSSION**

The Task Force reached a consensus that, in general, environmental contamination treatment costs should be charged to expense. Those costs may be capitalized if recoverable but only if any one of the following criteria is met:

1. The costs extend the life, increase the capacity, or improve the safety or efficiency of property owned by the company. For purposes of this criterion, the condition of that property after the costs are incurred must be improved as compared with the condition of that property when originally constructed or acquired, if later.
2. The costs mitigate or prevent environmental contamination that has yet to occur and that otherwise may result from future operations or activities. In addition, the costs improve the property compared with its condition when constructed or acquired, if later.
3. The costs are incurred in preparing for sale that property currently held for sale.

The Task Force also discussed the implication of that consensus on the consensus previously reached on Issue No. 89-13, "Accounting for the Cost of Asbestos Removal." The Task Force affirmed its earlier consensus, noting that capitalization of asbestos treatment costs could be justified under the first criterion.

Exhibit 90-8A provides examples of the application of this consensus.

### **STATUS**

No further EITF discussion is planned.

Capitalization of Costs to Treat Environmental Contamination

Exhibit 90-8A

EXAMPLES OF THE APPLICATION OF THE  
CONSENSUS ON EITF ISSUE 90-8

<i>Environmental Contamination, Treatments</i>	<i>Evaluation of Criteria</i>
1. Tanker Oil Spill: A. Clean up waterway and beachfront	<div>1. Costs to clean up the waterway and beachfront are not eligible for consideration under the first criterion because the oil company does not own the property.</div> <div>2. The cleanup of the waterway and beachfront does not mitigate or prevent a future oil spill from future operations.</div> <div>3. The waterway and beachfront are not owned assets and, therefore, the third criterion does not apply.</div> <div>Conclusion: Costs incurred for cleanup and restoration in connection with the oil spill should be charged to expense.<sup>1</sup></div>
B. Reinforce tanker's hull to reduce risk of future spill	<div>1. Reinforcing the hull improves the tanker's safety compared to when the tanker was originally constructed or acquired.</div> <div>2. Reinforcing the hull mitigates the risk that the tanker will experience a similar oil spill during future operations and improves the tanker's safety compared to when the tanker was originally constructed or acquired.</div> <div>Conclusion: The costs incurred in connection with reinforcing the tanker's hull may be capitalized under either the first or second criterion.</div>
2. Rusty Chemical Storage Tank: A. Remove rust that developed during ownership	<div>1. Removing the rust has not improved the tank compared with its condition when built or acquired.</div> <div>2. Removing the rust has mitigated the possibility of future leaks. However, removing the rust has not improved the tank compared with its condition when built or acquired.</div>

<sup>1</sup> This consensus does not require that tangible assets acquired to clean a particular spill be charged to expense immediately. Rather, to the extent that those tangible assets have future uses, they may be capitalized and depreciated over their remaining useful lives.

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*Environmental  
Contamination, Treatments*

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*Evaluation of Criteria*

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- B. Apply rust prevention chemicals
3. Air Pollution Caused by Manufacturing Activities:
- A. Acquire and install pollution control equipment
- B. Pay fines for violations of the Clean Air Act
4. Lead Pipes in Office Building Contaminate Drinking Water:
- A. Remove lead pipes and replace with copper pipes

*Conclusion:* Rust removal costs should be expensed unless the tank is currently held for sale and the costs were incurred to prepare the tank for sale.

1. The application of rust prevention chemicals has improved the tank's condition compared with its condition when built or acquired.
2. Rust prevention chemicals mitigate the possibility that future rust will cause leaks and also improve the tank's condition compared with its condition when built or acquired.

*Conclusion:* The costs of applying the rust prevention chemicals may be capitalized under either the first or second criterion.

1. The pollution control equipment improves the safety of the plant compared with its condition when built or acquired.
2. The pollution control equipment mitigates or prevents air pollution that has yet to occur but that may otherwise result from future operation of the plant and improves the safety of the plant compared with its condition when built or acquired.

*Conclusion:* Costs associated with acquisition and installation of the pollution control equipment may be capitalized under either the first or second criterion.

1. Payment of fines does not extend the plant's life, increase its capacity, or improve its efficiency or safety.
2. Payment of fines does not mitigate or prevent pollution that has yet to occur but that may otherwise result from future operation of the plant.

*Conclusion:* Fines paid in connection with violations of the Clean Air Act should be charged to expense. Even if the plant is currently held for sale, the fines should be charged to expense because the costs would not have been incurred to prepare the plant for sale.

1. Removing the lead pipes has improved the safety of the

*Environmental  
Contamination, Treatments*

*Evaluation of Criteria*

5. Soil Contamination Caused by an Operating Garbage Dump:  
A. Refine soil on dump property

- building's water system compared with its condition when the water system was built or acquired.
2. By removing the lead pipes, the building's owner eliminated an existing environmental problem and prevented any further contamination from that lead. However, by removing the existing pipes, the building's owner has not mitigated or prevented environmental problems yet to occur, if any, from future operation of the building.

*Conclusion:* Costs to remove the lead pipes and install copper pipes may be capitalized under the first criterion. The book value of the lead pipes should be charged to expense when removed.

1. The life of a garbage dump is not extended by refining its soil. Further, the condition of the soil after refining will not be improved over its condition when the garbage dump was constructed or acquired. Removal of the toxic waste restores the soil to its original uncontaminated condition.
2. Removal of toxic waste from the soil addresses an existing environmental concern. It also prevents that waste from leaching in the future. However, removing the waste does not mitigate or prevent future operations from creating future toxic waste. The risk will continue regardless of how much of the existing soil is refined.

*Conclusion:* Soil refinement costs should be charged to expense unless the garbage dump is currently held for sale and the costs were incurred to prepare the garbage dump for sale.

- B. Install liner

1. The liner does not extend the useful life or improve the efficiency or capacity of the garbage dump. However, the liner has improved the garbage dump's safety compared to when the dump was constructed or acquired.
2. The liner addresses an existing and potential future problem. In this example, the garbage dump contains toxic waste from past operations and will likely generate

*Environmental  
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*Evaluation of Criteria*

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toxic waste during future operations. The liner partly addresses the existing environmental problem by preventing future leaching of existing toxic waste into the soil. The liner also mitigates or prevents leaching of toxic waste that may result from garbage dumping in a future period and has improved the garbage dump's safety compared to when the dump was constructed or acquired.

*Conclusion:* The liner may be capitalized under either the first or second criterion.

6. Water Well Contamination Caused by Chemicals That Leaked into Wells Containing Water That Will Be Used in Future Beer Production:

A. Neutralize water in wells

1. The treatment does not extend the life of the wells, increase their capacity, or improve efficiency. The condition of the water is not safer after the treatment compared to when the wells were initially acquired.
2. By neutralizing the water, the possibility of future contamination of the wells from future operations has not been mitigated or prevented.

*Conclusion:* Costs incurred to neutralize well water should be charged to expense unless the wells were held for sale and the costs were incurred to prepare the wells for sale.

B. Install water filters

1. The water filters improve the safety of the wells compared with their uncontaminated state when built or acquired.
2. The water filters address future problems that may result from future operations. Since the water filters are effective in filtering environmental contamination, they mitigate the effect of spilling new contaminants into the wells during future operations. In addition, the water filters represent an improvement compared with the wells' original condition without water filters.

*Conclusion:* The water filtering system may be capitalized under either the first or the second criterion.

7. Underground Gasoline Storage Tanks Leak and Contaminate the Company's Property:

<i>Environmental Contamination, Treatments</i>	<i>Evaluation of Criteria</i>
A. Refine soil	<div>1. Soil refinement does not extend the useful life, increase the capacity, or improve the efficiency or safety of the land relative to its unpolluted state when acquired.</div> <div>2. By refining the contaminated soil, the oil company has addressed an existing problem. However, the company has not mitigated or prevented future leaks during future operations.</div> <div>Conclusion: Soil refining costs should be charged to expense unless the property is currently held for sale and the costs were incurred to prepare the property for sale.</div>
B. Encase tanks so as to prevent future leaks from contaminating surrounding soil	<div>1. In some cases, encasement may increase the life of the tanks because of their increased resistance to corrosion, leaking, etc. In other situations, the treatment does not increase the life of the tanks. However, the encasement has improved the tanks' safety compared with their condition when built or acquired.</div> <div>2. Encasement has mitigated or prevented future leakage and soil contamination that might otherwise result from future operations. In addition, the encasement has improved the tanks' safety compared with their condition when built or acquired.</div> <div>Conclusion: The cost of encasement may be capitalized under either the first or the second criterion.</div>
8. Air in Office Building Contaminated with Asbestos Fibers:	
A. Remove asbestos	<div>1. Removal of the asbestos improves the building's safety over its original condition since the environmental contamination (asbestos) existed when the building was constructed or acquired.</div> <div>2. By removing the asbestos, the building's owner has eliminated an existing environmental problem and has prevented any further contamination from that asbestos. However, by removing the existing asbestos, the building's owner has not mitigated or prevented new environmental problems, if any, that might result from future operation of the building.</div> <div>Conclusion: Asbestos removal costs may be capitalized as a betterment under the first criterion.</div>



**EITF Issue 89-13, Accounting for the Cost of Asbestos Removal**

**A-14.** EITF Issue 89-13, *Accounting for the Cost of Asbestos Removal*, is reprinted below in its entirety.

**Date Discussed:** October 26, 1989

**References:** FASB Concepts Statement No. 6, *Elements of Financial Statements*

APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*

AICPA Accounting Interpretation 1, *Illustration of the Application of APB Opinion No. 30*

**ISSUE**

Various federal, state, and local laws require removal or containment of “dangerous asbestos” in buildings and regulate the manner in which the asbestos is removed or contained. A property owner incurs costs to remove or contain (“treat”) asbestos in compliance with those laws.

The issues are:

1. Whether the costs incurred to treat asbestos when a property with a *known* asbestos problem is acquired should be capitalized or charged to expense
2. Whether the costs incurred to treat asbestos in an existing property should be capitalized or charged to expense
3. If it is deemed appropriate to charge asbestos treatment costs to expense, whether they should be reported as an extraordinary item

**EITF DISCUSSION**

The Task Force reached a consensus on the first issue that costs incurred to treat asbestos within a reasonable time period after a property with a known asbestos problem is acquired should be capitalized as part of the cost of the acquired property subject to an impairment test for that property.

The Task Force reached a consensus on the second issue that costs incurred to treat asbestos may be capitalized as a betterment subject to an impairment test for that property. When costs are incurred in anticipation of a sale of property, they should be deferred and recognized in the period of the sale to the extent that those costs can be recovered from the estimated sales price.

The Task Force reached a consensus on the third issue that asbestos treatment costs that are charged to expense are not extraordinary items under Opinion 30.

The SEC Observer noted that regardless of whether asbestos treatment costs are capitalized or charged to expense, SEC registrants should disclose significant exposure for asbestos treatment costs in “Management’s Discussion and Analysis.”

**STATUS**

No further EITF discussion is planned. A related issue was discussed in Issue No. 90-8, “Capitalization of Costs to Treat Environmental Contamination.” The Task Force affirmed the consensus above, noting that capitalization of asbestos treatment costs could be justified under the consensus in Issue 90-8.

## **SEC Staff Accounting Bulletin No. 92, Accounting and Disclosures Relating to Loss Contingencies**

**A-15.** For SEC registrants, SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies*, provides additional accounting, display, and disclosure guidance. SAB No. 92 is reproduced below.

### **STAFF ACCOUNTING BULLETIN NO. 92**

The staff hereby adds Section Y to Topic 5 of the Staff Accounting Bulletin Series. Topic 5-Y provides guidance regarding the accounting and disclosures relating to loss contingencies. In addition, the staff hereby adds Question 7 to Topic 2-A and adds Section F to Topic 10. Question 7 of Topic 2-A discusses loss contingencies assumed in a business combination accounted for as a purchase. Topic 10-F discusses the presentation by utility companies of liabilities for environmental costs.

### **TOPIC 5: MISCELLANEOUS ACCOUNTING**

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#### **Y. Accounting and disclosures relating to loss contingencies.**

**Facts:** A registrant believes it may be obligated to pay material amounts as a result of product or environmental liability. These amounts may relate to, for example, damages attributed to the registrant's products or processes, clean-up of hazardous wastes, reclamation costs, fines, and litigation costs. The registrant may seek to recover a portion or all of these amounts by filing a claim against an insurance carrier or other third parties.

Paragraph 8 of *Statement of Financial Accounting Standards No. 5*, "Accounting for Contingencies," ("SFAS 5") states that an estimated loss from a loss contingency shall be accrued by a charge to income if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. The Emerging Issues Task Force ("EITF") of the Financial Accounting Standards Board reached a consensus on EITF Issue 93-5, "Accounting for Environmental Liabilities," that an environmental liability should be evaluated independently from any potential claim for recovery. Under that consensus, any loss arising from the recognition of an environmental liability should be reduced by a potential claim for recovery only when that claim is probable<sup>1</sup> of realization. The EITF also reached a consensus that discounting an environmental liability for a specific clean-up site to reflect the time value of money is appropriate only if the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for that site. Further, any asset that is recognized relating to a claim for recovery of a liability that is recognized on a discounted basis also should be discounted to reflect the time value of money.

Because uncertainty regarding the alternative methods of presenting in the balance sheet the amounts recognized as contingent liabilities and claims for recovery from third parties was not resolved by the EITF and current disclosure practices remain diverse, the staff is publishing its interpretation of the current accounting literature and disclosure requirements to serve as guidance for public companies. The AICPA's Accounting Standards Executive Committee has appointed a task force to address environmental concerns. The staff encourages efforts by the profession to develop comprehensive guidance applicable to the accounting and financial statement disclosures relating to environmental matters.

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<sup>1</sup> Paragraph 3 of SFAS 5 defines probable as "likely to occur."

**Question 1:** Does the staff believe that it is appropriate to offset in the balance sheet a claim for recovery that is probable of realization against a probable contingent liability, that is, report the two as a single net amount on the face of the balance sheet?

**Interpretive Response:** Not ordinarily. The staff believes that separate presentation of the gross liability and related claim for recovery in the balance sheet most fairly presents the potential consequences of the contingent claim on the company's resources and is the preferable method of display. Recent reports of litigation over insurance policies' coverage of product and environmental liabilities and financial failures in the insurance industry indicate that there are significant uncertainties regarding both the timing and the ultimate realization of claims made to recover amounts from insurance carriers and other third parties. The risks and uncertainties associated with a registrant's contingent liability are separate and distinct from those associated with its claim for recovery from third parties.

Separate presentation of the gross liability and the claim for recovery is consistent with the recent consensus of the EITF, which concluded that the amounts of the contingent liability and any claim for recovery should be estimated and evaluated independently. Furthermore, accounting guidance generally proscribes the offsetting of assets and liabilities except where a right of setoff exists.<sup>2</sup> This general proscription was strengthened by the recent issuance of *Financial Accounting Standards Board Interpretation No. 39, "Offsetting of Amounts Relating to Certain Contracts,"* ("FIN 39"), which is effective for financial statements issued for periods beginning after December 15, 1993. The guidance in that interpretation indicates that the prohibition on setoff in the balance sheet should be applied more comprehensively than previously may have been the practice.

It is the staff's view that presentation of liabilities net of claims for recovery will not be appropriate after the provisions of FIN 39 are required to be applied in financial statements. In the interim, registrants should ensure that notes to the financial statements include information necessary to an understanding of the material uncertainties affecting both the measurement of the liability and the realization of recoveries. The staff believes these disclosures should include the gross amount of any claims for recovery that are netted against the liability.

**Question 2:** If a registrant is jointly and severally liable with respect to a contaminated site but there is a reasonable basis for apportionment of costs among responsible parties, must the registrant recognize a liability with respect to costs apportioned to other responsible parties?

**Interpretive Response:** No. However, if it is probable that other responsible parties will not fully pay costs apportioned to them, the liability that is recognized by the registrant should include the registrant's best estimate, before consideration of potential recoveries from other parties, of the additional costs that the registrant expects to pay. Discussion of uncertainties affecting the registrant's ultimate obligation may be necessary if, for example, the solvency of one or more parties is in doubt or responsibility for the site is disputed by a party. A note to the financial statements should describe any additional loss that is reasonably possible.

**Question 3:** Estimates and assumptions regarding the extent of environmental or product liability, methods of remedy, and amounts of related costs frequently prove to be different from the ultimate outcome. How do these uncertainties affect the recognition and measurement of the liability?

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<sup>2</sup> Paragraph 7 of Accounting Principles Board Opinion No. 10, "Omnibus Opinion." Also, FASB Technical Bulletin 88-2, "Definition of a Right of Setoff."

*Interpretive Response:* The measurement of the liability should be based on currently available facts, existing technology, and presently enacted laws and regulations, and should take into consideration the likely effects of inflation and other societal and economic factors. Notwithstanding significant uncertainties, management may not delay recognition of a contingent liability until only a single amount can be reasonably estimated. If management is able to determine that the amount of the liability is likely to fall within a range and no amount within that range can be determined to be the better estimate, the registrant should recognize the minimum amount of the range pursuant to *Financial Accounting Standards Board Interpretation No. 14, "Reasonable Estimation of the Amount of a Loss"* ("FIN 14"). The staff believes that recognition of a loss equal to the lower limit of the range is necessary even if the upper limit of the range is uncertain.

In measuring its environmental liability, a registrant should consider available evidence including the registrant's prior experience in remediation of contaminated sites, other companies' clean-up experience, and data released by the Environmental Protection Agency or other organizations. Information necessary to support a reasonable estimate or range of loss may be available prior to the performance of any detailed remediation study. Even in situations in which the registrant has not determined the specific strategy for remediation, estimates of the costs associated with the various alternative remediation strategies considered for a site may be available or reasonably estimable. While the range of costs associated with the alternatives may be broad, the minimum clean-up cost is unlikely to be zero. As additional information becomes available, changes in estimates of the liability should be reported in the period that those changes occur in accordance with paragraphs 31–33 of *Accounting Principles Board Opinion No. 20, "Accounting Changes."*

**Question 4:** Assuming that the registrant's estimate of an environmental or product liability meets the conditions set forth in the consensus on EITF Issue 93-5 for recognition on a discounted basis, what discount rate should be applied?

*Interpretive Response:* The staff believes that the rate used to discount the cash payments should be the rate that will produce an amount at which the environmental or product liability could be settled in an arm's-length transaction with a third party. If that rate is not readily determinable, the discount rate used to discount the cash payments should not exceed the interest rate on monetary assets that are essentially risk free<sup>3</sup> and have maturities comparable to that of the environmental or product liability.

If the liability is recognized on a discounted basis to reflect the time value of money, the notes to the financial statements should, at a minimum, include disclosures of the discount rate used, the expected aggregate undiscounted amount, expected payments for each of the five succeeding years and the aggregate amount thereafter, and a reconciliation of the expected aggregate undiscounted amount to amounts recognized in the statements of financial position. Material changes in the expected aggregate amount since the prior balance sheet date, other than those resulting from pay-down of the obligation, should be explained.

**Question 5:** What financial statement disclosures should be furnished with respect to recorded and unrecorded product or environmental liabilities?

*Interpretive Response:* Paragraphs 9 and 10 of SFAS 5 identify disclosures regarding loss contingencies that generally are furnished in notes to financial

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<sup>3</sup> As described in paragraph 4(a) of *Statement of Financial Accounting Standards No. 76, "Extinguishment of Debt."*

statements. The staff believes that product and environmental liabilities typically are of such significance that detailed disclosures regarding the judgments and assumptions underlying the recognition and measurements of the liabilities are necessary to prevent the financial statements from being misleading and to inform readers fully regarding the range of reasonably possible outcomes that could have a material effect on the registrant's financial condition, results of operations, or liquidity. Examples of disclosures that may be necessary include:

- Circumstances affecting the reliability and precision of loss estimates.
- The extent to which unasserted claims are reflected in any accrual or may affect the magnitude of the contingency.
- Uncertainties with respect to joint and several liability that may affect the magnitude of the contingency, including disclosure of the aggregate expected cost to remediate particular sites that are individually material if the likelihood of contribution by the other significant parties has not been established.
- Disclosure of the nature and terms of cost-sharing arrangements with other potentially responsible parties.
- The extent to which disclosed but unrecognized contingent losses are expected to be recoverable through insurance, indemnification arrangements, or other sources, with disclosure of any material limitations of that recovery.
- Uncertainties regarding the legal sufficiency of insurance claims or solvency of insurance carriers.<sup>4</sup>
- The time frame over which the accrued or presently unrecognized amounts may be paid out.
- Material components of the accruals and significant assumptions underlying estimates.

Registrants are cautioned that a statement that the contingency is not expected to be material does not satisfy the requirements of SFAS 5 if there is at least a reasonable possibility that a loss exceeding amounts already recognized may have been incurred and the amount of that additional loss would be material to a decision to buy or sell the registrant's securities. In that case, the registrant must either (a) disclose the estimated additional loss, or range of loss, that is reasonably possible, or (b) state that such an estimate cannot be made.

**Question 6:** What disclosures regarding loss contingencies may be necessary outside the financial statements?

**Interpretive Response:** Registrants should consider the requirements of Items 101 (Description of Business), 103 (Legal Proceedings), and 303 (Management's Discussion and Analysis) of Regulations S-K and S-B. The Commission has issued two interpretive releases that provide additional guidance with respect to these items.<sup>5</sup> In a 1989 interpretive release, the Commission noted that the availability of insurance, indemnification, or contribution may be relevant in determining whether the criteria for disclosure have been met with respect to

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<sup>4</sup> The staff believes there is a rebuttable presumption that no asset should be recognized for a claim for recovery from a party that is asserting that it is not liable to indemnify the registrant. Registrants that overcome that presumption should disclose the amount of recorded recoveries that are being contested and discuss the reasons for concluding that the amount is probable of recovery.

<sup>5</sup> See Securities Act Release No. 6130 (September 27, 1979) and Financial Reporting Release No. 36 (May 18, 1989).

a contingency.<sup>6</sup> The registrant's assessment in this regard should include consideration of facts such as the periods in which claims for recovery may be realized, the likelihood that the claims may be contested, and the financial condition of third parties from which recovery is expected.

Disclosures made pursuant to the guidance identified in the preceding paragraph should be sufficiently specific to enable a reader to understand the scope of the contingencies affecting the registrant. For example, a registrant's discussion of historical and anticipated environmental expenditures should, to the extent material, describe separately (a) recurring costs associated with managing hazardous substances and pollution in on-going operations, (b) capital expenditures to limit or monitor hazardous substances or pollutants, (c) mandated expenditures to remediate previously contaminated sites, and (d) other infrequent or nonrecurring clean-up expenditures that can be anticipated but which are not required in the present circumstances. Disaggregated disclosure that describes accrued and reasonably likely losses with respect to particular environmental sites that are individually material may be necessary for a full understanding of these contingencies. Also, if management's investigation of potential liability and remediation cost is at different stages with respect to individual sites, the consequences of this with respect to amounts accrued and disclosed should be discussed.

Examples of specific disclosures typically relevant to an understanding of historical and anticipated product liability costs include the nature of personal injury or property damages alleged by claimants, aggregate settlement costs by type of claim, and related costs of administering and litigating claims. Disaggregated disclosure that describes accrued and reasonably likely losses with respect to particular claims may be necessary if they are individually material. If the contingency involves a large number of relatively small individual claims of a similar type, such as personal injury from exposure to asbestos, disclosure of the number of claims filed for each period presented, the number of claims dismissed, settled, or otherwise resolved for each period, and the average settlement amount per claim may be necessary. Disclosures should address historical and expected trends in these amounts and their reasonably likely effects on operating results and liquidity.

**Question 7:** What disclosures should be furnished with respect to site restoration costs or other environmental exit costs?

**Interpretive Response:** The staff believes that material liabilities for site restoration, post-closure, and monitoring commitments, or other exit costs that may occur on the sale, disposal, or abandonment of a property should be disclosed in the notes to the financial statements. Appropriate disclosures generally would include the nature of the costs involved, the total anticipated cost, the total costs accrued to date, the balance sheet classification of accrued amounts, and the range or amount of reasonably possible additional losses.

If an asset held for sale or development will require remediation to be performed by the registrant prior to development, sale, or as a condition of sale, a note to the financial statements should describe how the necessary expenditures are considered in the assessment of the asset's net realizable value. Additionally, if the registrant may be liable for remediation of environmental damage relating to assets or businesses previously disposed, disclosure should be made in the financial statements unless the likelihood of a material unfavorable outcome of that contingency is remote. The registrant's accounting policy with

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<sup>6</sup> See, for example, footnote 30 of Financial Reporting Release No. 36 (footnote 17 of Section 501.02 of the Codification of Financial Reporting Policies).

respect to such costs should be disclosed in accordance with *Accounting Principle Board Opinion No. 22*, "Disclosure of Accounting Policies."

**Question 8:** A registrant expects to incur site restoration costs, post-closure and monitoring costs, or other environmental exit costs at the end of the useful life of the asset. Would the staff object to the registrant's proposal to accrue the exit costs over the useful life of the asset?

**Interpretive Response:** No. This is an established accounting practice in some industries. In other industries, the staff will raise no objection to that accounting provided that the criteria in paragraph 8 of SFAS 5 are met. The staff acknowledges that in some circumstances the use of the asset in operations gives rise to growing exit costs that represent a probable liability. The accrual of the liability should be recognized as an expense in accordance with the consensus on EITF Issue 90-8, "Capitalization of Costs to Treat Environmental Contamination." See interpretive responses to questions 7 and 8 for guidance on appropriate disclosures.

## TOPIC 2: BUSINESS COMBINATIONS

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### A: Purchase Method

#### 7. Loss contingencies assumed in a business combination.

**Facts:** A registrant acquires a business enterprise in a transaction accounted for by the purchase method. In connection with the acquisition, the acquiring company assumes certain contingent liabilities of the acquired company.

**Question:** How should the acquiring company account for and disclose contingent liabilities that have been assumed in a business combination?

**Interpretive Response:** In accordance with *Accounting Principles Board Opinion No. 16*, "Business Combinations," the acquiring company should allocate the cost of an acquired company to the assets acquired and liabilities assumed based on their fair values at the date of acquisition. With respect to contingencies for which a fair value is not determinable at the date of acquisition, the guidance of *Statement of Financial Accounting Standards No. 5*, "Accounting for Contingencies" and *Financial Accounting Standards Board Interpretation No. 14*, "Reasonable Estimation of the Amount of a Loss" should be applied. If the registrant is awaiting additional information that it has arranged to obtain for the measurement of a contingency during the allocation period specified by *Statement of Financial Accounting Standards No. 38*, "Accounting for Preacquisition Contingencies of Purchased Enterprises," the staff believes that the registrant should disclose that the purchase price allocation is preliminary. In that circumstance, the registrant should describe the nature of the contingency and furnish other available information that will enable a reader to understand its potential effects on the final allocation and on post-acquisition operating results. Management's Discussion and Analysis should include appropriate disclosure regarding any unrecognized preacquisition contingency and its reasonably likely effects on operating results, liquidity, and financial condition.

The staff believes that the allocation period should not extend beyond the minimum reasonable period necessary to gather the information that the registrant has arranged to obtain for purposes of the estimate. Since an allocation period usually should not exceed one year, registrants believing that they will require a longer period are encouraged to discuss their circumstances with the staff. If it is unlikely that the liability can be estimated on the basis of information known to be obtainable at the time of the initial purchase price allocation, the allocation period should not be extended with respect to that liability. An adjustment to the contingent liability after the expiration of the allocation period would be recognized as an element of net income.

## TOPIC 10: UTILITY COMPANIES

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## F. Presentation of Liabilities for Environmental Costs

*Facts:* A public utility company determines that it is obligated to pay material amounts as a result of an environmental liability. These amounts may relate to, for example, damages attributed to clean-up of hazardous wastes, reclamation costs, fines, and litigation costs.

*Question 1:* May a rate-regulated enterprise present on its balance sheet the amount of its estimated liability for environmental costs net of probable future revenue resulting from the inclusion of such costs in allowable costs for rate-making purposes?

*Interpretive Response:* No. *Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation,"* ("SFAS 71") specifies the conditions under which rate actions of a regulator can provide reasonable assurance of the existence of an asset. The staff believes that environmental costs meeting the criteria of paragraph 9<sup>7</sup> of SFAS 71 should be presented on the balance sheet as an asset and should not be offset against the liability. Contingent recoveries through rates that do not meet the criteria of paragraph 9 should not be recognized either as an asset or as a reduction of the probable liability.

*Question 2:* May a rate-regulated enterprise delay recognition of a probable and estimable liability for environmental costs which it has incurred at the date of the latest balance sheet until the regulator's deliberations have proceeded to a point enabling management to determine whether this cost is likely to be included in allowable costs for rate-making purposes?

*Interpretive Response:* No. *Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies,"* states that an estimated loss from a loss contingency shall be accrued by a charge to income if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. The staff believes that actions of a regulator can affect whether an incurred cost is capitalized or expensed pursuant to SFAS 71, but the regulator's actions cannot affect the timing of the recognition of the liability.

## GASB Literature

**A-16.** Although this SOP does not include state and local governmental entities in its scope,<sup>18</sup> guidance issued by the GASB may be relevant to some reporting entities applying this SOP.

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<sup>7</sup> Paragraph 9 of SFAS 71 requires a rate-regulated enterprise to capitalize all or part of an incurred cost that would otherwise be charged to expense if it is probable that future revenue will be provided to recover the previously incurred cost from inclusion of the costs in allowable costs for rate-making purposes.

<sup>18</sup> Under the provisions of Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, paragraph 7, proprietary activities may apply all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements. Paragraph 33 of the Basis For Conclusions of that Statement explains that, for proprietary activities that apply paragraph 7, an AICPA SOP or Industry Audit and Accounting Guide that does not include governmental entities in its scope but that has been cleared by the FASB would be considered category (b) guidance under SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, issued by the Auditing Standards Board (ASB) of the AICPA.



**A-17.** GASB Statement No. 18, *Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs*, which is effective for financial statements for periods beginning after June 15, 1993, applies to state and local governmental entities that are required by federal, state, or local laws or regulations to incur closure and postclosure care costs on landfills.

**A-18.** Under GASB Statement No. 18, the estimated total current cost of a landfill closure and postclosure care includes the following (measured in terms of current dollars):

- Cost of equipment expected to be installed and facilities expected to be constructed near or after the date the landfill stops accepting solid waste and during the postclosure period.
- Cost of the final cover (capping) expected to be applied near or after the date the landfill stops accepting solid waste.
- Cost of monitoring and maintaining the expected usable landfill area during the postclosure period.

**A-19.** A portion of the estimated total current cost of a landfill closure and postclosure care is required to be recognized as an expense and as a liability in each period the landfill accepts solid waste, and recognition is to be completed by the time the landfill stops accepting waste. The cumulative effect of changes in the estimate of the current cost of landfill closure and postclosure care (including the impact of inflation) is recognized in the period of the change.

## Appendix B

### Remediation Liability Case Study

**B-1.** *The following case study illustrates the application of the recognition and measurement guidance provided in this SOP; it does not illustrate all disclosure requirements set forth in this SOP. The case study is not intended to be used to evaluate financial statements issued prior to the effective date of this SOP.*

#### Typical Superfund Off-Site Scenario

Prior to 1980, the XYZ Manufacturing Company contracted with a state-licensed waste hauling contractor to remove specified, nonhazardous solid and liquid industrial waste from one of its plants for disposal off-site at a state-licensed disposal facility. A purchase order was let, and the work was performed. The contractor complied with all applicable laws and regulations, and monthly reports were filed with appropriate state environmental agencies.

#### 1986

In 1986, the company received an information request from the United States Environmental Protection Agency (EPA) pursuant to section 104 of the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA). The information request stated that the EPA believed that hazardous substances at a site, now listed by the EPA on its National Priorities List (NPL), were generated at XYZ's plant. XYZ was named as a potentially responsible party (PRP) and was directed by the EPA, under penalty of law, to search its records exhaustively and answer a series of questions possibly implicating it directly to the site, or indirectly by its having used one or more transporters the EPA said it was also investigating.

XYZ searched its records as directed and determined late in 1986 that it had, in fact, contributed hazardous substances to the site. XYZ could not, however, determine how significant the hazardous substances it had sent to the site were in relation to the total population of hazardous substances at the site. The minimum remediation cost, including a minimum amount of legal fees, that XYZ was able to estimate was not material to its financial statements. XYZ was able, however, to determine that it was reasonably possible that its ultimate liability could be material.

#### 1987

The EPA identified a number of waste generators, transporters, and site owner/operators as likely PRPs. The identified PRPs were invited to a meeting at which government lawyers requested that one or more of the PRPs voluntarily perform a remedial investigation/feasibility study (RI/FS) to evaluate existing site conditions (including a public health and ecological risk assessment) and to develop a proposed array of remedial alternatives from which the EPA would select a remedy and demand that it be implemented. Standardized EPA terms and conditions, stipulated penalty provisions, and indeterminate scope of work elements inhibited voluntary agreement among the PRPs, and so a consent decree was not achieved.

#### 1988

The EPA asserted the existence of "imminent and substantial endangerment" at the site early in 1988 under section 106 of CERCLA, and it issued a unilateral

administrative order to the PRP with the deepest pockets—XYZ—to undertake the RI/FS.

Because treble damages are authorized under section 106 of CERCLA, XYZ agreed to conduct the RI/FS specified in the order and demanded that other identified PRPs participate in the effort. XYZ initially estimated the cost that would be incurred to perform the RI/FS to be between \$1 million and \$2 million. Based on the limited information that was available about the site, information that XYZ had about its contribution to the site, and the number and financial condition of other PRPs, XYZ initially estimated that its ultimate share of this cost would prove to be in the range of 20 percent to 50 percent. XYZ also estimated that it would incur legal costs related to the remediation effort of \$200,000 to \$2 million in addition to any legal costs that might be incurred by any PRP group that might be formed. No amounts within any of these ranges were considered to be better estimates than any other amounts within any of these ranges. Because of a lack of information about the type and extent of the remediation effort that could be required, no range of cost of the overall remediation effort could be developed at this time.

Under threat of a contribution lawsuit by XYZ, a PRP group was formed late in 1988. The PRP group had three objectives: (1) to implement the requirements of the unilateral administrative order in the most cost-effective and scientifically valid way, (2) to raise money and allocate costs among the PRPs willing to perform the work based on the types and relative quantities of wastes shipped to the site or another agreed-upon formula, and (3) to recover costs from nonparticipating PRPs, if possible.

### 1989

Because of the lack of a good data base of factual information upon which to make sound allocation decisions agreeable to all, outside arbitration was utilized in 1989 to allocate "fair share" costs among participating PRPs. The arbitrator preliminarily apportioned 65 percent of the costs for the site to the four participating PRPs, as follows:

XYZ	20%
PRP No. 2	20
PRP No. 3	15
PRP No. 4	<u>10</u>
	65%
Orphan share	25
Recalcitrant share	<u>10</u>
	<u>100%</u>

Twenty-five percent of the site was determined to be the "orphan share," for which no PRP could be identified. Ten percent was attributed to two recalcitrant (nonparticipating) PRPs, and there was insufficient information to overcome the presumption that costs will be allocated only among the participating PRPs.

XYZ gained some understanding of the other participating PRPs' financial condition and believed each of them was able and likely to pay its full share of the costs of the RI/FS. XYZ was concerned, however, about the ability of PRP No. 3 to pay its full share of the cost of the overall remediation effort.

Based on the amount already spent on legal costs and the results of PRP organization efforts, XYZ determined that \$350,000 was the best estimate of its

separate legal costs. The estimate of the costs that will be incurred to perform the RI/FS, which now included group administration costs, now stood at \$1.2 million to \$2.2 million.

### 1991

The RI/FS was substantially completed in 1991. No changes were made to the PRP allocation percentages as a result of the RI/FS completion. The PRP group's initial estimate of the cost of implementing the remedy expected to be required by the EPA was \$25 million to \$30 million. No amount within this range was considered to be a better estimate than any other amount within the range. This estimate included estimates of the cost of all elements of the remediation effort, including common legal, engineering, construction, monitoring, operation and maintenance costs (including postremediation monitoring for a period of thirty years), and so forth.

XYZ believed that PRP No. 2 and PRP No. 4 could and would pay their full shares of the cost of the remediation effort. PRP No. 3, however, indicated that, because of its deteriorating financial position, it would likely be unable to pay more than two-thirds of its 15 percent share and none of its allocated amount attributed to the orphan and recalcitrant shares, or 10 percent of those costs. XYZ shared PRP No. 3's views about PRP No. 3's ability to pay.

### 1992

Three years after site studies began, the EPA and its outside contractors evaluated the reports submitted under the terms of the unilateral administrative order. A record of decision (ROD) was issued by the EPA on September 30, 1992, in which remedial actions based on the RI/FS were selected and cost estimates were presented. The PRPs were requested to voluntarily implement the ROD and again sign up to the terms demanded by the government. No preenforcement federal court review is permitted, even if the remedy specified in the ROD is scientifically flawed, unattainable by available, proven technology, non-cost-effective, or open-ended. The PRPs had the following choices: perform the remedy specified in the ROD voluntarily, or refuse to do work, in which case the EPA would either issue another unilateral administrative order or perform the work using its contractor procurement systems and sue the PRPs for cost recovery. The PRPs agreed to perform the remedy specified in the ROD and entered into a consent judgment.

*Note:* The law requires the EPA to review the ROD and remedy within five years of its implementation by the PRPs. If the objectives of the ROD have not been attained, the EPA may make additional demands on the PRPs. If one or more PRPs believe they have paid a disproportionate share of the costs, they may track down other PRPs and sue them in a contribution action. Although requests for reimbursement from Superfund can also be made for allocations attributed to unidentified or unknown parties (the orphan share) under certain conditions, this is not usually allowed by terms and conditions of consent order settlements with EPA.

### Discussion of Case

FASB Statement No. 5, *Accounting for Contingencies*, requires accrual of a loss contingency when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Receipt in 1986 of an information request did not establish that a liability was probable because, notwithstanding the EPA's interest in XYZ's connection, if any, to the site, it had not

been established that XYZ was in fact associated with the site. As noted in chapter 5 of the SOP, however, "receipt of notification that an entity may be a PRP compels the entity to action."

When XYZ determined late in 1986 that it had, in fact, contributed hazardous substances to the site, the liability became probable. The criteria for recognition had not yet been met, however, because XYZ did not have sufficient information to reasonably estimate a minimum amount in the range of its liability that would be material to its financial statements. Disclosure of the nature of the contingency and a statement that an estimate of the loss or range of loss cannot be made was required under FASB Statement No. 5.

During 1987, little additional information that would aid XYZ in making an estimate of the loss or range of loss became available. Therefore, the accounting and disclosure for the contingent loss related to the remediation liability remained the same.

In 1988, when XYZ agreed to perform an RI/FS in accordance with the EPA's unilateral administrative order and the PRP group was formed, XYZ should have recorded a liability of \$400,000, computed as follows:

XYZ's estimated share of the minimum amount in the range of the estimated cost of the RI/FS [20 percent of \$1,000,000]	\$200,000
XYZ's minimum estimate of its legal costs	<u>200,000</u>
	<u>\$400,000</u>

Because other PRPs had agreed during 1988 to participate in the RI/FS effort, they are considered to be participating PRPs. Neither the fact that the unilateral administrative order named only XYZ nor the fact that a preliminary cost-sharing formula had not yet been determined by the arbitrator should have required XYZ to accrue more than its estimated allocable share of the minimum estimated liability.

Although no recognition benchmarks were achieved in 1989 or 1990, XYZ should have refined its estimate of its liability as additional significant information became available. For example, in 1989, when the preliminary cost-sharing formula was developed by the arbitrator and the estimate of the cost of the RI/FS was revised, XYZ should have refined its estimate of its share of the cost of the RI/FS and adjusted its liability to \$719,231, less any amounts already expended. \$719,231 is computed as follows:

XYZ's allocable share of the minimum amount in the range of the estimated cost of the RI/FS [20 percent of \$1.2 million]	\$240,000
XYZ's pro rata share of amounts allocable to other parties but that are not expected to be paid by those other parties [20/65 of 35 percent of \$1.2 million]	129,231
XYZ's estimated legal costs	<u>350,000</u>
	<u>\$719,231</u>

By the time the feasibility study was substantially completed in 1991, XYZ should have adjusted its liability to reflect its estimated share of the minimum amount of the overall remediation liability. Based on the facts presented, this amount should be \$9,350,000, less any amounts already expended. \$9,350,000 is computed as follows:

20% of \$25 million	\$5,000,000
20/65 of 35 percent of \$25 million	2,692,308
20/50 of amount allocable to PRP No. 3 that is not expected to be paid by PRP No. 3 <i>[20/50 of 5 percent of \$25 million plus 20/50 of 15/65 of 35 percent of \$25 million]</i>	1,307,692
Estimated legal costs	<u>350,000</u>
	<u>\$9,350,000</u>

The estimate of the environmental remediation liability should be further refined when the ROD is issued in 1992 and at various other points when additional information becomes available.

The measurement of the remediation liability should not have been discounted at any point during the period under discussion because the amount of the obligation and the amount and timing of cash payments were not fixed or reliably determinable.

## Appendix C

### Auditing Environmental Remediation Liabilities

This section presents the recommendations of the Environmental Issues Task Force of the Auditing Standards Board regarding the application of generally accepted auditing standards to the audit of an entity's financial statements as it relates to environmental remediation liabilities. Members of the AICPA's Auditing Standards Board have found this guidance to be consistent with existing auditing standards. AICPA members should be prepared to justify departures from this guidance.

#### Environmental Issues Task Force

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## Introduction and Scope

**C-1.** The accounting and disclosure issues related to environmental remediation liabilities are complex. The exposure to such liabilities and the controls implemented by entities to identify and evaluate these liabilities vary from entity to entity. Estimates of environmental remediation liabilities usually are predicated on subjective information and numerous judgments about how matters will be resolved in the future. Such matters generally increase audit risk in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).

**C-2.** Management is responsible for establishing and maintaining controls that will enable it to identify, evaluate, and account for litigation, claims, and assessments and to reflect them in the financial statements in conformity with GAAP. FASB Statement No. 5, *Accounting for Contingencies*, requires accrual of a liability when (a) information available prior to issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements, and (b) the amount of the loss can be reasonably estimated. FASB Statement No. 5 also requires certain disclosures about contingencies. Chapters 5 to 7 of this SOP provide guidance on applying FASB Statement No. 5 to matters involving environmental remediation liabilities.

**C-3.** The guidance in this section focuses on planning, performing, and reporting on an audit of financial statements in accordance with GAAS as it relates to auditing environmental remediation liabilities arising from Superfund laws, the corrective action provisions of the Resource Conservation and Recovery Act of 1976 (RCRA), and other analogous federal, state, and non-United States laws and regulations. The guidance is not intended to apply to other types of environmental engagements, such as engagements to report on compliance with environmental laws and regulations as performed under Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation*. However, certain aspects of this guidance may be useful in such engagements. This appendix does not provide guidance on auditing the liabilities of insurance companies for unpaid claims or auditing asset impairment.

## Audit Planning and Objectives

### *Understanding the Business*

**C-4.** Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision*, presents guidance on planning the audit of an entity's financial statements. Planning involves the development of an overall strategy for the expected conduct of an audit. SAS No. 22 recognizes that the nature, timing, and extent of the planning will vary with the size and complexity of the entity whose financial statements are being audited and with the auditor's experience with the entity and knowledge of the entity's business. As part of the planning process, the auditor should obtain an understanding of the accounting and disclosure requirements for environmental remediation liabilities, which are set forth in chapters 5 to 7 of this SOP. As stated in paragraphs 6 to 8 of SAS No. 22, the auditor should obtain a level of knowledge about matters related to the nature of the entity's business, its organization, and its operating characteristics that will enable the auditor to plan and perform the audit in accordance with GAAS. Examples of such matters that pertain to environmental remediation liabilities include the following:



- The industry or industries in which the entity operates
- The types of products or services provided by the entity
- The number and characteristics of the entity's locations
- Applicable governmental regulations
- Production and distribution processes

Knowledge about such matters ordinarily is obtained through experience with the entity or its industry and inquiry of entity personnel. Inquiries about environmental remediation liabilities might be directed to accounting, finance, operations, environmental, compliance, or legal personnel. Other useful sources of information about environmental remediation liabilities may include industry publications, financial statements, and other publicly available information from entities in the same industry, and information available from regulatory agencies.

**C-5.** Questions that might be asked of entity personnel to obtain an understanding of potential environmental remediation liabilities to which an entity may be exposed include the following:

- What controls are in place to identify potential environmental remediation liabilities or related contingencies affecting the entity?
- Has the entity been designated as a PRP by the EPA under the Superfund laws or by state regulatory agencies under analogous state laws?
- If the entity has been designated as a PRP, are there any pending civil or criminal investigations or actions?
- Have regulatory authorities or environmental consultants issued any reports about the entity, such as site assessments or environmental impact studies?
- Are landfills or underground storage tanks used to store or dispose of environmentally hazardous substances?
- Is the entity required to have environmental permits, such as hazardous waste transporter permits or hazardous waste treatment, storage, and disposal permits?
- For property sold, abandoned, purchased, or closed, are there any requirements for site cleanup or for future removal and site restoration?
- Have there been any violations of environmental laws, such as the Superfund laws and the corrective action provisions of RCRA?

It also may be helpful when planning the audit of environmental remediation liabilities to review minutes of meetings of the board of directors (or committees) and reports related to such matters prepared by the entity's internal auditors, compliance officers, or other individuals responsible for such matters.

**C-6.** Depending on the extent of the entity's exposure to environmental remediation liabilities, the auditor may decide to involve personnel knowledgeable about such matters in the audit and to use the work of a specialist.

### ***Audit Objectives***

**C-7.** It is management's responsibility to develop appropriate estimates of environmental remediation liabilities for use in the preparation of the financial

statements. It is the auditor’s responsibility to evaluate the reasonableness of those estimates in forming his or her opinion on the financial statements taken as a whole. Most of the auditor’s work in forming his or her opinion consists of obtaining and evaluating evidential matter concerning assertions in the financial statements. Assertions are representations by management that are embodied in the financial statement components. With respect to environmental remediation liabilities, the relevant financial statement assertions and the related objectives of the auditor are shown in the following table:

Assertions	Objective
Completeness and valuation	To determine whether all environmental remediation liabilities that should be presented in the financial statements are identified and reflected in the financial statements in conformity with GAAP
Presentation and disclosure	To determine whether environmental remediation liabilities and contingencies are classified, described, and disclosed in the financial statements in conformity with GAAP

The auditor assesses inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures that will be performed to achieve these objectives.

**Assessing Audit Risk**

C-8. Once the auditor has obtained an understanding of the potential environmental remediation liabilities to which the entity may be exposed, he or she should make preliminary judgments about materiality and should assess audit risk. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, provides guidance to the auditor on assessing audit risk and materiality when planning and performing an audit of an entity’s financial statements. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Audit risk is composed of inherent risk, control risk, and detection risk.

C-9. *Inherent Risk.* SAS No. 47 defines inherent risk as the susceptibility of an assertion to a material misstatement, assuming there are no related internal controls. In assessing inherent risk for assertions about environmental remediation liabilities, the auditor should consider the knowledge he or she has obtained about the industry in which the entity operates. Certain industries, by nature, tend to have a significant risk of exposure to environmental remediation liabilities. Examples of such industries include chemicals, oil and gas, pharmaceuticals, mining, and utilities. However, an entity need not operate in one of these industries to be exposed to environmental remediation liabilities. Examples of other industries with potential exposure to environmental remediation liabilities are real estate, banking, insurance, and health care. Certain research and development activities (including those engaged in by some not-for-profit entities) also may be subject to significant exposures.

**C-10.** Certain transactions, such as past acquisitions involving real property (including acquisitions by a creditor pursuant to default by a debtor), may expose an entity to environmental remediation liabilities. Under the Superfund laws, current and former owners of land may be responsible for clean-up costs. Situations such as the following may indicate the existence of potential environmental remediation liabilities:

- Past or current ownership of property on which hazardous substances are being or were disposed of
- Recent purchases of property at prices that appear to be significantly below market
- Sales of contaminated land under arrangements whereby the seller retains responsibility for clean-up pursuant to indemnification clauses
- Aborted real estate sales transactions
- Sales of businesses involving the retention of real property by the seller

**C-11.** When assessing inherent risk, the auditor should recognize that estimates of environmental remediation liabilities are affected by factors that management cannot control, such as the actions of regulators and the recommendations and opinions of technical and engineering experts. For this reason, the evaluation of environmental remediation liabilities usually involves considerable analysis and subjective estimation by management and the assistance of third parties such as attorneys and environmental engineers.

**C-12. Control Risk.** SAS No. 47 defines control risk as the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, identifies the components of internal control and explains how an independent auditor should consider internal control in planning and performing an audit. An entity's internal control consists of five components: control environment, risk assessment, control activities, information and communication, and monitoring. For an entity with potential exposure to environmental remediation liabilities, the auditor's understanding of the entity's internal control generally should extend to controls designed to help management identify and evaluate environmental remediation liabilities and loss contingencies. The level of sophistication of an entity's internal control as it relates to environmental remediation matters varies from entity to entity. Relevant factors that an entity might consider when designing its internal control include such matters as the extent of exposure to which the entity is subject, the geographical diversity of the entity, and the remediation activities undertaken or expected to be required. Some entities have specially designed systems for data collection and quantification, and expert personnel involved in the evaluation and oversight of remediation activities. Other entities have less formal means of gathering information and may rely on outside parties to assist management in its evaluation and oversight of remediation activities.

**C-13.** SAS No. 55 also provides guidance on assessing control risk. The auditor may decide to perform tests of controls, to the extent deemed appropriate in the circumstances, to determine whether control risk may be assessed at less than the maximum level. In other cases, the auditor may assess control risk at the maximum level for all or a portion of the financial statement assertions related to environmental remediation liabilities because the auditor

believes that the controls are unlikely to be effective or because evaluating the effectiveness of the controls would be inefficient. The auditor's assessment of inherent risk and control risk, as discussed above, forms the basis for his or her decisions about the nature, timing, and extent of substantive audit procedures to be performed.

## Substantive Audit Procedures

**C-14.** Substantive audit procedures are designed to obtain sufficient competent evidential matter related to the audit objectives. The auditor's substantive tests of environmental remediation liabilities generally consist of testing the accounting estimates recorded by management, making inquiries of legal counsel or identified specialists, and obtaining representations from management.

**C-15.** SAS No. 57, *Auditing Accounting Estimates*, provides guidance to the auditor on obtaining and evaluating sufficient competent evidential matter to support financial statement assertions that are based on significant accounting estimates. When evaluating the reasonableness of the estimates of environmental remediation liabilities, the auditor should first understand how management developed the estimates. Based on that understanding, the auditor should use one or a combination of the following approaches set forth in SAS No. 57 to audit the estimate.

- a. Review and test the process used by management to develop the estimate.
- b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- c. Review subsequent events or transactions occurring prior to the completion of fieldwork.

When auditing environmental remediation liabilities, approaches *a* and *b*, or a combination thereof, usually will be most effective. Approach *c*, taken alone, normally will not be effective because remediation costs are expended over a long period of time, usually extending well beyond the completion of fieldwork.

**C-16.** The auditor should select the approach or approaches based on his or her judgment as to the degree of evidential matter necessary in the circumstances, including consideration of the approach or approaches expected to be most efficient. Because of the complexity involved in developing estimates of environmental remediation liabilities, including the possible need to use the work of a specialist, approach *a* normally will be most efficient.

### ***Reviewing and Testing the Process Used by Management to Develop the Estimate***

**C-17.** The auditor may evaluate the reasonableness of estimates of environmental remediation liabilities by reviewing the process used by management to develop the estimate and by performing procedures to test it. This approach often is the most appropriate when the estimates are developed by or based on the work of an environmental specialist.

**C-18.** SAS No. 57 identifies the following as procedures the auditor may consider performing when using this approach:

- a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation. Some of the more common controls over the preparation of estimates of environmental remediation liabilities that might be considered by the auditor include—
- The nature and extent of monitoring by senior management or the board of directors of the entity's consideration of environmental remediation liabilities.
  - The nature and extent of procedures in place for assessing compliance with applicable environmental laws and regulations and for evaluating possible violations.
  - The nature and extent of procedures in place for involving appropriate operating, financial, legal, and compliance personnel in monitoring the entity's environmental remediation liabilities, and in developing the estimates.
  - The information systems used by the entity to compile and access data about the entity's waste generation, emissions, and other environmental impacts.
  - The entity's use of environmental specialists, including its procedures for determining whether the specialists have the requisite skill or knowledge regarding environmental remediation matters, knowledge of the entity's business, and understanding of the available methodologies for calculating environmental remediation cost estimates.
  - The procedures in place for verifying that data about the nature, destinations, and volumes of hazardous substances or wastes are appropriately collected, classified, and summarized.
  - The procedures in place for assessing the appropriateness of industry or other external sources of data used in developing assumptions (for example, information provided by other PRPs, regulatory authorities, and industry associations) and, where applicable, for substantiating such information.
- b. Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose, based on information gathered in other audit tests. Sources of data and factors used may include—
- Internal company records, such as payroll records for employees who devote significant time directly to environmental remediation efforts.
  - Information from published sources about socioeconomic trends or other factors that might affect environmental remediation liabilities, such as inflation rates, judicial decisions, and enacted changes in legislation affecting remediation methods or definitions of hazardous substances.
- c. Consider whether there are additional key factors or alternative assumptions about the factors. Key factors that might be considered include—

- Information about environmental remediation liabilities included in the response to the inquiry of the entity's lawyer.
  - Studies or reports by environmental consultants.
  - Reports, notices, or correspondence issued by regulatory authorities.
- d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data. Assumptions that might be evaluated include—
- Allocations of remediation responsibilities (and consequently the attendant liabilities) among PRPs.
  - Remediation technologies and expected time frames.
  - Postclosure monitoring requirements.
- e. Analyze historical data used in developing the assumptions to assess whether the data are comparable and consistent with data of the period under audit, and consider whether the data are sufficiently reliable for this purpose. Factors to consider include—
- Whether the entity's current process for estimating environmental remediation liabilities has resulted in reasonably accurate, appropriate estimates in prior periods, and the extent to which current data indicate changes from prior experience.
  - Whether changes in the entity's business have been factored into the estimate.
  - Relationships between estimates of liabilities for one location and estimates or actual costs incurred for similar locations.
- f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.
- g. Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions. Consider the following, for example:
- Practices concerning the resolution of environmental contingencies that may have a significant effect on the entity's ultimate environmental remediation liability (for example, a practice of vigorously contesting remediation plans proposed by regulators as opposed to a practice of tacitly accepting those plans)
  - Plans to sell, dispose of, or abandon specific facilities
  - Financial statements or other information used by management to assess participating PRPs' abilities to pay their allocable shares of the estimated environmental remediation liability
- h. Consider using the work of a specialist regarding certain assumptions.
- i. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.

### ***Developing an Independent Expectation of the Estimate***

**C-19.** The auditor may decide to develop an independent expectation of the estimate of environmental remediation liabilities generally by using the work of an environmental specialist. For example, the auditor might use this approach if management has not engaged or employed an environmental specialist, or to assess the reasonableness of, or the effects of alternative key factors and assumptions on, an estimate prepared by a specialist engaged or employed by management.

### ***Using the Work of a Specialist***

**C-20.** Because of the complexity of environmental remediation activities and the difficulties involved in developing estimates of environmental remediation liabilities, management often will engage or employ a specialist to perform this work. Examples of such specialists are remediation technologies specialists, responsibility allocation specialists, claims specialists, environmental engineers, and environmental attorneys.

**C-21.** Specialists might be involved in one or more stages of the process of developing estimates of environmental remediation liabilities, including—

- Identifying situations for which remediation is required.
- Designing or recommending a remedial action plan for the entity.
- Gathering and analyzing data on which to base the estimates of remediation costs (for example, performing a baseline risk assessment).
- Providing information to management that will enable management to estimate the entity's environmental remediation liability and develop the related financial statement disclosures.

**C-22.** As noted previously, the process of estimating environmental remediation liabilities usually is complex and involves many subjective judgments. Consequently, the auditor may decide to use the work of a specialist to evaluate financial statement assertions about environmental remediation liabilities. SAS No. 73, *Using the Work of a Specialist*, provides guidance to the auditor who uses the work of a specialist in performing an audit.

**C-23. *Qualifications and Work of a Specialist.*** SAS No. 73 also provides guidance on matters the auditor should consider when evaluating the professional qualifications of a specialist to determine whether the specialist possesses the necessary skill or knowledge in a particular field. The specialist's level of skill or knowledge should be commensurate with the nature and complexity of the entity's environmental remediation liabilities that the specialist has been asked to address. Matters that might be relevant in evaluating the professional qualifications of a specialist include—

- Knowledge of various remediation technologies, including their acceptability, strengths, weaknesses, and applicability.
- Knowledge of environmental remediation issues that are likely to affect the entity, including legal, regulatory, industry, and social developments.
- Technical or educational background related to environmental remediation matters.

- Work experience related to environmental remediation matters.

**C-24.** The auditor should obtain an understanding of the nature of the work performed or to be performed by the specialist. That understanding should include—

- The objectives and scope of the specialist's work, for example, whether the specialist is engaged to perform a baseline risk assessment or a feasibility study.
- The specialist's relationship to the entity, if any.
- The methods and assumptions used by the specialist, including, for example, a comparison of the methods and assumptions used by the specialist with those used by management or other specialists, or with those used in the preceding period.
- The appropriateness of using the specialist's work for the intended purpose. In some cases, the auditor may decide it is necessary to contact the specialist to determine whether the specialist is aware that his or her work will be used for evaluating assertions in the financial statements.
- The form and content of the specialist's findings, for example, the extent of detail included or to be included in the report.

Reports issued by environmental specialists are not standard in their form or content and do not always clearly express the underlying assumptions or methods used by the specialist. Communication with the specialist in these circumstances may assist the auditor in obtaining the necessary understanding.

**C-25. *The Specialist's Relationship to the Entity.*** If a specialist is employed by an entity, or otherwise has a relationship that might directly or indirectly influence the findings of the specialist, the auditor should assess the risk that the specialist's objectivity might be impaired. Factors that the auditor might consider when determining whether the specialist's objectivity might be impaired include the auditor's prior experience with the specialist, discussions with the specialist and management, and additional information about the specific nature and significance of the relationship. If the auditor concludes that the specialist's objectivity might be impaired, the auditor should perform additional procedures with respect to the specialist's work, for example, engaging another specialist to review some or all of the related specialist's work.

**C-26. *Using the Findings of the Specialist.*** The specialist is responsible for the appropriateness and reasonableness of the methods and assumptions used and for their application. However, the auditor should (a) obtain an understanding of the methods and assumptions used by the specialist, (b) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (c) evaluate whether the specialist's findings support the related financial statement assertions.

**C-27.** If the auditor concludes that the specialist's findings are unreasonable, the auditor should apply additional procedures that may include obtaining the opinion of another specialist.

### ***Auditing Potential Recoveries***

**C-28.** Potential claims for recovery from insurers, PRPs other than participating PRPs, prior property owners, and governmental or third-party funds



should be evaluated separately from the environmental remediation liability. To evaluate whether the recovery of a potential claim is probable, correspondence or communication with others such as the insurer, PRPs other than participating PRPs, or legal counsel generally is necessary. Requests for confirmation of recoverable amounts from such parties should be carefully designed to ensure that the parties fully understand what is being requested. Also, because confirmations do not necessarily provide sufficient evidence regarding the realizability of such amounts, the auditor may need to obtain other evidence to evaluate the realizability of recorded recoverable amounts. As noted in paragraph .141 of this SOP, if a claim is the subject of litigation, a rebuttable presumption exists that realization of the claim is not probable. SAS No. 67, *The Confirmation Process*, provides guidance to the auditor about the confirmation process in audits performed in accordance with GAAS.

### ***Inquiries of a Client's Lawyer***

**C-29.** The auditor should consider requesting information about environmental remediation liabilities and loss contingencies in the letter of inquiry sent to the entity's counsel because such matters frequently involve litigation. The letter of inquiry of a client's lawyer should include a list prepared by management (or a request by management that the lawyer prepare a list) that describes each of the matters the lawyer is currently handling and the expected outcomes of those matters. SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, provides guidance on the procedures an auditor should consider performing to identify litigation, claims, and assessments and to satisfy himself or herself as to the financial reporting and disclosure of such matters.

### ***Client Representations***

**C-30.** The auditor should consider obtaining written representations from management about estimates and disclosures of environmental remediation liabilities and loss contingencies affecting the financial statements, including specific representations as to the adequacy of such disclosures and the expected outcomes of uncertainties. SAS No. 19, *Client Representations*, provides guidance to the auditor about representations to be obtained from management as part of an audit.

### ***Assessing Disclosures***

**C-31.** Guidelines for disclosure related to environmental remediation liabilities and loss contingencies are presented in chapter 7 of this SOP. SAS No. 32, *Adequacy of Disclosure in Financial Statements*, requires the auditor to assess the adequacy of disclosures of material matters in the financial statements in connection with rendering an opinion on the presentation of financial statements in conformity with GAAP. In the context of environmental remediation loss contingencies, the auditor should evaluate management's assessment of the likelihood of loss and ability to reasonably estimate the potential loss. If disclosure is required, the auditor should assess the adequacy of the disclosures, including any conclusions expressed by management regarding the expected outcome of such contingencies, based on evidence obtained, as applicable, from the following:

- Operating, environmental, legal, and financial management personnel
- Specialists

- Other audit tests

### **Evaluating Audit Test Results**

**C-32.** The auditor should evaluate the results of tests of the environmental remediation liabilities and related disclosures in the context of the entity's financial statements taken as a whole. Other auditing literature that provides guidance on evaluating the results of audit tests includes SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, which provides guidance on the evaluation of audit test results, and paragraph 29 of SAS No. 47, which provides additional guidance on the auditor's responsibility for evaluating the reasonableness of estimates in relationship to the financial statements taken as a whole.

### **Reporting**

**C-33.** Departures from GAAP or scope limitations related to environmental remediation liabilities or loss contingencies may require modification of the auditor's standard report on an entity's financial statements. SAS No. 58, *Reports on Audited Financial Statements*, provides guidance to the auditor on reporting when there is a GAAP departure or a scope limitation.

### **Departures From GAAP**

**C-34.** Departures from GAAP involving environmental remediation liabilities or loss contingencies generally involve (1) inadequate disclosures, (2) the application of inappropriate accounting principles, or (3) unreasonable accounting estimates. The auditor should determine whether the presentation and disclosure of an environmental remediation liability or the disclosure of an uncertainty involving an environmental remediation loss contingency complies with the guidance in chapter 7 of this SOP. The auditor should also assess the appropriateness of the accounting policies used and the reasonableness of the estimates. Chapters 5 and 6 of this SOP present the accounting principles for the recognition and measurement of environmental remediation liabilities. If the auditor concludes that the financial statements are not fairly presented in all material respects because the accounting principles followed are inappropriate or misapplied, the disclosures are inadequate, or management's estimates are unreasonable, the auditor should express a qualified or adverse opinion.

### **Scope Limitations**

**C-35.** The auditor should consider whether he or she has obtained sufficient competent evidential matter to support management's assertions about environmental remediation liabilities and loss contingencies and their presentation and disclosure in the financial statements. The auditor should distinguish between situations involving uncertainties and those involving scope limitations. An uncertainty exists if resolution of the environmental remediation loss contingency is expected to occur at a future date at which time conclusive evidential matter concerning the outcome of the uncertainty is expected to become available. However, if sufficient evidential matter currently exists or did exist but is not available to the auditor because of restrictions imposed by management, inadequate recordkeeping, or other conditions that prevent the auditor from gaining access to the information, a limitation on the scope of the auditor's work may exist sufficient to cause the auditor to qualify or disclaim an opinion because of a scope limitation.

### ***Making Reference to a Specialist***

**C-36.** Use of specialists is common in the determination and development of financial statement estimates of environmental remediation liabilities and disclosures related to environmental remediation loss contingencies. SAS No. 73 provides the auditor with guidance on considering the effect of the specialist's work on the auditor's report. That guidance precludes the auditor from referring to the work of a specialist in the auditor's report, because such reference might be interpreted as a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. However, the guidance permits the auditor to refer to the specialist in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for a departure from an unqualified opinion.

### ***Accounting Changes***

**C-37.** As indicated in paragraph .102 of this SOP, the effect of initially applying the provisions of this SOP may have elements of a change in accounting principle that are inseparable from a change in accounting estimate; accordingly, the effect shall be reported as a change in accounting estimate. If the initial application of the accounting guidance in this SOP has a material effect on the comparability of the financial statements, an explanatory paragraph should be added to the auditor's report pursuant to paragraph 12 of SAS No. 1, section 420, *Consistency of Application of Generally Accepted Accounting Principles*.

### ***Communication With Audit Committees***

**C-38.** SAS No. 61, *Communication With Audit Committees*, provides the auditor with guidance on the types of matters related to the scope and results of the audit that should be reported to the audit committee or those of equivalent authority and responsibility. Such matters include management judgments and accounting estimates. The auditor should determine whether the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates, such as those for environmental remediation liabilities, and the basis for the auditor's conclusions regarding the reasonableness of the estimates.

## Appendix D

### Response to Comments Received

**D-1.** An exposure draft of a proposed SOP, *Environmental Remediation Liabilities (Including Auditing Guidance)*, was issued for public comment on June 30, 1995. More than seventy comment letters were received in response to the exposure draft.

**D-2.** The majority of the comments related to the measurement of environmental remediation liabilities. A significant number of commentators also expressed concerns about a lack of symmetry in the measurement of the remediation liability and of any probable recoveries, about the proposed SOP's scope, and about the proposed transition provisions and effective date of the SOP. Some commentators also suggested that, because environmental remediation liabilities is a broad topic, it should be addressed by the FASB rather than the Accounting Standards Executive Committee (AcSEC).

**D-3.** These comments and AcSEC's responses to them are discussed below.

#### Scope

**D-4.** The exposure draft excluded from its scope accounting for remediation actions that are undertaken at the sole discretion of management and that are not induced by the threat of litigation or assertion of a claim or an assessment. A number of commentators recommended expanding the scope to include such actions, with the majority of them recommending that the SOP specifically permit or require the recording of a liability for voluntary remediation programs when management intends to undertake such programs.

**D-5.** AcSEC continues to believe that such remediation actions should be outside the scope of this SOP. AcSEC believes that addressing the issues would require a far broader project than this SOP was intended to be. Such a broader project would possibly need to be undertaken by the FASB rather than AcSEC since it might require reconsideration of the liability-recognition model established by FASB Statement No. 5, *Accounting for Contingencies*. Moreover, AcSEC believes this SOP, with its relatively narrow scope, will produce significant improvements in practice that should not be delayed unnecessarily.

#### Measurement of the Liability

**D-6.** The exposure draft provided that the measurement of the liability should include the following:

- a. Incremental direct costs of the remediation effort
- b. Costs of compensation and benefits for employees to the extent an employee is expected to devote time directly to the remediation effort

The exposure draft defined the remediation effort to include, among other things, the costs of defending against assertions of liability for remediation.

**D-7.** Many commentators stated that payroll and payroll-related costs, including the costs of in-house legal counsel, should be treated as period costs rather than being included in the measurement of the environmental remediation liability. Among the reasons cited were the following.

- Because environmental-affairs, technical, and legal personnel who devote time to the remediation effort would be employed by an entity even in the absence of an obligation to remediate a particular site, devoting a portion of their time to a particular site does not represent a sacrifice of economic benefits.
- Salaries and related costs that are not inventoriable generally are treated as period costs; such costs generally are not accrued as part of other kinds of liabilities.
- The cost of estimating and tracking this element of the accrual would be burdensome.
- Whether such costs should be included in the measurement of the liability should be considered by the FASB because of its implications to areas beyond environmental liabilities.

**D-8.** In addition, many commentators said that the cost of defending against assertions of liability, regardless of whether the defense is to be performed by in-house counsel or outside counsel, should be treated as a period cost. Among the reasons cited were the following.

- Costs of defending against assertions of liability are discretionary and, therefore, do not have one of the essential characteristics of a liability set forth in FASB Concepts Statement No. 6, *Elements of Financial Statements*.
- Such costs may be incurred before it can be determined whether a remediation liability exists.
- The guidance inevitably would be analogized to other kinds of liabilities. Accordingly, it would represent a *de facto* Interpretation of FASB Statement No. 5 that should be exposed and debated as such.

**D-9.** AcSEC believes that devoting the time of employees to a particular activity, by definition, represents a sacrifice of economic resources. AcSEC acknowledges that, in most situations, compensation and benefits for employees who are not involved with production of inventory are treated as a period cost. AcSEC believes, however, that the measurement of an environmental remediation liability should be based on the cost that will be incurred to extinguish the liability and that the measurement should not vary significantly merely because an entity chooses to satisfy elements of the liability using employees rather than outside contractors. The need to include internal costs in the measurement of a liability is addressed explicitly in various items of authoritative literature. FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, states in footnote 15, "If significant, the internal and external costs directly associated with administering the postretirement benefit plan also should be accrued as a component of assumed per capita claims costs." FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, states in paragraph 20, "A liability for all costs expected to be incurred in connection with the settlement of unpaid claims (claim adjustment expenses) shall be accrued when the related liability for unpaid claims is accrued. . . . Claim adjustment expenses also include other costs that cannot be associated with specific claims but are related to claims paid or in the process of settlement, such as internal costs of the claims function." SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* [section 10,330], states in paragraph 87 [section 10,330.87] that a provision for anticipated losses on contracts should include all costs of the type

allocable to contracts under paragraph 72 of that SOP [section 10,330.72]. Paragraph 72 of SOP 81-1 [section 10,330.72] states that such costs include all direct costs, such as material, labor, and subcontracting costs, and the following indirect costs: the costs of indirect labor, contract supervision, tools and equipment, supplies, quality control and inspection, insurance, repairs and maintenance, depreciation and amortization, and, in some circumstances, support costs, such as central preparation and processing of payrolls.

**D-10.** Finally, AcSEC considered accounting literature that provides that certain internal cost be deferred or capitalized rather than treated as a period expense. FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, provides that direct loan-origination costs of a completed loan are to be offset against loan-origination fees and any excess deferred. Direct loan-origination costs include incremental direct costs incurred in transactions with independent third parties and certain costs directly related to specified activities performed by the lender. The costs directly related to those activities include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent for the origination of the loan.

**D-11.** AcSEC was concerned, however, that the requirement to include in the measurement of the environmental remediation liability the costs of compensation and benefits for all employees who are expected to devote time to the remediation effort would create an unjustified record keeping burden on reporting entities. Accordingly, the approach used in the SOP limited the inclusion of nonincremental direct costs to the costs of compensation and benefits for those employees who are expected to devote a *significant amount* of time directly to the remediation effort. AcSEC believes this approach will produce sound and useful reported information at a reasonable cost. As discussed in the SOP, the remediation effort does not include routine environmental compliance matters and costs involved with potential recoveries. Also, indirect internal costs such as administrative and occupancy costs are not included in the measurement of the environmental remediation liability.

**D-12.** AcSEC believes the cost associated with including the appropriate compensation and benefit costs in the measurement of the liability will not be excessive. In this regard, AcSEC notes that in many cases periodic adjustment of the liability could be performed by reestimating this component of the liability and that this SOP does not impose an obligation to use formal procedures such as time sheets for the development of the liability and to track the actual expenditures.

**D-13.** AcSEC acknowledges that the treatment of costs to defend against assertions of this and other kinds of liability is diverse: Some include such costs in the measurement of a liability for a loss contingency under FASB Statement No. 5, while the majority of practice treats litigation costs as period costs. AcSEC believes that any authoritative guidance on the treatment of such costs should be developed as a broad issue with appropriate due process. AcSEC, therefore, concluded not to provide guidance on inclusion of the cost of defense against assertions of liability in the measurement of the environmental remediation liability. Costs to defend against assertions of liability in the context of environmental remediation liabilities involve determining whether an entity is responsible for participating in a remediation process. Legal costs involved with determining (a) the extent of remedial actions that are required, (b) the type of remedial actions to be used, and (c) the allocation of costs among PRPs are not part of the cost to defend against assertions of liability and are to be included in the measurement of the environmental remediation liability.

**D-14.** The exposure draft provided that current measurements of the liability "... should be based on remediation technology that exists currently." Certain commentators agreed with this conclusion. In their opinions, the nature of the remediation effort was sufficiently different from liabilities for closure or removal of long-lived assets that a difference in anticipating changes in technology was justified.

**D-15.** Some commentators concluded that differences between the guidance in the exposure draft concerning anticipation of advances in technology and the FASB's tentative conclusions concerning anticipation of advances in technology in its project on accounting for certain liabilities related to closure or removal of long-lived assets (formerly nuclear decommissioning) should be resolved. These commentators did not always express a preference.

**D-16.** The majority of commentators suggested that to ignore advances in technology is unrealistic and recommended that changes in technology that are reasonable and that can be supported should be allowed to be considered in determining the remediation liability. FASB Statement No. 106 was cited as an example of authoritative literature that permits consideration of anticipated changes in technology.

**D-17.** AcSEC acknowledges that, by restricting remediation technologies to those currently available, realistic developments in technology that could substantially reduce the ultimate obligation would be ignored. This approach would be inconsistent with the objective of reporting, in the financial statements, a liability that represents the most likely amount to be paid. Further, AcSEC agrees that the FASB's approach in Statement No. 106 to estimating postemployment health care costs demonstrates the acceptability of anticipating realistic changes in technology when estimating future costs that are affected significantly by technological advances.

**D-18.** AcSEC believes that information regarding expected advances in remediation technologies is considered routinely by environmental engineers and consultants as they evaluate the effectiveness and cost of alternative remediation strategies. AcSEC acknowledges the inherent uncertainty involved in anticipating developments in technology but concluded that acceptable constraints would be placed on this uncertainty by requiring that advances be considered only to the extent that the entity has a reasonable basis to expect that a remediation technology will be approved. Further, this uncertainty becomes resolved at such time as a record of decision is issued since, at that stage in the process, the remediation technology to be used is defined. Accordingly, AcSEC modified its original position to require that the estimated liability be measured based on the technology that is expected to be approved to remediate the site.

**D-19.** Paragraph .131 of the SOP states: "In situations in which it is not practicable to estimate inflation and such other factors [productivity improvements] because of uncertainty about the timing of expenditures, a current-cost estimate would be the minimum in the range of the liability to be recorded until such time as these cost effects can be reasonably estimated." That guidance is different from the guidance proposed in the FASB's May 31, 1996, exposure draft of a Proposed Statement of Financial Accounting Standards, *Accounting for Certain Liabilities Related to Closure or Removal of Long-Lived Assets*, which provides that, in determining the estimated future cash outflows that will be required to satisfy closure or removal obligations, current-cost estimates should be adjusted for inflation in all cases. AcSEC believes the difference is

justified, because the degree of timing uncertainty that exists concerning some environmental remediation liabilities is significantly greater than the degree of timing uncertainty that typically exists concerning closure or removal liabilities.

**D-20.** For example, an entity may know that a remedial action for which it has a liability could begin within, say, one year of the reporting date. The entity may also know that, for reasons such as disagreements among potentially responsible parties over their relative responsibility for the site and the methodology to be used at the site, it is equally likely that remedial action will not begin for five, or perhaps ten, years. In such circumstances, consideration of the effects of inflation and of productivity improvements in the measurement of the liability would require an arbitrary assumption about when the remedial action will begin, which would diminish the reliability of the measurement and the usefulness of the reported information.

**D-21.** Although timing uncertainties also often exist in closure situations (concerning the end of the useful life of a long-lived asset, which is when cash outflows for closure or removal of a long-lived asset would occur), those uncertainties tend to concern periods that are more distant from the measurement date. This factor mitigates the effects of such uncertainties.

**D-22.** AcSEC believes that, in the context of environmental remediation liabilities, using a current cost estimate until there is a basis for estimating productivity improvements and the timing of the satisfaction of the liability will result in reported information that has the characteristics of usefulness and reliability.

**D-23.** Uncertainties are pervasive in the measurement of environmental remediation liabilities, and the SOP's approach to addressing those uncertainties is to require reporting entities to recognize their best estimate at the particular point in time (or, if no best estimate can be made, the minimum estimate) of their share of the liability and to refine their estimate as events in the remediation process occur. The guidance provided in this SOP—that an undiscounted current cost estimate would be the minimum in the range of the liability to be recognized until such time as a better estimate can be made—is consistent with that approach.

## Measurement of Probable Recoveries

**D-24.** The exposure draft required discounting of recovery assets in all circumstances. Many commentators expressed concerns that that guidance, in combination with the SOP's guidance concerning discounting of liabilities, produced counterintuitive results when applied, for example, to fully insured liabilities. AcSEC agreed with commentators that the measurement of some recovery assets should be symmetrical with the measurement of the related liability. AcSEC noted that, in FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, the FASB provided for the measurement of reinsurance receivables on a basis symmetrical to that of the liability. Accordingly, AcSEC concluded that probable recoveries should be measured at their undiscounted amounts if (a) the liability is not discounted and (b) the timing of the recovery is dependent on the timing of the payment of the liability. This second criterion—dependency of the timing of the recovery on the timing of the payment of the liability—would usually be met, for example, if an insurance company agrees, in accordance with



the terms of an insurance contract, to reimburse the reporting entity for all or a percentage of the remediation costs incurred by the reporting entity as the reporting entity expends money to satisfy its obligation, whereas the criterion likely would not be met, for example, in a lump-sum buyout by an insurance company of contested coverage.

## Relationship of the Guidance in This SOP to FASB Statement No. 121

**D-25.** This SOP addresses the recognition of environmental remediation liabilities and explicitly does not address the recognition of asset impairment. FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, provides guidance on the recognition and measurement of impairment of long-lived assets. Under FASB Statement No. 121, an entity determines whether a long-lived asset is impaired by comparing the expected future cash flows (undiscounted and without interest charges) from the use and eventual disposition of the asset to the asset's carrying amount. If the asset is determined to be impaired, the impairment loss is measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset.

**D-26.** FASB Statement No. 121 does not address explicitly cash flows related to environmental remediation that may be associated with a long-lived asset. The EITF reached a consensus in Issue No. 95-23, *The Treatment of Certain Site Restoration / Environmental Exit Costs When Testing a Long-Lived Asset for Impairment*, that future cash flows for environmental exit costs that are associated with a long-lived asset and that have been recognized as a liability should be excluded from the undiscounted expected future cash flows used to test the asset for recoverability under Statement No. 121. However, EITF Issue No. 95-23 relates only to environmental exit costs that may be incurred if a long-lived asset is sold, is abandoned, or ceases operations. It does not address the appropriate treatment of cash outflows to satisfy the environmental remediation liabilities that are the subject of this SOP when an asset would continue operating. AcSEC believes guidance should be developed to address the recognition test under FASB Statement No. 121 and the measurement of impairment under the Statement when an environmental remediation liability associated with a long-lived asset has been recognized pursuant to this SOP. The guidance should avoid consideration of the effect of the environmental remediation obligation twice.

## Disclosures

**D-27.** A number of commentators said the disclosures that are encouraged, but not required, by the SOP should be mandatory. Those commentators believe that the encouraged disclosures provide valuable, or even essential, information to users of the financial statements.

**D-28.** AcSEC believes the encouraged disclosures will enhance the usefulness of financial statements as tools for decision making. AcSEC recognizes, however, that the FASB is undertaking a project on disclosure effectiveness and decided that it would be inappropriate to impose new disclosure requirements concerning environmental remediation liabilities at this time. Accordingly, the SOP imposes no disclosure requirements that go beyond the requirements of existing authoritative literature.

## Transition

**D-29.** A number of commentators said that the effect of initially applying the SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle. A number of those commentators believe the SOP's guidance on what elements should be included in the accrual; on estimation of the liability in the strict, joint and several, and retroactive legal scheme of environmental remediation liabilities; and on accrual of estimates of components of the overall liability before the overall liability can be reasonably estimated constitute significant new guidance that would result in a change in the application of an accounting principle and should be accounted for as such. Some of those commentators believe that, although in individual cases the effect of applying the SOP would have elements of a change in the application of an accounting principle and of a change in an accounting estimate, the entire change should be reported as a change in accounting principle because that is the predominant characteristic of the change. AcSEC rejected those arguments because treating the effect of initially applying the SOP as a change in accounting principle would directly contradict APB Opinion No. 20, *Accounting Changes*, paragraph 32, which states in part:

A change in accounting estimate that is recognized in whole or in part by a change in accounting principle should be reported as a change in an estimate because the cumulative effect attributable to the change in accounting principle cannot be separated from the current or future effects of the change in estimate.

## Coordination With the FASB

**D-30.** A number of commentators expressed the view that, because the accounting and reporting issues embraced by the scope of this SOP are of such a broad nature, the FASB rather than AcSEC should address them. AcSEC notes that it coordinates its efforts with the FASB throughout the process of developing an SOP. This coordination begins when AcSEC sends a prospectus that describes a possible project to the FASB. That prospectus is discussed at a public board meeting and, if no more than two FASB members object to having AcSEC take on the project, the project can proceed.

**D-31.** The criteria considered by the FASB in clearing AcSEC's prospectuses include the following:

- The project does not conflict with current or proposed accounting requirements, unless it is a limited circumstance that is adequately justified.
- The project will result in an improvement in practice.
- The AICPA has demonstrated a need for the project.
- The benefits of any SOP are expected to outweigh the costs of applying it.

**D-32.** All AcSEC meetings are open to the public, and an FASB representative generally attends all AcSEC meetings. The FASB also clears AcSEC exposure drafts and final SOPs at public board meetings before their promulgation. In connection with clearing the final SOP, the FASB is provided with copies of all comment letters received by AcSEC.

## Appendix E

### Acronyms

ARAR	Applicable or relevant and appropriate requirement
BACT	Best available control technology
CERCLA	Comprehensive Environmental Response, Compensation and Liability Act (Also referred to as Superfund, together with SARA)
CERCLIS	Comprehensive Environmental Response, Compensation and Liability Information System
DMR	Discharge monitoring report
EPCRA	Emergency Planning and Community Right-to-Know Act (also referred to as SARA title III)
LAER	Lowest achievable emission rate
MSDS	Material safety data sheet
NAAQS	National ambient air quality standards
NPDES	Nation Pollutant Discharge Elimination System
NPL	National Priorities List
NSPS	New source performance standards
POTW	Publicly owned treatment works
PRAP	Proposed remedial action plan
PRP	Potentially responsible party
PSD	Prevention of significant deterioration
RCRA	Resource Conservation and Recovery Act
RFA	RCRA facility assessment
RFI	RCRA facility investigation
RI/FS	Remedial investigation/feasibility study
ROD	Record of Decision
SARA	Superfund Amendments and Reauthorization Act of 1986 (together with CERCLA, also referred to as Superfund)
SWMU	Solid waste management unit
TSCA	Toxic Substances Control Act
TSDF	Treatment, storage, or disposal facility
UST	Underground storage tank

## Glossary

**Administrative record.** Related to Superfund and EPCRA: all documents containing information the government uses to select response actions and impose administrative sanctions relating to CERCLA and Title III of SARA, the Emergency Planning and Community Right-to-Know Act. This paper trail includes correspondence, the RI/FS, the Record of Decision, and public comments. SARA appears to limit judicial review of the adequacy of a response action to the administrative record.

**Applicable or Relevant and Appropriate Requirements (ARARs).** ARARs include the federal standards and more stringent state standards that are legally applicable or relevant and appropriate under the circumstances. ARARs include cleanup standards, standards of control, and other environmental protection requirements, criteria, or limitations. RCRA has frequently been used as an ARAR for remediation of Superfund sites.

**Baseline risk assessment.** Related to Superfund and RCRA: the qualitative and quantitative evaluation performed in an effort to define the risk posed to human health, the environment, or both by the presence or potential presence, use, or both of specific pollutants. Baseline risk assessments are performed as part of the RI/FS process under Superfund and as part of the RCRA facility investigation in RCRA corrective actions.

**Closure.** Related to RCRA: the process in which the owner-operator of a hazardous waste management unit discontinues active operation of the unit by treating, removing from the site, or disposing of on site all hazardous wastes in accordance with an EPA- or state-approved plan. Included, for example, are the process of emptying, cleaning, and removing or filling underground storage tanks (USTs) and the capping of a landfill. Closure entails specific financial guarantees and technical tasks that are included in a closure plan and must be implemented.

**Comprehensive Environmental Response, Compensation, and Liability Information System (CERCLIS) or CERCLA Information System.** A database maintained by the U.S. EPA and the states that lists sites where releases have either been addressed or need to be addressed. CERCLIS consists of three inventories: CERCLIS Removal Inventory, CERCLIS Remedial Inventory, and CERCLIS Enforcement Inventory. Within the three inventories are inactive and active release sites. Inactive release sites are those sites where no further action is needed. Active release sites are those sites that may have an ongoing response action; that may not yet have been addressed by the EPA, but are scheduled for future action; or that may have been addressed and are targeted for further investigation of environmental impacts.

**Consent decree.** A legal document, approved by a judge, that formalizes an agreement reached between the EPA and potentially responsible parties (PRPs) through which PRPs will conduct all or part of a remedial action at a Superfund site; cease or correct actions or processes that are polluting the environment; or otherwise comply with regulations where PRPs' failure to comply caused the EPA to initiate regulatory enforcement actions. The consent decree describes the actions PRPs will take and may be subject to a public comment period.

**Containment.** Measures taken to prevent the migration of, or exposure of humans and the environment to, hazardous substances. Containment includes, for example, the construction of dikes, trenches, ditches, fences, underground barrier walls, surface caps, and groundwater pumping facilities as well as monitoring to ensure the integrity of the containment system.

**Corrective action.** Related to RCRA: action to remedy releases from hazardous waste management units, or any other sources of releases at or from a TSDF.

**Disposal.** Related to CERCLA and RCRA: under RCRA, the discharge, deposit, injection, dumping, spilling, leaking, or placing of any solid waste or hazardous waste into or on any land or water so that such solid waste or hazardous waste or any constituent thereof may enter the environment or be emitted into the air or discharged into any waters, including groundwaters. Similarly under CERCLA with regard to hazardous substances.

**Hazardous substance.** Related to Superfund: the definition of hazardous *substance* in CERCLA is broader than the definition of hazardous *wastes* under RCRA. Under CERCLA, a hazardous substance is any element, compound, mixture, solution, or substance that, when released to the environment, may present substantial danger to the public health or welfare or to the environment. It also includes (1) specifically designated substances; (2) toxic pollutants under the Federal Water Pollution Control Act; (3) hazardous wastes having the characteristics identified under or listed pursuant to RCRA (excluding any waste suspended from regulation under the Solid Waste Disposal Act by Congress); (4) hazardous air pollutants under the Clean Air Act; and (5) any imminently hazardous chemical substance or mixture for which the government has taken action under section 7 of the Toxic Substances Control Act. Petroleum (including crude oil not otherwise specifically listed or designated as a hazardous substance under any of the above laws), natural gas, natural gas liquids, liquefied natural gas, or synthetic gas useable for fuel (or mixtures of natural gas and such synthetic gas) are excluded.

**Hazardous waste.** Related to RCRA: a waste, or combination of wastes, that because of its quantity, concentration, toxicity, corrosiveness, mutagenicity or inflammability, or physical, chemical, or infectious characteristics may (1) cause, or significantly contribute to, an increase in mortality or an increase in serious irreversible, or incapacitating reversible illness; or (2) pose a substantial present or potential hazard to human health or the environment when improperly treated, stored, transported, or disposed of, or otherwise managed. Technically, those wastes that are regulated under RCRA 40 CFR Part 261.

**Hazardous waste constituent.** A constituent that caused the waste to be listed as a hazardous waste under 40 CFR Part 261 Subpart D.

**National Priorities List (NPL).** The EPA's list of the most serious uncontrolled or abandoned hazardous waste sites identified for possible long-term remedial action under Superfund. The list is based primarily on the score a site receives from the Hazard Ranking System. The EPA is required to update the NPL at least once a year.

**Orphan share.** Equitable share of liability for response or remediation costs attributed to orphan-share PRPs, or the amount by which the equitable share of liability for response or remediation costs attributable to other parties exceeds the amount for which those parties have settled their liability.

**Orphan-share PRP.** An identified PRP that cannot be located or that is insolvent.

**Orphan site.** A Superfund site where all identified potentially responsible parties no longer exist or are insolvent.

**Participating PRP.** A party to a Superfund site that has acknowledged potential involvement with respect to the site. Also referred to as a *player*.

**Potentially responsible party (PRP).** Any individual, legal entity, or government—including owners, operators, transporters, or generators—potentially responsible for, or contributing to, the environmental impacts at a Superfund site. The EPA has the authority to require PRPs, through administrative and legal actions, to remediate such sites.

**Recalcitrant PRP.** A party whose liability with respect to a Superfund site is substantiated by evidence, but that refuses to acknowledge potential involvement with respect to the site. Also referred to as a *nonparticipating PRP*.

**Release.** Related to Superfund: any spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping, or disposing into the environment. Includes the abandonment or discarding of barrels, containers, and other closed receptacles containing any hazardous substance, pollutant, or contaminant. The law provides for several exclusions. Release also means the substantial threat of release.

**Remedial action, remediation.** Related to Superfund: generally long-term actions taken to (a) investigate, alleviate, or eliminate the effects of a release of a hazardous substance into the environment; (b) investigate, alleviate, or eliminate a threat of the release of an existing hazardous substance that could potentially harm human health or the environment; or (c) restore natural resources. Also used in this SOP to refer to corrective action under RCRA.

**Remedial investigation/feasibility study (RI/FS).** Extensive technical studies conducted by the government or by the PRPs to investigate the scope of site impacts (RI) and determine the remedial alternatives (FS) that, consistent with the National Contingency Plan, may be implemented at a Superfund site. Government-funded RI/FSs do not recommend a specific alternative for implementation. RI/FSs conducted by PRPs usually do recommend and technically support a remedial alternative. An RI/FS may include a variety of on- and off-site activities, such as monitoring, sampling, and analysis.

**Removal, removal action.** Under CERCLA, generally short-term actions taken to respond promptly to an urgent need. The cleanup or removal of released hazardous substances from the environment; actions in response to the threat of release; actions that may be necessary to monitor, assess, and evaluate the release or threat; disposal of removed material; or other actions needed to prevent, minimize, or mitigate damage to public health

or welfare or to the environment. Removal also includes, without being limited to, security fencing or other measures to limit access; provision of alternative water supplies; temporary evacuation and housing of threatened individuals not otherwise provided for; and any emergency assistance provided under the Disaster Relief Act.

**Response action.** Related to Superfund: a broad term encompassing removal, remediation, and containment actions, as well as precleanup and enforcement-related activities.

**Solid waste management unit (SWMU).** Related to RCRA: any discernible waste management unit from which hazardous constituents may migrate, irrespective of whether the unit was intended for the management of solid or hazardous wastes. The types of units considered SWMUs are landfills, surface impoundments, waste piles, land treatment units, incinerators, injection wells, tanks, container storage areas, waste-water treatment systems, and transfer stations. In addition, areas associated with production processes at facilities that have been affected by routine, systematic, and deliberate releases of wastes (which may include abandoned or discarded products), or hazardous constituents from wastes, are considered SWMUs.

**Treatment, storage, or disposal facility (TSDF).** Related to RCRA: with some exceptions, any facility that treats hazardous wastes; any facility that stores hazardous wastes, except generators who store their own wastes for less than 90 days for subsequent transport off-site; or any facility that serves to receive hazardous waste and disposes of it.

**Unilateral administrative order.** Order issued unilaterally by the EPA under section 106(a) of CERCLA to PRPs, or to non-PRPs such as adjacent landowners, requiring them to take a response action. Unilateral administrative orders contain findings of fact and conclusions of law, and they specify the work to be performed and the EPA's right to take over the work in the event of noncompliance, inadequate performance, or an emergency. A unilateral administrative order does not allocate conduct required by the order between individual PRPs; however, the EPA may issue carve-out orders requiring individual PRPs to perform specific actions. Also referred to as a "section 106 order."

**Unknown PRP.** A party that has liability with respect to a Superfund site, but that has not yet been identified as a potentially responsible party by the U.S. EPA or by an analogous state agency.

**Unproven PRP.** A party that has been identified as a potentially responsible party for a Superfund site by the U.S. Environmental Protection Agency or by an analogous state agency, but that does not acknowledge potential involvement with respect to the site because no evidence has been presented linking the party to the site. Also referred to as a *hiding-in-the-weeds PRP*.

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The task force and staff gratefully acknowledge the contributions made to the development of this Statement of Position by Peter L. Gray and Steven M. Oster and by former members Larry Farmer and Victor Sussman.

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[The next page is 20,301.]



## Section 10,690

# Statement of Position 97-1 Accounting by Participating Mortgage Loan Borrowers

May 9, 1997

### NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## Scope

.01 This Statement of Position (SOP) establishes the borrower's accounting for a participating mortgage loan if the lender is entitled to participate in appreciation in the market value of the mortgaged real estate project, the results of operations of the mortgaged real estate project, or in both. This SOP applies to all borrowers in participating mortgage loan arrangements.

.02 This SOP does not apply to participating leases, debt convertible at the option of the lender into equity ownership of the property, or participating loans resulting from troubled debt restructurings.<sup>1</sup> It also does not apply to creditors in participating mortgage loan arrangements.

## Background

.03 Through the 1960s, most loans collateralized by real estate projects had fixed interest rates and long-term payment periods with full amortization

<sup>1</sup> Accounting for leases is addressed in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 13, *Accounting for Leases*. Accounting for debt convertible at the option of the lender into equity ownership of the property is addressed in Accounting Principles Board (APB) Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*. Participating loans originating from troubled debt restructurings should be accounted for in conformity with FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*.

of principal. Thereafter, loans with variable features, such as adjustable interest rates and variable payments, began to emerge. The desire for instruments in which the return to the lenders was tied more closely to the performance of the property led to the introduction of participating mortgage loans.

.04 Participating mortgage loans and nonparticipating mortgage loans share the following characteristics:

- Debtor-creditor relationships between those who provide initial cash outlays and hold the mortgages, and those who are obligated to make subsequent payments to the mortgage holders
- Real estate collateral
- Periodic fixed-rate or floating-rate interest payments
- Fixed maturity dates for stated principal amounts

.05 However, unlike a nonparticipating mortgage loan arrangement, in a participating mortgage loan, the lender participates in appreciation in the market value of the mortgaged real estate project or the results of operations of the mortgaged real estate project, or in both. The terms and economics of participating mortgage loan agreements vary by agreement. The terms and economics of one agreement may create a circumstance in which any participation payment is remote. In another agreement, the terms and economics may transfer many of the risks and rewards of property ownership.

.06 A lender may be entitled to participate in appreciation in the market value of a project either upon the sale of the project, at a deemed sale date, or at the maturity or refinancing of the loan. In agreements in which lenders participate in results of operations, the definition of the results of operations may vary among agreements. Examples of these definitions include but are not limited to revenue, income, or cash flows before or after debt service.

.07 The participation terms of a participating mortgage loan agreement usually are negotiated concurrently with the other terms of the underlying mortgage loan. A borrower agrees to participation rights generally because of market conditions, or in exchange for concessions granted by the lender on some other term(s) of the loan, such as a lower interest rate or a higher loan-to-value ratio.

.08 The lender's participation reduces the borrower's potential realization of operating results or gain on the sale of the real estate. However, the participation also may reduce the following:

- The contract interest the borrower is required to pay
- The risk that the borrower will be unable to pay interest at the stated or floating rate in the loan agreement and, consequently, the risk that the borrower will default on the loan and need to sell the property
- The amount of capital the borrower has at risk, because the loan-to-value ratio normally is higher

Further, the obligation to pay the lender a share of the property appreciation does not increase the current exposure of the borrower to loss in its investment, because the participation payments are made only if the market value of the property appreciates.

.09 In FASB Emerging Issues Task Force (EITF) Issue No. 86-28, *Accounting Implications of Indexed Debt Instruments*, the EITF considered indexed debt instruments, including participating mortgage obligations. The

consensus indicates that the borrower's obligation under a participating mortgage to pay the lender a share of unrealized property appreciation should be recognized as a liability immediately when the property appreciates. A consensus was not reached, however, on how to account for the corresponding charge. In order to enhance consistency in practice, this SOP provides additional guidance that specifically addresses the borrower's accounting for participating mortgage loans.

## Conclusions

### At Origination

.10 If the lender is entitled to participate in appreciation in the market value of the mortgaged real estate project, the borrower should determine the fair value of the participation feature at the inception of the loan. The borrower should recognize a participation liability for that amount, with a corresponding debit to a debt discount account. The debt discount should be amortized by the interest method, using the effective interest rate.

### Interest Expense

.11 Interest expense on participating mortgage loans consists of the following three components:

- a. Amounts designated in the mortgage agreement as interest
- b. Amounts related to the lender's participation in results of operations
- c. Amortization of debt discount related to the lender's participation in the market value appreciation of the mortgaged real estate project

#### ***Amounts Designated in the Mortgage Agreement as Interest***

.12 Amounts designated in the mortgage agreement as interest should be charged to income in the period that the interest is incurred. If the loan's stated interest rate varies based on changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate, or the United States Treasury bill weekly average rate), the calculation of the interest should be based on the factor (the index or the rate) as it changes over the life of the loan.

#### ***Amounts Related to the Lender's Participation in the Results of the Operations of the Mortgaged Real Estate Project***

.13 Amounts due to a lender pursuant to the lender's participation in the real estate project's results of operations (as defined in the participating mortgage loan agreement) should be charged to interest expense in the borrower's corresponding financial reporting period, with a corresponding credit to the participation liability.

#### ***Amounts Related to the Lender's Participation in the Market Value Appreciation of the Mortgaged Real Estate Project***

.14 As discussed in paragraph .10 of this SOP, if the lender is entitled to participate in appreciation in the market value of the mortgaged real estate

project, at the inception of the loan the borrower should establish a participation liability equal to the fair value of the participation feature. The corresponding debit should be to a debt-discount account and should be amortized by the interest method over the life of the loan, using the effective interest rate. This amortization should be included in interest expense.<sup>2</sup>

### **Accounting for a Participation in Appreciation Subsequent to Inception of the Loan**

.15 At the end of each reporting period, the balance of the participation liability should be adjusted to equal the current fair value of the participation feature. The corresponding debit or credit should be to the related debt-discount account. The revised debt discount should be amortized prospectively, using the effective interest rate.

### **Extinguishment of Participating Mortgage Loans**

.16 If the participating mortgage loan is extinguished prior to its due date, the difference between the recorded amount of the debt (including the unamortized debt discount and the participation liability) and the amount exchanged to extinguish the debt is a debt extinguishment gain or loss that should be reported as required by FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*.

### **Disclosures**

.17 The borrower's financial statements should disclose the following:

- The aggregate amount of participating mortgage obligations at the balance-sheet date, with separate disclosure of the aggregate participation liabilities and related debt discounts
- Terms of the participations by the lender in either the appreciation in the market value of the mortgaged real estate project or the results of operations of the mortgaged real estate project, or both

### **Effective Date and Transition**

.18 This SOP is effective for financial statements issued for fiscal years beginning after June 30, 1997, and for financial statements for interim periods in such years. The effect of the initial application of the provisions of this SOP should be reported as a cumulative effect of a change in accounting principle. Presentation of pro forma effects of retroactive application is not required. Restatement of previously issued annual financial statements is not permitted.

.19 Early adoption is encouraged but not required. If a decision is made to adopt the provisions of this SOP in a fiscal year beginning on or before June 30, 1997, and the decision is made in other than the first interim period of the fiscal year, financial statements for previous interim periods of that year should be restated.

.20 For participating loans with variable interest rates, the cumulative effect of adoption should be calculated using the interest rate in effect at incep-

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<sup>2</sup> Interest recognized pursuant to this SOP is subject to the requirements of FASB Statement No. 34, *Capitalization of Interest Costs*. Once capitalized, amounts should not be adjusted for the effects of reversals of appreciation.

tion of the participating mortgage loan. The initial interest rate should be treated as a fixed rate for purposes of this calculation.

**The provisions of this Statement of Position need not be applied to immaterial items.**

## Basis for Conclusions

### At Origination

.21 In a participating mortgage loan arrangement, the lender generally grants certain concessions to the borrower in return for the right to participate in either the appreciation in the market value of the mortgaged real estate project or the operations of the mortgaged real estate project, or in both. A common concession is granting an interest rate lower than that which would have been included in a comparable nonparticipating mortgage loan. Another common concession is a higher loan-to-value ratio than would be allowed at the same interest rate in a loan that does not include the participation in appreciation. AcSEC believes that in participating loan arrangements, the borrower has received something of value (the lower interest rate) in exchange for something of value (the participation feature) and that such exchanges should be given accounting recognition.

.22 Paragraph 11 of Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, states that "If cash and some other rights or privileges are exchanged for a note, the value of the rights or privileges should be given accounting recognition as described in paragraph 7." The participation feature included in the loan represents such a right. The participation feature has a market value separate from the loan agreement itself. In order to eliminate the participation feature while retaining the other terms of the mortgage loan, the borrower would be required to make a payment to the lender equal to the market value of the participation feature.

.23 The proposed accounting in the exposure draft that preceded this SOP would have required that borrowers record the loan at inception without allocating any of the proceeds to a liability related to the participation feature. AcSEC had been concerned about the ability to separately price the rights to participate in appreciation in value. AcSEC was informed by several respondents, however, that borrowers do have the ability to price these participation features separately. AcSEC, therefore, modified its original position to require that a separate liability for the participation in appreciation be recognized at inception and that liability should be measured at the fair value of the participation feature.

.24 Also, because of the participation feature, the stated rate of interest on the loan is less than the market rate of interest. AcSEC believes that, in accordance with paragraph 7 of APB Opinion 21, a discount, equal in amount to the fair value of the participation feature, should be established for this difference. That discount should be amortized over the life of the loan.

.25 Although AcSEC notes that a participation in the operations of a mortgaged property can be valued similarly, AcSEC believes that the cost of monitoring and updating the information needed to record and review the ongoing estimate of such a liability would exceed the benefits to be gained by reporting the liability. Consequently, AcSEC concluded that amounts due to a

lender pursuant to a participation in operations of the mortgaged real estate should be included in interest expense in the borrower's corresponding financial reporting period.

## Interest Expense

.26 Paragraph 15 of APB Opinion 21 requires that the difference between the present value and the face amount of a note be treated as a discount or premium and be amortized over the life of the note in such a way as to result in a constant rate of interest when applied to the carrying amount at the beginning of any given period. Consequently, AcSEC concluded that requiring amortization of the debt discount using the interest method is consistent with paragraph 15 of APB Opinion 21.

.27 Additionally, as discussed in paragraph .25 of this SOP, AcSEC believes that the cost of monitoring and updating the information needed to record and review the fair value of a lender's participation in operations would exceed the benefits to be gained by adjusting the liability. Consequently, AcSEC concluded that amounts due to a lender pursuant to a participation in operations of the mortgaged real estate should be treated as interest expense in the borrower's corresponding financial reporting period and that they should be accounted for in a manner consistent with the accounting for amounts designated in the mortgage loan agreement as interest.

## Accounting for a Participation in Appreciation Subsequent to Inception of the Loan

.28 This SOP requires adjustment of the participation liability at each reporting date to its fair value. The exposure draft would have required the borrower to estimate at each balance sheet date the value on which the participation payment would have been based. For example, if the borrower would have been required to make a payment to the lender pursuant to the participation feature if the property were sold at the balance sheet date, the borrower would have been required to recognize a participation liability at the financial statement date equal to the estimated amount of the payment.

.29 Each period, the participation liability would have been debited or credited, if necessary, to adjust the balance in the account to the amount that would have been paid to the lender if the property were sold at its then-estimated market value or if the mortgage loan matured or was refinanced at that date. The corresponding debit or credit would have been made to the related debt-discount account. When applying the interest method, the borrower would have been required to recalculate the effective interest rate to reflect the changes in expected future payments (exclusive of payments related to participations in operations) assuming that (a) the expected future payment pursuant to the participation feature was to be paid on the due date of the loan and (b) the recalculated expected future payment amount was known at the inception of the loan. The debt discount related to the participation liability would have been adjusted to the amount that would have existed had the new effective interest rate been applied since the origination of the participating mortgage loan. In addition, a corresponding charge or credit to interest expense for this cumulative interest adjustment would have been required.

.30 Several respondents to the exposure draft commented that the proposed accounting in the exposure draft was unnecessarily complex and would

have been costly and burdensome to apply. These respondents also commented that the proposed annual cumulative catch-up adjustment would lead to volatility of earnings. These respondents stated that changes in residual-value estimates and their effect on interest rates were more analogous to modifications of interest rates of debt instruments, which are accounted for prospectively. AcSEC considered these comments and agreed that the accounting should be simplified.

.31 This SOP does not require that the borrower's entire debt obligation (including the participation feature) be recorded at fair value. The underlying debt obligation should be recorded at amortized cost, while the participation feature should be recorded at fair value. AcSEC notes that recording debt obligations at fair value is not common practice. Therefore, AcSEC concluded that the underlying debt obligation should continue to be recorded on an amortized cost basis.

.32 However, AcSEC believes that the amortized cost basis is not meaningful with respect to the participation feature. AcSEC believes that because the fair value of the participation feature represents the best estimate of the amount at which it could be settled, the participation feature should be recorded at its fair value.

.33 AcSEC believes that requiring recognition in the current period of the entire amount of the change in the fair value of the participation feature would result in unnecessary volatility. AcSEC notes that the impact of factors that affect effective yields (for example, changes in interest rates) is commonly recognized prospectively. Therefore, AcSEC concluded that changes in the fair value of the participation feature should be amortized into income prospectively as adjustments to the effective yield.

.34 AcSEC believes that this approach results in relevant and reliable reported information about the obligation, that it is broadly consistent with existing practices in accounting for liabilities, and that it alleviates respondents' concerns about complexity and costliness.

.35 Other methods considered and rejected by AcSEC included (a) offsetting changes in the participation liability by changing the reported amount of the related asset, (b) requiring disclosure, but not recognition, of the lender's share in the appreciation, and (c) requiring adjustment of the participation liability balance to the amount that would have been paid to the lender if the property were sold at its estimated market value at the reporting date.

### ***Increasing the Reported Amount of the Asset***

.36 AcSEC considered a method under which any change to the participation liability would have been offset by changes in the reported amount of the related asset. This method was proposed by several respondents to the exposure draft. These respondents noted that the change in value of the asset was the underlying and directly offsetting source of the change in the participation liability. They commented that it was troubling that the determination of the property's value is considered reliable enough to recognize and measure a potential obligation and a charge to operations in accordance with FASB Statement No. 5, *Accounting for Contingencies*, but is not reliable enough to recognize an increase in the value of the asset. AcSEC concluded that to use an asset to account for changes in the value of the property would be inconsistent with the historical cost model of accounting. Furthermore, AcSEC believes that amounts due pursuant to participation features represent additional interest

on the participating mortgages. Therefore, AcSEC believes that the amount should be recognized as interest expense over the life of the loan. If the change in the participation liability had been offset by changing the reported amount of the related asset, that change would have been recognized through depreciation over the remaining depreciable life of the asset, which only coincidentally would match the remaining life of the loan.

### **Disclosure**

.37 Several respondents to the exposure draft recommended that AcSEC require only disclosure of the lender's share of the appreciation in value of the property or properties. This position appeared to be linked to disagreement with the accounting proposed in the exposure draft. These respondents opposed recording a lender's share of the appreciation in value without recognizing a corresponding increase in the value of the asset. AcSEC considered these comments but notes that disclosure is not a substitute for recognition in financial statements for items that meet recognition criteria.

### **Disclosures**

.38 AcSEC believes that the disclosures required by this SOP are necessary to provide users with adequate information related to the financial position of borrowers in participating mortgage loan arrangements. AcSEC believes that, given the susceptibility of real estate to fluctuations in value, requiring disclosure of the terms of the participations provides users of financial statements with information that is helpful in assessing the risks facing participating mortgage loan borrowers.

### **Transition**

.39 AcSEC believes that the adoption of this SOP constitutes a change in accounting principle for which the advantages of retroactive treatment in prior-period financial statements do not outweigh the disadvantages, as discussed in paragraphs 27 to 30 of APB Opinion 20, *Accounting Changes*. Accordingly, AcSEC concluded that the effect of initial application of this SOP should be reported as a cumulative effect of a change in accounting principle.



## Appendix

### Illustration of a Participation in Appreciation

**A-1.** Assume that on January 1, 19X1, Borrower Co. purchased a property for \$10 million. On that date, Borrower paid \$1 million cash and entered into a participating mortgage loan agreement with Lender Co. in the amount of \$9 million.

**A-2.** The loan agreement has the following terms:

- Fifteen-year term
- Interest-only periodic payments, principal to be repaid at end of term
- Five-percent stated interest rate
- Twenty-percent participation in appreciation in the value of the property above \$10 million, payable at maturity (or earlier if the asset is sold or the loan is refinanced)

**A-3.** Assumptions related to the fair value of the participation feature are as follows:

<u>Date</u>	<u>Fair Value</u>	<u>Estimated Payment</u>	<u>Years in Future</u>
1/1/X1	\$25,055	\$300,000	15
12/31/X1	40,063	320,000	14
12/31/X2	54,122	333,000	13

**A-4.** Based on the preceding assumptions, Borrower Co. should make the following journal entries for this participating mortgage loan.

a. On January 1, 19X1, the following journal entries should be recorded:

Cash	\$ 9,000,000	
Loan discount	25,055	
Mortgage loan payable		9,000,000
Participation liability		25,055

To record participating debt and estimate of participation liability (based on fair value of participation feature).

Property	\$10,000,000	
Cash		10,000,000

To record purchase of property.

b. By the end of 19X1, entries to record interest expense and amortization of discount throughout the year would have taken the following form:

Interest expense	\$ 451,159	
Interest payable		450,000
Loan discount		1,159

To record interest expense and amortization of debt discount using the interest method and an effective rate of 5.03 percent (rounded).

Statements of Position

Loan discount	\$ 15,008	
Participation liability		15,008

To adjust balance of participation liability to fair value at end of period. The adjustment is calculated as follows:

Fair value at 12/31/X1	\$ 40,063
Fair value at 1/1/X1	25,055
Adjustment	<u>\$ 15,008</u>

*Note:* For purposes of this illustration, the fair value of the participation feature at 12/31/X1 is based on a revised estimate of the equity participation that would be payable in fourteen years of \$320,000.

- c. At the end of 19X2, entries to record interest expense and amortization of discount throughout the year would have taken the following form:

Interest expense	\$451,979	
Interest payable		450,000
Loan discount		1,979

To record interest expense and amortization of debt discount, using the interest method and an effective rate of 5.04 percent (rounded).

Loan discount	\$ 14,059	
Participation liability		14,059

To adjust recorded participation liability of \$40,063 to fair value at 12/31/X2 of \$54,122.

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[The next page is 20,321.]



## Section 10,700

# Statement of Position 97-2 Software Revenue Recognition

An effective date provision of this SOP has been deferred by SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition*. See section 10,740. These SOPs have been further amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*. See section 10,770 for the full text of these changes.

October 27, 1997

### NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## Introduction

.01 Statement of Position (SOP) 91-1, *Software Revenue Recognition*, was issued in 1991 to provide guidance on applying generally accepted accounting principles to software transactions and to narrow the range of revenue recognition practices that were in use before its issuance. Since the issuance of SOP 91-1, practice issues have been identified that the AICPA's Accounting Standards Executive Committee (AcSEC) believes are not addressed adequately in SOP 91-1. In addition, AcSEC believes some of the guidance in SOP 91-1 should be reconsidered. This SOP supersedes SOP 91-1.

## Scope

.02 This SOP provides guidance on when revenue should be recognized and in what amounts for **licensing**, selling, leasing, or otherwise marketing computer software.<sup>1</sup> It should be applied to those activities by all entities that earn such revenue. It does not apply, however, to revenue earned on products or services containing software that is incidental<sup>2</sup> to the products or services as a whole.

<sup>1</sup> Terms defined in the glossary are set in **boldface** type the first time they appear in this SOP.

<sup>2</sup> Indicators of whether software is incidental to a product as a whole include (but are not limited to) (a) whether the software is a significant focus of the marketing effort or is sold separately, (b) whether the vendor is providing postcontract customer support, and (c) whether the vendor incurs significant costs that are within the scope of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. An example of the applicability of this SOP to revenue earned on products containing software is included in appendix A [paragraph .146].

.03 In connection with the licensing of an existing product, a vendor might offer a small discount (for example, a coupon or other form of offer for five percent off) on additional licenses of the licensed product or other products that exist at the time of the offer but are not part of the arrangement. Such marketing and promotional activities are not unique to software and are not included in the scope of this SOP.<sup>3</sup>

## Relationship to Other Pronouncements

.04 If a lease of software includes property, plant, or equipment, the revenue attributable to the property, plant, or equipment should be accounted for in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 13, *Accounting for Leases*, and any revenue attributable to the software, including **postcontract customer support (PCS)**, should be accounted for separately in conformity with the guidance set forth in this SOP. However, in conformity with paragraph .02, if the property, plant, or equipment contains software that is incidental to the property, plant, or equipment as a whole, the software should not be accounted for separately.

.05 A number of the requirements of this SOP are similar to or overlap those in certain pronouncements of the Accounting Principles Board (APB) or the FASB, such as FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*. This SOP does not alter the requirements of any APB Opinion or FASB pronouncement.

## Conclusions

.06 The following conclusions should be read in conjunction with the *Basis for Conclusions* section, beginning with paragraph .93 of this SOP, and the examples in appendix A, *Examples of the Application of Certain Provisions of this SOP* [paragraph .146].

## Basic Principles

.07 Software arrangements range from those that provide a license for a single software product to those that, in addition to the **delivery** of software or a software system, require significant production, modification, or customization of software. If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement should be accounted for in conformity with Accounting Research Bulletin (ARB) No. 45, *Long-Term Construction-Type Contracts*, using the relevant guidance herein, and in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* [section 10,330].<sup>4</sup>

.08 If the arrangement does not require significant production, modification, or customization of software, revenue should be recognized when all of the following criteria are met.

- Persuasive evidence of an arrangement exists.
- Delivery has occurred.

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<sup>3</sup> As discussed in paragraph .09, arrangements may include multiple elements. If the discount or other concessions in an arrangement are more than insignificant, a presumption is created that an additional element(s) (as defined in paragraph .09) is being offered in the arrangement.

<sup>4</sup> If a software arrangement includes services that meet the criteria discussed in paragraph .65 of this SOP, those services should be accounted for separately.

- The vendor's fee is fixed or determinable.
- Collectibility is probable.<sup>5</sup>

.09 Software arrangements may provide licenses for multiple software deliverables (for example, software products, **upgrades/enhancements**, PCS, or services), which are termed multiple *elements*. A number of the elements may be described in the arrangement as being deliverable only on a **when-and-if-available** basis. When-and-if-available deliverables should be considered in determining whether an arrangement includes multiple elements. Accordingly, the requirements of this SOP with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only on a when-and-if-available basis.

.10 If an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated within the contract for each element. Vendor-specific objective evidence of fair value is limited to the following:

- The price charged when the same element is sold separately
- For an element not yet being sold separately, the price established by management having the relevant authority; it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace

The amount allocated to undelivered elements is not subject to later adjustment.<sup>6</sup> However, if it becomes probable that the amount allocated to an undelivered element will result in a loss on that element of the arrangement, the loss should be recognized pursuant to FASB Statement No. 5, *Accounting for Contingencies*. When a vendor's pricing is based on multiple factors such as the number of products and the number of users, the amount allocated to the same element when sold separately must consider all the factors of the vendor's pricing structure.

.11 If a discount is offered in a multiple-element arrangement, a proportionate amount of that discount should be applied to each element included in the arrangement based on each element's fair value without regard to the discount. However, as discussed in paragraph .37, no portion of the discount should be allocated to any upgrade rights. Moreover, to the extent that a discount exists, the residual method described in paragraph .12 attributes that discount entirely to the delivered elements. [Paragraph amended, effective for transactions entered into in fiscal years beginning after March 15, 1999, by Statement of Position 98-9.]

.12 If sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement should be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered. The following exceptions to this guidance are provided.

- If the only undelivered element is PCS, the entire fee should be recognized ratably (see paragraphs .56 through .62).

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<sup>5</sup> The term *probable* is used in this SOP with the same definition as used in FASB Statement No. 5, *Accounting for Contingencies*.

<sup>6</sup> This does not apply to changes in the estimated percentage of customers not expected to exercise an upgrade right. See paragraph .37.

- If the only undelivered element is services that do not involve significant production, modification, or customization of software (for example, training or installation), the entire fee should be recognized over the period during which the services are expected to be performed (see paragraphs .63 through .71).
- If the arrangement is in substance a subscription, the entire fee should be recognized ratably (see paragraphs .48 and .49).
- If the fee is based on the number of copies, the arrangement should be accounted for in conformity with paragraphs .43 through .47.
- There may be instances in which there is vendor-specific objective evidence of the fair values of *all* undelivered elements in an arrangement but vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement. In such instances, the fee should be recognized using the residual method, provided that (a) all other applicable revenue recognition criteria in this SOP are met and (b) the fair value of all of the undelivered elements is less than the arrangement fee. Under the residual method, the arrangement fee is recognized as follows: (a) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and (b) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

[Paragraph amended, effective for transactions entered into in fiscal years beginning after March 15, 1999, by Statement of Position 98-9.]

.13 The portion of the fee allocated to an element should be recognized as revenue when the criteria in paragraph .08 of this SOP are met with respect to the element. In applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element, because the **customer** would not have the full use of the delivered element.

.14 No portion of the fee (including amounts otherwise allocated to delivered elements) meets the criterion of collectibility if the portion of the fee allocable to delivered elements is subject to forfeiture, refund, or other concession if any of the undelivered elements are not delivered. In order for the revenue related to an arrangement to be considered not subject to forfeiture, refund, or other concession, management must intend not to provide refunds or concessions that are not required under the provisions of the arrangement. All available evidence should be considered to determine whether the evidence persuasively indicates that the revenue is not subject to forfeiture, refund, or other concession. Although no single item of evidence may be persuasive, the following additional items should be considered:

- Acknowledgment in the arrangement of products not currently available or not to be delivered currently
- Separate prices stipulated in the arrangement for each deliverable element
- Default and damage provisions as defined in the arrangement
- Enforceable payment obligations and due dates for the delivered elements that are not dependent on the delivery of the future deliverable elements, coupled with the intent of the vendor to enforce rights of payment
- Installation and use of the delivered software



- Support services, such as telephone support, related to the delivered software being provided currently by the vendor

Regardless of the preceding, the vendor's historical pattern of making refunds or other concessions that were not required under the original provisions (contractual or other) of other arrangements should be considered more persuasive than terms included in the arrangement that indicate that no concessions are required.

## **Evidence of an Arrangement**

.15 Practice varies with respect to the use of written contracts. Although a number of sectors of the industry rely upon signed contracts to document arrangements, other sectors of the industry that license software (notably the packaged software sector) do not.

.16 If the vendor operates in a manner that does not rely on signed contracts to document the elements and obligations of an arrangement, the vendor should have other forms of evidence to document the transaction (for example, a purchase order from a third party or on-line authorization). If the vendor has a customary business practice of utilizing written contracts, evidence of the arrangement is provided only by a contract signed by both parties.

.17 Even if all other requirements set forth in this SOP for the recognition of revenue are met (including delivery), revenue should not be recognized on any element of the arrangement unless persuasive evidence of an arrangement exists.

## **Delivery**

.18 The second criterion in paragraph .08 for revenue recognition is delivery. The principle of not recognizing revenue before delivery applies whether the customer is a **user** or a **reseller**. Except for arrangements in which the fee is a function of the number of copies, delivery is considered to have occurred upon the transfer of the product master or, if the product master is not to be delivered, upon the transfer of the first copy. For software that is delivered electronically, the delivery criterion of paragraph .08 is considered to have been met when the customer either (a) takes possession of the software via a download (that is, when the customer takes possession of the electronic data on its hardware), or (b) has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software. In such cases, revenue should be recognized if the other criteria of paragraph .08 have been satisfied.

.19 Paragraphs .20 through .25 provide guidance on determining whether delivery is considered to have occurred in certain kinds of software transactions.

### **Customer Acceptance**

.20 After delivery, if uncertainty exists about customer acceptance of the software, license revenue should not be recognized until acceptance occurs.

### **Determining Delivery—Multiple Copies of Software Products Versus Multiple Licenses**

.21 Arrangements to use multiple copies of a software product under **site licenses** with users and to market multiple copies of a software product under similar arrangements with resellers should be distinguished from arrangements to use or market multiple single licenses of the same software.

- In the former kind of arrangement, duplication is incidental to the arrangement and the delivery criterion is met upon the delivery of the

first copy or product master. The vendor may be obligated to furnish up to a specified number of copies of the software, but only if the copies are requested by the user. The licensing fee is payable even if no additional copies are requested by the user or reseller. If the other criteria in this SOP for revenue recognition are met, revenue should be recognized upon delivery of the first copy or product master. The estimated costs of duplication should be accrued at that time.

- In the latter kind of arrangement, the licensing fee is a function of the number of copies delivered to, made by, or deployed by the user or reseller. Delivery occurs and revenue should be recognized as the copies are made by the user or sold by the reseller if the other criteria in this SOP for revenue recognition are met.

### ***Delivery Other Than to the Customer***

.22 Delivery should not be considered complete unless the destination to which the software is shipped is the customer's place of business or another site specified by the customer. In addition, if a customer specifies an intermediate site but a substantial portion of the fee is not payable until the delivery by the vendor to another site specified by the customer, revenue should not be recognized until the delivery is made to that other site.

### ***Delivery Agents***

.23 Vendors may engage agents, often referred to as fulfillment houses, to either duplicate and deliver or only deliver software products to customers. Revenue from transactions involving delivery agents should be recognized when the software is delivered to the customer. Transferring the fulfillment obligation to an agent of the vendor does not relieve the vendor of the responsibility for delivery. This is the case even if the vendor has no direct involvement in the actual delivery of the software product to the customer.

### ***Authorization Codes***

.24 In a number of software arrangements, vendors use **authorization codes**, commonly referred to as *keys*, to permit customer access to software that otherwise would be restricted. Keys are used in a variety of ways and may serve different purposes. For example, permanent keys may be used to control access to the software, or additional permanent keys may be necessary for the duplication of the software. Temporary keys may be used for the same purposes and also may be used to enhance the vendor's ability to collect payment or to control the use of software for demonstration purposes.

.25 In software arrangements involving the use of keys, delivery of a key is not necessarily required to satisfy the vendor's delivery responsibility. The software vendor should recognize revenue on delivery of the software if all other requirements for revenue recognition under this SOP and all of the following conditions are met.

- The customer has licensed the software and the vendor has delivered a version of the software that is fully functional except for the permanent key or the additional keys (if additional keys are used to control the reproduction of the software).
- The customer's obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on delivery of the permanent key or additional keys (if additional keys are used to control the reproduction of the software).

- The vendor will enforce and does not have a history of failing to enforce its right to collect payment under the terms of the original arrangement.

In addition, if a temporary key is used to enhance the vendor's ability to collect payment, the delivery of additional keys, whether temporary or permanent, is not required to satisfy the vendor's delivery responsibility if (a) the above conditions are met and (b) the use of a temporary key in such circumstances is a customary practice of the vendor. Selective issuance of temporary keys might indicate that collectibility is not probable or that the software is being used only for demonstration purposes.

### **Fixed or Determinable Fees and Collectibility**

.26 The other prerequisites in paragraph .08 for revenue recognition are that (a) the vendor's fee is fixed or determinable and (b) collectibility is probable. A software licensing fee is not fixed or determinable if the amount is based on the number of units distributed or copied, or the expected number of users of the product. Revenue recognition for variable-pricing arrangements is discussed in paragraphs .43 through .47 of this SOP. Additionally, if an arrangement includes (a) rights of return or (b) rights to refunds without return of the software, FASB Statement No. 48 requires that conditions that must be met in order for the vendor to recognize revenue include that the amount of future returns or refunds can be reasonably estimated.

### **Factors That Affect the Determination of Whether a Fee is Fixed or Determinable and Collectible**

.27 A number of arrangements that call for fixed or determinable payments, including minimum royalties or license fees from resellers, specify a payment period that is short in relation to the period during which the customer is expected to use or market the related products. Other arrangements have payment terms that extend over a substantial portion of the period during which the customer is expected to use or market the related products. Because a product's continuing value may be reduced due to the subsequent introduction of enhanced products by the vendor or its competitors, the possibility that the vendor still may provide a refund or concession to a creditworthy customer to liquidate outstanding amounts due under the original terms of the arrangement increases as payment terms become longer.

.28 For the reason cited in paragraph .27 any extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable. Further, if payment of a significant portion of the software licensing fee is not due until after expiration of the license or more than twelve months after delivery, the licensing fee should be *presumed* not to be fixed or determinable. However, this presumption may be overcome by evidence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. In such a situation, a vendor should consider such fees fixed or determinable and should recognize revenue upon delivery of the software, provided all other conditions for revenue recognition in this SOP have been satisfied.

.29 If it cannot be concluded that a fee is fixed or determinable at the outset of an arrangement, revenue should be recognized as payments from customers become due (assuming all other conditions for revenue recognition in this SOP have been satisfied).

.30 For reseller arrangements, the following factors also should be considered in evaluating whether the fixed or determinable fee and collectibility criteria for revenue recognition are met.

- Business practices, the reseller's operating history, competitive pressures, informal communications, or other factors indicate that payment is substantially contingent on the reseller's success in distributing individual units of the product.<sup>7</sup>
- Resellers are new, undercapitalized, or in financial difficulty and may not demonstrate an ability to honor a commitment to make fixed or determinable payments until they collect cash from their customers.
- Uncertainties about the potential number of copies to be sold by the reseller may indicate that the amount of future returns cannot be reasonably estimated on delivery; examples of such factors include the newness of the product or marketing channel, competitive products, or dependence on the market potential of another product offered (or anticipated to be offered) by the reseller.
- Distribution arrangements with resellers require the vendor to rebate or credit a portion of the original fee if the vendor subsequently reduces its price for a product and the reseller still has rights with respect to that product (sometimes referred to as price protection). If a vendor is unable to reasonably estimate future price changes in light of competitive conditions, or if significant uncertainties exist about the vendor's ability to maintain its price, the arrangement fee is not fixed or determinable. In such circumstances, revenue from the arrangement should be deferred until the vendor is able to reasonably estimate the effects of future price changes and the other conditions of this SOP have been satisfied.

**.31 Customer Cancellation Privileges.** Fees from licenses cancelable by customers are neither fixed nor determinable until the cancellation privileges lapse. Fees from licenses with cancellation privileges expiring ratably over the license period are considered to become determinable ratably over the license period as the cancellation privileges lapse. In applying the provisions of this paragraph, obligations related to warranties for defective software, including warranties that are routine, short-term, and relatively minor, should be accounted for in conformity with FASB Statement No. 5. Additionally, short-term rights of return, such as thirty-day money-back guarantees, should not be considered cancellation privileges; the related returns should be accounted for in conformity with FASB Statement No. 48.

**.32 Fiscal Funding Clauses.** Fiscal funding clauses sometimes are found in software license arrangements in which the licensees are governmental units. Such clauses generally provide that the license is cancelable if the legislature or funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the licensing arrangement.

**.33** Consistent with FASB Technical Bulletin No. 79-10, *Fiscal Funding Clauses in Lease Agreements*, a software licensing arrangement with a governmental unit containing a fiscal funding clause should be evaluated to determine whether the uncertainty of a possible license arrangement cancellation is a remote contingency.<sup>8</sup> If the likelihood is assessed as remote, the software licensing arrangement should be considered noncancelable. Such an assessment should include the factors discussed in paragraphs .27 and .28 of this

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<sup>7</sup> Contractual arrangements under which the reseller is obligated to pay only as and if sales are made to users should be accounted for as consignments.

<sup>8</sup> The evaluation of whether the level of uncertainty of possible cancellation is remote should be consistent with FASB Statement No. 5, which defines *remote* as relating to conditions in which "the chance of the future event or events occurring is slight."

SOP. If the likelihood is assessed as other than remote, the license should be considered cancelable, thus precluding revenue recognition. A fiscal funding clause with a customer other than a governmental unit that is required to include such a clause creates a contingency that precludes revenue recognition until the requirements of the clause and all other provisions of this SOP have been satisfied.

## Multiple-Element Arrangements

.34 As discussed in paragraph .09, multiple-element arrangements to which contract accounting does not apply may include customer rights to any combination of additional software deliverables, services, or PCS. If contract accounting does not apply, individual elements in such arrangements should be accounted for in accordance with paragraphs .08 through .14. Paragraphs .35 through .73 provide guidance on the application of those paragraphs to multiple-element arrangements.

### ***Additional Software Deliverables and Rights to Exchange or Return Software***

.35 As part of a multiple-element arrangement, a vendor may agree to deliver software currently and to deliver additional software in the future. The additional deliverables may include upgrades/enhancements or additional software products. Additionally, a vendor may provide the customer with the right to exchange or return software, including the right to transfer software from one hardware **platform** or operating system to one or more other platforms or operating systems (a **platform-transfer right**).

.36 *Upgrades/enhancements.* As part of a multiple-element arrangement, a vendor may agree to deliver software currently and provide the customer with an **upgrade right** for a specified upgrade/enhancement. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice. (Rights to receive *unspecified* upgrades/enhancements on a when-and-if-available basis are PCS, as it has been redefined in this SOP.) The upgrade right should be accounted for as a separate element in accordance with paragraphs .08 through .14. Guidance on the application of those paragraphs to multiple-element software arrangements that include upgrade rights is given in paragraphs .37 and .38.

.37 If a multiple-element arrangement includes an upgrade right, the fee should be allocated between the elements based on vendor-specific objective evidence of fair value. The fee allocated to the upgrade right is the price for the upgrade/enhancement that would be charged to existing users of the software product being updated. If the upgrade right is included in a multiple-element arrangement on which a discount has been offered (see paragraph .11), no portion of the discount should be allocated to the upgrade right. If sufficient vendor-specific evidence exists to reasonably estimate the percentage of customers that are not expected to exercise the upgrade right, the fee allocated to the upgrade right should be reduced to reflect that percentage. This estimated percentage should be reviewed periodically. The effect of any change in that percentage should be accounted for as a change in accounting estimate.

.38 The amount of the fee allocated to the upgrade right should be recognized as revenue when the conditions in paragraphs .08 through .14 are met. If sufficient vendor-specific objective evidence does not exist for the allocation of the fee to the upgrade right, revenue from the arrangement should

be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered.

**.39 Additional Software Products.** As part of a multiple-element arrangement, a vendor may agree to deliver software currently and deliver specified additional software products in the future. The rights to these additional products may be included either in the terms of a PCS arrangement or in a separate agreement. Even if the rights to the additional software products are included in a PCS arrangement, the revenue allocable to the additional software products should be accounted for separately from the PCS arrangement as an element of a multiple-element arrangement.

**.40 Multiple-element arrangements that include rights to undelivered additional software products that are not subscriptions** (see paragraphs .48 and .49) should be accounted for in accordance with paragraphs .08 through .14 of this SOP. Guidance on the application of those paragraphs to such arrangements is provided in paragraphs .41 through .47 below.

**.41** The fee from the arrangement should be allocated among the products based on vendor-specific objective evidence of fair value. The allocation should be based on the relative sales prices (determined pursuant to paragraphs .10 and .11 of this SOP) of the products. If vendor-specific objective evidence of fair value does not exist, paragraph .12 of this SOP requires that all revenue from the arrangement be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered. The fee allocated to the additional software products should not be reduced by the percentage of any customers that are not expected to exercise the right to receive additional software products.

**.42** If the arrangement is based on a price per product (not a price per copy), the portion of the fee allocated to a product should be recognized as revenue when the product is delivered, assuming all other provisions of paragraphs .08 through .14 of this SOP are met.

**.43** Some **fixed fee** license or reseller arrangements provide customers with the right to reproduce or obtain copies at a specified price per copy (rather than per product) of two or more software products up to the total amount of the fixed fee. A number of the products covered by the arrangement may not be deliverable or specified at the inception of the arrangement. Although the price per copy is fixed at the inception of the arrangement, an allocation of the arrangement fee to the individual products generally cannot be made, because the total revenue allocable to each software product is unknown and depends on the choices to be made by the customer and, sometimes, future development activity while the arrangement is in effect. Nevertheless, as discussed in paragraph .46 of this SOP, in certain situations, revenue can be allocated to the products that are undeliverable or not specified at the inception of the arrangement.

**.44** In arrangements in which no allocation can be made, until the first copy or product master of each product covered by the arrangement has been delivered to the customer assuming the provisions of paragraphs .08 through .14 of this SOP are met, revenue should be recognized as copies of delivered products either (a) are reproduced by the customer or (b) are furnished to the customer if the vendor is duplicating the software. Once the vendor has delivered the product master or the first copy of all products covered by the arrangement, any licensing fees not previously recognized should be recognized.

(At that point, only duplication of the software is required to satisfy the vendor's delivery requirement. As discussed in paragraph .21 of this SOP, duplication of the software is incidental to the arrangement, and delivery is deemed to have occurred upon delivery of the product master or first copy.) When the arrangement terminates, the vendor should recognize any licensing fees not previously recognized.

.45 The revenue from the kind of arrangements discussed in paragraph .44 should not be recognized fully until at least one of the following conditions is met.

- Delivery is complete for all products covered by the arrangement.
- The aggregate revenue attributable to all copies of the software products delivered is equal to the fixed fee, provided that the vendor is not obligated to deliver additional software products under the arrangement.

.46 Nevertheless, certain arrangements that include products that are not deliverable at the inception impose a maximum number of copies of the undeliverable product(s) to which the customer is entitled. In such arrangements, a portion of the arrangement fee should be allocated to the undeliverable product(s). This allocation should be made assuming that the customer will elect to receive the maximum number of copies of the undeliverable product(s).

.47 The revenue allocated to the delivered products should be recognized when the product master or first copy is delivered. If, during the term of the arrangement, the customer reproduces or receives enough copies of these delivered products so that revenue allocable to the delivered products exceeds the revenue previously recognized, such additional revenue should be recognized as the copies are reproduced or delivered. The revenue allocated to the undeliverable product(s) should be reduced by a corresponding amount.

.48 As part of a multiple-element arrangement with a user, a vendor may agree to deliver software currently and to deliver *unspecified* additional software products in the future (including unspecified platform transfer rights that do not qualify for exchange accounting as described in paragraphs .50 through .55). For example, the vendor may agree to deliver all new products to be introduced in a family of products over the next two years. These arrangements are similar to arrangements that include PCS in that future deliverables are unspecified. Nevertheless, they are distinguished from arrangements that include PCS because the future deliverables are products, not unspecified upgrades/enhancements.

.49 The software elements of the kinds of arrangements discussed in paragraph .48 should be accounted for as subscriptions. No allocation of revenue should be made among any of the software products, and all software product-related revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with delivery of the first product. If the term of the arrangement is not stated, the revenue should be recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first product. An intent on the part of the vendor not to develop new products during the term of the arrangement does not relieve the vendor of the requirement to recognize revenue ratably over the term of the arrangement, beginning with the delivery of the first product.

**.50 *Rights to Exchange or Return Software.*** As part of an arrangement, a software vendor may provide the customer with the right to return software or to exchange software for products with no more than minimal differences in price, functionality, or features. The accounting for returns is significantly different from the accounting for exchanges. Although it is sometimes difficult to determine whether a transaction is a return or exchange of software, the fact that the software is not returned physically does not preclude accounting for the transaction as either an exchange or as a return. If the software is not returned physically and the customer contractually is entitled to continue to use the previously delivered software, the arrangement should be accounted for in the manner prescribed in the section herein entitled "Additional Software Products" (see paragraphs .39 through .49). If the software is not returned physically and the customer contractually is not entitled to continue to use the previously delivered software, the transaction should be accounted for either as a return or as an exchange, as discussed in the following paragraphs.

**.51** If the rights discussed in the previous paragraph are offered to users (but not resellers), the exchanges are analogous to "exchanges by ultimate customers of one item for another of the same kind, quality, and price . . . [that] are not considered returns" described in footnote 3 of FASB Statement No. 48. Conversely, exchanges by users of software products for dissimilar software products or for similar software products with more than minimal differences in price, functionality, or features are considered returns, and revenue related to arrangements that provide users with the rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48. If the other product(s) is not available at the time the initial product is delivered, there should be persuasive evidence that demonstrates there will be no more than minimal differences in price, features, or functionality among the products in order for the right to qualify as a right to exchange. Additionally, if the vendor expects to incur a significant amount of development costs related to the other product, the other product should be considered to have more than a minimal difference in functionality.

**.52** As part of a multiple-element arrangement, a vendor may grant a user a platform-transfer right. Depending on the circumstances, the exercise of a platform-transfer right may represent an exchange, a return, or additional software products for accounting purposes. If the customer contractually is entitled to continue to use the software that was delivered originally (in addition to the software that is to be delivered for the new platform), the platform transfer right should be accounted for in the manner prescribed in the section herein entitled "Additional Software Products" (see paragraphs .39 through .49).

**.53** If, as part of a multiple-element arrangement, a vendor offers a user (not a reseller) a platform-transfer right, and the provisions of paragraphs .08 through .14 of this SOP are met, the revenue from the software license should be recognized upon the initial delivery of the software, and the exercise of the platform-transfer right should be treated as an exchange, if the platform-transfer right—

- Is for the same product (see paragraph .54)
- Does not increase the number of copies or concurrent users of the software product available under the license arrangement.

**.54** Products are considered to be the same product if there are no more than minimal differences among them in price, features, and functions, and if



they are marketed as the same product, even though there may be differences arising from environmental variables such as operating systems, databases, user interfaces, and platform scales. Indicators of “marketed as the same product” include (a) the same product name (although version numbers may differ) and (b) a focus on the same features and functions.

.55 As part of their standard sales terms or as a matter of practice, vendors may grant resellers the rights to exchange unsold software for other software (including software that runs on a different hardware platform or operating system). Because the reseller is not the ultimate customer (see paragraph .51), such exchanges, including those referred to as stock balancing arrangements, should be accounted for as returns. Arrangements that grant rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48, even if the vendors require the resellers to purchase additional software to exercise the exchange rights.

### **Postcontract Customer Support**

.56 Software arrangements may include the right to PCS. PCS includes the right to receive PCS services or *unspecified* upgrades/enhancements, or both, offered to users or resellers. A vendor may develop historical patterns of regularly providing all customers or certain kinds of customers with the services or unspecified upgrades/enhancements normally associated with PCS, or may anticipate doing so, even though there is no written contractual obligation or the stipulated PCS term commences at some date after delivery. In those situations, an implied PCS arrangement exists that commences upon product delivery. For purposes of applying the guidance in this SOP, PCS includes a vendor's expected performance based on such patterns, even if performance is entirely at the vendor's discretion and not pursuant to a formal agreement.

.57 If a multiple-element software arrangement includes explicit or implicit rights to PCS, the total fees from the arrangement should be allocated among the elements based on vendor-specific objective evidence of fair value, in conformity with paragraph .10. The fair value of the PCS should be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate). The portion of the fee allocated to PCS should be recognized as revenue ratably over the term of the PCS arrangement, because the PCS services are assumed to be provided ratably. However, revenue should be recognized over the period of the PCS arrangement in proportion to the amounts expected to be charged to expense for the PCS services rendered during the period if—

- Sufficient vendor-specific historical evidence exists demonstrating that costs to provide PCS are incurred on other than a straight-line basis. In making this determination, the vendor should take into consideration allocated portions of cost accounted for as research and development (R&D) costs and the amortization of costs related to the upgrade-enhancement capitalized in conformity with FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. Such costs should be considered as part of the costs to provide PCS.
- The vendor believes that it is probable that the costs incurred in performing under the current arrangement will follow a similar pattern.

Because the timing, frequency, and significance of unspecified upgrades/enhancements can vary considerably, the point at which unspecified upgrades/en-

hancements are expected to be delivered should not be used to support income recognition on other than a straight-line basis.

**.58** If sufficient vendor-specific objective evidence does not exist to allocate the fee to the separate elements and the only undelivered element is PCS, the entire arrangement fee should be recognized ratably over (a) the contractual PCS period (for those arrangements with explicit rights to PCS) or (b) the period during which PCS is expected to be provided (for those arrangements with implicit rights to PCS).

**.59** PCS revenue may be recognized together with the initial licensing fee on delivery of the software if all of the following conditions are met.

- a. The PCS fee is included with the initial licensing fee.
- b. The PCS included with the initial license is for one year or less.
- c. The estimated cost of providing PCS during the arrangement is insignificant.
- d. Unspecified upgrades/enhancements offered during PCS arrangements historically have been and are expected to continue to be minimal and infrequent.

If PCS revenue is recognized upon the delivery of the software, the vendor must accrue all estimated costs of providing the services, including upgrades/enhancements. Upgrades/enhancements are not developed solely for distribution to PCS customers; revenues are expected to be earned from providing the enhancements to other customers as well. Therefore, costs should be allocated between PCS arrangements and other licenses.

**.60** A determination that unspecified upgrades/enhancements offered during the PCS arrangement are expected to be minimal and infrequent should be evidenced by the patterns of minimal and infrequent unspecified upgrades/enhancements offered in previous PCS arrangements. A conclusion that unspecified upgrades/enhancements are expected to be minimal and infrequent should not be reached simply because unspecified upgrades/enhancements have been or are expected to be offered less frequently than on an annual basis. Regardless of the vendor's history of offering unspecified upgrades/enhancements to initial licensees, PCS should be accounted for separately from the initial licensing fee if the vendor expects to offer upgrades/enhancements that are greater than minimal or more than infrequent to the users or resellers of the licensed software during the PCS arrangement.

**.61** *Postdelivery Telephone Support at No Additional Charge.* Postdelivery telephone support provided to users by the vendor at no additional charge should be accounted for as PCS, in conformity with this SOP, regardless of whether the support is provided explicitly under the licensing arrangement. Although such telephone support may be offered or available for periods exceeding one year, if the vendor has established a history of providing substantially all the telephone support within one year of the licensing or sale of the software, the PCS may be considered to have a term of one year or less in applying paragraph .59, item (b) of this SOP. Accordingly, revenue allocable to telephone support may be recognized together with the initial licensing fee on delivery of the software if all the conditions in paragraph .59 of this SOP are met. This provision applies only to telephone support provided at no additional charge. If revenue allocable to telephone support is recognized together with the licensing fee on delivery, the vendor should accrue the estimated cost of providing that support.

**.62 PCS Granted by Resellers.** An arrangement in which a vendor grants a reseller the right to provide unspecified upgrades/enhancements to the reseller's customers is an implied PCS arrangement between the vendor and the reseller, even if the vendor does not provide direct telephone support to the reseller's customers. If sufficient vendor-specific objective evidence does not exist to allocate the fee to the software and the PCS, revenue from both the licensing arrangement and the PCS should be recognized ratably over the period during which PCS is expected to be provided.

### Services

**.63** Certain arrangements include both software and service elements (other than PCS-related services). The services may include training, installation, or consulting. Consulting services often include implementation support, software design or development, or the customization or modification of the licensed software.

**.64** If an arrangement includes such services, a determination must be made as to whether the service element can be accounted for separately as the services are performed. Paragraph .65 discusses the criteria that must be considered in making such a determination. If the nature of the services is such that the service element does not qualify for separate accounting as a service, contract accounting must be applied to both the software and service elements included in the arrangement. Paragraphs .74 through .91 of this SOP address the application of contract accounting to software arrangements.

**.65** In order to account separately for the service element of an arrangement that includes both software and services, sufficient vendor-specific objective evidence of fair value must exist to permit allocation of the revenue to the various elements of the arrangement (as discussed in paragraphs .10 and .12). Additionally, the services (a) must not be essential to the functionality of any other element of the transaction and (b) must be described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services.

**.66** If an arrangement includes services that meet the criteria of paragraph .65 for separate accounting, revenue should be allocated among the service and software elements of the contract. This allocation should be based on vendor-specific objective evidence of fair values. (Fair values are not necessarily the same as any separate prices stated for the separate elements of the arrangement.) Revenue allocated to the service element should be recognized as the services are performed or, if no pattern of performance is discernible, on a straight-line basis over the period during which the services are performed.

**.67** If vendor-specific objective evidence of the fair value does not exist to allocate a portion of the fee to the service element, and the only undelivered element is services that do not involve significant production, modification, or customization of the software (for example, training or installation), the entire arrangement fee should be recognized as the services are performed. If no pattern of performance is discernible, the entire arrangement fee should be recognized on a straight-line basis over the period during which the services are performed.

**.68** An important factor to consider in determining whether the services are essential to the functionality of any other element is whether the software included in the arrangement is considered **core** or **off-the-shelf software**. Core software is software that a vendor uses in creating other software. It is

not sold as is because customers cannot use it unless it is customized to meet system objectives or customer specifications. Off-the-shelf software is software that is marketed as a stock item that can be used by customers with little or no customization.

.69 Software should be considered off-the-shelf software if it can be added to an arrangement with insignificant changes in the underlying code and it could be used by the customer for the customer's purposes upon installation. Actual use by the customer and performance of other elements of the arrangement is not required to demonstrate that the customer could use the software off-the-shelf. If significant modifications or additions to the off-the-shelf software are necessary to meet the customer's purpose (for example, changing or making additions to the software, or because it would not be usable in its off-the-shelf form in the customer's environment), the software should be considered core software for purposes of that arrangement. If the software that is included in the arrangement is not considered to be off-the-shelf software, or if significant modifications or additions to the off-the-shelf software are necessary to meet the customer's functionality, no element of the arrangement would qualify for accounting as a service, and contract accounting should be applied to both the software and service elements of the arrangement.

.70 Factors indicating that the service element is essential to the functionality of the other elements of the arrangement, and consequently should not be accounted for separately, include the following.

- The software is not off-the-shelf software.
- The services include significant alterations to the features and functionality of the off-the-shelf software.
- Building complex interfaces is necessary for the vendor's software to be functional in the customer's environment.
- The timing of payments for the software is coincident with performance of the services.
- **Milestones** or customer-specific acceptance criteria affect the realizability of the software-license fee.

.71 Judgment is required in determining whether the obligation to provide services in addition to the delivery of software should be accounted for separately as a service element. Services that qualify for accounting as a service element of a software arrangement always are stated separately and have one or more of the following characteristics.

- The services are available from other vendors.
- The services do not carry a significant degree of risk or unique acceptance criteria.
- The software vendor is an experienced provider of the services.
- The vendor is providing primarily implementation services, such as implementation planning, loading of software, training of customer personnel, data conversion, building simple interfaces, running test data, and assisting in the development and documentation of procedures.
- Customer personnel are dedicated to participate in the services being performed.

**.72 Funded Software-Development Arrangements.** Software-development arrangements that are fully or partially funded by a party other than the vendor that is developing the software typically provide the funding party with some or all of the following benefits:

- Royalties payable to the funding party based solely on future sales of the product by the software vendor (that is, reverse royalties)
- Discounts on future purchases by the funding party of products produced under the arrangement
- A nonexclusive sublicense to the funding party, at no additional charge, for the use of any product developed (a prepaid or paid-up nonexclusive sublicense)

**.73** A funded software-development arrangement within the scope of FASB Statement No. 68, *Research and Development Arrangements*, should be accounted for in conformity with that Statement. If the technological feasibility of the computer software product pursuant to the provisions of FASB Statement No. 86 has been established before the arrangement has been entered into, FASB Statement No. 68 does not apply because the arrangement is not a research and development arrangement. Accounting for costs related to funded software-development arrangements is beyond the scope of this SOP. However, if capitalization of the software-development costs commences pursuant to FASB Statement No. 86, any income from the funding party under a funded software-development arrangement should be credited first to the amount of the development costs capitalized. If the income from the funding party exceeds the amount of development costs capitalized, the excess should be deferred and credited against future amounts that subsequently qualify for capitalization. Any deferred amount remaining after the project is completed (that is, when the software is available for general release to customers and capitalization has ceased) should be credited to income.

## Contract Accounting

**.74** If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the service element does not meet the criteria for separate accounting set forth in paragraph .65. The entire arrangement should be accounted for in conformity with ARB No. 45, using the relevant guidance in SOP 81-1 [section 10,330]. Nevertheless, transactions that normally are accounted for as product sales should not be accounted for as long-term contracts merely to avoid the delivery requirements normally associated with product sales for revenue recognition.

**.75** In applying contract accounting, the vendor must use either the percentage-of-completion method or the completed-contract method. The determination of the appropriate method should be made according to the recommendations in paragraphs 21 through 33 of SOP 81-1 [section 10,330.21 through .33].

**.76 Segmentation.** Software contracts may have discrete elements that meet the criteria for segmenting in paragraphs 39 through 42 of SOP 81-1 [section 10,330.39 through .42]. If a contract is segmented, each segment is treated as a separate profit center. Progress-to-completion for each segment should be measured in conformity with paragraphs .78 through .80 of this SOP.

.77 Some vendors of arrangements that include software combined with services or hardware or both do not identify the elements separately and do not sell them separately because of agreements with their suppliers. Other vendors who are not restricted by such agreements nevertheless bid or negotiate software and other products and services together. Arrangements that do not meet the segmentation criteria in paragraph 40 of SOP 81-1 [section 10,330.40] are prohibited from being segmented, unless the vendor has a history of providing the software and other products and services to customers under separate arrangements and the arrangement meets the criteria in paragraph 41 of SOP 81-1 [section 10,330.41].

.78 *Measuring Progress-to-Completion Under the Percentage-of-Completion Method.* Paragraph 46 of SOP 81-1 [section 10,330.46] describes the approaches to measuring progress on contracts (or segments thereof) under the percentage-of-completion method. Those approaches are grouped into input and output measures, as follows.

Input measures are made in terms of efforts devoted to a contract. They include the methods based on costs and on efforts expended. Output measures are made in terms of results achieved. They include methods based on units produced, units delivered, contract milestones, and value added. For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed.

For software contracts, an example of an input measure is labor hours; an example of an output measure is arrangement milestones, such as the completion of specific program modules.

.79 If, as discussed in paragraph .76 of this SOP, a software contract includes a discrete element that meets the segmentation criteria of SOP 81-1 [section 10,330], the method chosen to measure progress-to-completion on the element should be the method that best approximates progress-to-completion. Progress-to-completion on separate elements of the same software arrangement may be measured by different methods. The software vendor should choose measurement methods consistently, however, so that it uses similar methods to measure progress-to-completion on similar elements.

.80 Output measures, such as value-added or arrangement milestones, may be used to measure progress-to-completion on software arrangements, but many companies use input measures because they are established more easily. As noted in paragraph 47 of SOP 81-1 [section 10,330.47], "The use of either type of measure requires the exercise of judgment and the careful tailoring of the measure to the circumstances." Further, paragraph 51 of SOP 81-1 [section 10,330.51] states that

The acceptability of the results of input or output measures deemed to be appropriate to the circumstances should be periodically reviewed and confirmed by alternative measures that involve observation and inspection. For example, the results provided by the measure used to determine the extent of progress may be compared to the results of calculations based on physical observations by engineers, architects, or similarly qualified personnel. That type of review provides assurance somewhat similar to that provided for perpetual inventory records by periodic physical inventory counts.

.81 *Input Measures.* Input measures of progress-to-completion on arrangements are made in terms of efforts devoted to the arrangement and, for software arrangements, include methods based on costs, such as cost-to-cost

measures, and on efforts expended, such as labor hours or labor dollars. Progress-to-completion is measured indirectly, based on an established or assumed relationship between units of input and productivity. A major advantage of input measures is that inputs expended are easily verifiable. A major disadvantage is that their relationship to progress-to-completion may not hold if inefficiencies exist or if the incurrence of the input at a particular point does not indicate progress-to-completion.

.82 Costs incurred should be included in measuring progress-to-completion only to the extent that they relate to contract performance. Items not specifically produced for the arrangement, such as hardware purchased from third parties or off-the-shelf software, should not be included in the measurement of progress-to-completion.

.83 Labor hours often are chosen as the basis for measuring progress-to-completion, because they closely approximate the output of labor-intensive processes and often are established more easily than output measures. Core software requires labor-intensive customization. Therefore, labor hours provide a good measure of progress-to-completion on elements of software arrangements that involve the customization of core software.

.84 If the measurement of progress-to-completion is based primarily on costs, the contribution to that progress of hardware and software that were produced specifically for the arrangement may be measurable and recognizable before delivery to the user's site. For example, efforts to install, configure, and customize the software may occur at the vendor's site. The costs of such activities are measurable and recognizable at the time the activities are performed.

.85 *Output Measures.* Progress on arrangements that call for the production of identifiable units of output can be measured in terms of the value added or milestones reached. Although progress-to-completion based on output measures is measured directly from results achieved, thus providing a better approximation of progress than is provided by input measures, output measures may be somewhat unreliable because of the difficulties associated with establishing them.

.86 In order for the value added to be verifiable, the vendor must identify elements or subcomponents of those elements. If output measures are neither known nor reasonably estimable, they should not be used to measure progress-to-completion.

.87 If value added by off-the-shelf software is to be included in the measurement of progress-to-completion, such software cannot require more than minor modifications and must be usable by the customer for the customer's purpose in the customer's environment. If more than minor modifications or additions to the off-the-shelf software are necessary to meet the functionality required under the arrangement terms, either by changing or making additions to the software, or because the software would not be usable by the customer in its off-the-shelf form for the customer's purpose in the customer's environment, it should be accounted for as core software.

.88 Value added by the customization of core software should be included in the measurement of progress-to-completion of the customization and installation at the user's site. However, if the installation and customization processes are divided into separate output modules, the value of core software associated with the customization of a module should be included in the measurement of progress-to-completion when that module is completed.

.89 Contract milestones may be based on contractual project plans. Contractual provisions generally require the performance of specific tasks with the approval or acceptance by the customer; project plans generally schedule inspections in which the project's status is reviewed and approved by management. The completion of tasks that trigger such inspections are natural milestones because they are subject to relatively independent review as an intrinsic part of the project management process.

.90 Considerations other than progress-to-completion affect the amounts that become billable at particular times under many arrangements. Accordingly, although the achievement of contract milestones may cause arrangement revenues to become billable under the arrangement, the amounts billable should be used to measure progress-to-completion only if such amounts indeed indicate such progress.

.91 The milestones that are selected to measure progress-to-completion should be part of the management review process. The percentage-of-completion designated for each milestone should be determined considering the experience of the vendor on similar projects.

## Effective Date and Transition

.92 This SOP is effective for transactions entered into in fiscal years beginning after December 15, 1997. Earlier application is encouraged as of the beginning of fiscal years or interim periods for which financial statements or information have not been issued. Retroactive application of the provisions of this SOP is prohibited. [Note: An effective date provision of this SOP has been deferred by SOP 98-4. See section 10,740.]

<p><b>The provisions of this Statement need not be applied to immaterial items.</b></p>
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## Basis for Conclusions

### Background

.93 SOP 91-1 was issued in December 1991. AcSEC understands that certain provisions of that Statement are being applied inconsistently in practice and that various practice issues have arisen that were not addressed in SOP 91-1. As a result, AcSEC added a project to its agenda in March 1993 to interpret those provisions and provide additional guidance. The key issues identified at the outset of the project related to accounting for arrangements that provided for multiple deliverables (including PCS). The project began as an amendment to SOP 91-1. However, as deliberations progressed, AcSEC determined that it would be more appropriate to supersede SOP 91-1 to (a) amend the provisions in question and (b) incorporate AcSEC's conclusions on practice issues that had not been addressed in SOP 91-1.

### Basic Principles

.94 Transfers of rights to software by licenses rather than by outright sales protect vendors from the unauthorized duplication of their products. Nevertheless, the rights transferred under software licenses are substantially the same as those expected to be transferred in sales of other kinds of products. AcSEC believes the legal distinction between a license and a sale should not cause revenue recognition on software products to differ from revenue recognition on the sale of other kinds of products.



**.95** Arrangements to deliver software or a software system, either alone or together with other products, may include services. AcSEC believes that if those services entail significant production, modification, or customization of the software, such software before those alterations (even if already delivered) is not the product that has been purchased by the customer. Instead, the product purchased by the customer is the software that will result from the alterations. Accordingly, AcSEC concluded that arrangements that include services that entail significant production, modification, or customization of software are construction-type or production-type contracts, and should be accounted for in conformity with ARB No. 45 and SOP 81-1 [section 10,330]. AcSEC concluded that if the services do not entail significant production, modification, or customization of software, the service element should be accounted for as a separate element.

**.96** AcSEC believes that revenue generally should not be recognized until the element has been delivered. The recognition of revenue from product sales on delivery is consistent with paragraphs 83(b) and 84 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. Paragraph 83(b) provides the following guidance for recognition of revenues.

Revenues are not recognized until earned. An entity's revenue-earning activities involve *delivering* or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. [Footnote omitted][Emphasis added]

Paragraph 84 states that in recognizing revenues and gains

[t]he two conditions [for revenue recognition] (being realized or realizable and being earned) are usually met by the time the product or merchandise is delivered...to customers, and revenues...are commonly recognized at time of sale (usually meaning *delivery*). [Emphasis added]

**.97** SOP 91-1 did not address arrangements that included software that was deliverable only when-and-if-available. Implementation questions arose as to whether when-and-if-available terms created contingencies that could be disregarded in determining whether an arrangement consists of multiple elements. AcSEC believes that because the when-and-if-available deliverables are bargained for in arrangements, they are of value to the customer. Accordingly, AcSEC concluded that when-and-if-available deliverables should be considered in determining whether an arrangement consists of multiple elements. Thus, the requirements of this SOP with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only when-and-if-available.

**.98** In SOP 91-1, the accounting for vendor obligations remaining after delivery of the software was dependent upon whether the obligation was significant or insignificant. However, these determinations were not being made in a consistent manner, leading to a diversity in practice. AcSEC believes that all obligations should be accounted for and that revenue from an arrangement should be allocated to each element of the arrangement, based on vendor-specific objective evidence of the fair values of the elements. Further, AcSEC concluded that revenue related to a particular element should not be recognized until the revenue-recognition conditions in paragraphs .08 through

.14 of this SOP are met, because the earnings process related to that particular element is not considered complete until that time.

.99 In paragraph .10 of this SOP, AcSEC concluded that the revenue from an arrangement should be allocated to the separate elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated in the contract for each element. AcSEC believes that separate prices stated in a contract may not represent fair value and, accordingly, might result in an unreasonable allocation of revenue. AcSEC believes that basing the allocation on fair values is consistent with the accounting for commingled revenue. An example is the following discussion in paragraph 12 of FASB Statement No. 45, *Accounting for Franchise Fee Revenue*.

The franchise agreement ordinarily establishes a single initial franchise fee as consideration for the franchise rights and the initial services to be performed by the franchisor. Sometimes, however, the fee also may cover tangible property, such as signs, equipment, inventory, and land and building. In those circumstances, the portion of the fee applicable to the tangible assets shall be based on the fair value of the assets.

.100 AcSEC considered allowing the use of surrogate prices such as competitor prices for similar products or industry averages to determine fair value. However, AcSEC believes that inherent differences exist between elements offered by different vendors. These inherent differences led AcSEC to conclude that only vendor-specific evidence of fair value can be considered sufficiently objective to allow the allocation of the revenue to the various elements of the arrangement.

.101 AcSEC believes that the best evidence of the fair value of an element is the price charged if that element is sold separately. Still, an arrangement may include elements that are not yet being sold separately. As discussed in the previous paragraph, because of inherent differences between the elements offered by different vendors, AcSEC concluded that companies should not use surrogate prices, such as competitor prices for similar products or industry averages, as evidence of the fair value for an element. AcSEC believes, however, that if a price for the element has been established by management having the relevant authority, such a price represents evidence of the fair value for that element. To meet the criterion of objectivity, it must be probable that the established price will not change before the introduction of the element to the marketplace. Thus, the internally established prices should be factual and not estimates. For this reason, AcSEC concluded that the allocations may not be adjusted subsequently.

.102 AcSEC is aware that the pricing structure of certain arrangements is not limited to the prices charged for the separate elements. Pricing may be based on many different factors or combinations thereof. For example, certain arrangements are priced based on a combination of (a) the prices of products to be licensed and (b) the number of users that will be granted access to the licensed products. In some of these arrangements, the vendor requires a minimum number of users.

.103 The products contained in such arrangements are not available to the customer at the prices charged in the arrangement unless the customer also pays for the minimum number of users. Therefore, the prices contained in the arrangement do not represent the prices charged for the product when sold separately. AcSEC believes that it would be inappropriate to determine the fair values of the products (as discussed in paragraph .10) without giving consider-

ation to the impact of the user-based portion of the fee. For this reason, AcSEC concluded in paragraph .10 that when a vendor's pricing is based on multiple factors such as the number of products and the number of users, the price charged for the same element when sold separately must consider all factors of the vendor's pricing structure.

.104 Often, multiple element arrangements are sold at a discount rather than at the sum of the list prices for each element. If the amounts deferred for undelivered elements were based on list prices, the amount of revenue recognized for delivered elements would be understated. Accordingly, AcSEC concluded that relative sales prices should be used in determining the amount of revenue to be allocated to the elements of an arrangement.

.105 AcSEC believes that if an undelivered element is essential to the functionality of a delivered element, the customer does not have full use of the delivered element. Consequently, AcSEC concluded that delivery is considered not to have occurred in such situations.

.106 AcSEC believes that the earnings process with respect to delivered products is not complete if fees allocated to those products are subject to forfeiture, refund, or other concession if the vendor does not fulfill its delivery responsibilities. AcSEC believes that the potential concessions indicate the customer would not have licensed the delivered products without also licensing the undelivered products. Accordingly, AcSEC concluded that in order to recognize revenue, persuasive evidence should exist that fees allocated to delivered products are *not* subject to forfeiture, refund, or other concession. In determining the persuasiveness of the evidence, AcSEC believes that a vendor's history of making concessions that were not required by the provisions of an arrangement is more persuasive than terms included in the arrangement that indicate that no concessions are required.

## Delivery

.107 In paragraph .18 of this SOP, AcSEC concluded that for software that is delivered electronically, the delivery criterion of paragraph .08 is deemed to have been met when the customer either (a) takes possession of the software via a download or (b) has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software. AcSEC believes that the delivery criterion is met by use of access codes only when software is being delivered electronically.

.108 AcSEC believes that if the fee is not based on the number of copies to be delivered to or made or deployed by the customer, duplication of the software may be incidental to the arrangement. Paragraph .21 of this SOP describes circumstances (arrangements in which duplication is required only if additional copies are requested by the customer; arrangements in which the licensing fee is payable even if no additional copies are requested) that would lead to a conclusion that duplication is incidental to the arrangement. In other arrangements, vendors insist on duplicating the software to maintain quality control or to protect software transmitted by telecommunications. Others agree to duplicate the software as a matter of convenience to the customer.

.109 In arrangements in which duplication is considered incidental, AcSEC believes the vendor has fulfilled its delivery obligation as soon as the first copy or product master of the software has been delivered. Therefore, AcSEC

concluded that in such instances, the vendor should not be precluded from recognizing revenue if the customer has not requested additional copies (particularly since the fee is payable regardless of whether such additional copies are requested by the customer). However, the estimated costs of duplicating the software should be accrued when the revenue is recognized.

### Fixed or Determinable Fees and Collectibility

.110 In paragraphs .27 through .30, in the discussion of factors that affect the determination of whether a fee is fixed or determinable, AcSEC sought to clarify—but not change—similar provisions in SOP 91-1. In practice, some had interpreted those provisions to mean the following.

- Extended payment considerations could be overcome if customers were creditworthy.
- A fee could never be considered fixed or determinable if payment terms extended for more than twelve months after delivery.

.111 Others had interpreted these provisions to mean the following.

- If payment terms extended beyond customary terms but were twelve months or less, they were fixed or determinable.
- If payment terms exceeded twelve months, a vendor could recognize amounts due in the first twelve months as revenue at the time of the license. Additional revenue would be recognized based on the passage of time such that, at any point, any amounts due within one year would have been recognized as revenue (the *rolling twelve months* approach).

Paragraphs .112 through .114 of this SOP—

- Explain that the concern with extended payment terms is technological obsolescence and similar factors, not customer creditworthiness.
- Describe circumstances in which the presumption that a fee is not fixed or determinable because of extended payment terms may be overcome.
- Confirm that any extended payment terms, even if for less than twelve months, must be assessed for their effects on the fixed or determinable aspects of the fee.
- Clarify that the rolling twelve months approach should not be used.

.112 AcSEC believes that, given the susceptibility of software to significant external factors (in particular, technological obsolescence), the likelihood of vendor refunds or concessions is greater in an arrangement with extended payment terms than in an arrangement without extended payment terms. This is true regardless of the creditworthiness of the customer. Because of this greater likelihood of refunds or concessions, AcSEC believes that *any* extended payment terms outside of a vendor's normal business practices may indicate that the fee is not fixed or determinable.

.113 In paragraph .28 of this SOP, AcSEC concluded that if payment of a significant portion of a licensing fee is not due until after the expiration of the license or more than twelve months after delivery, the fee should be *presumed* not to be fixed or determinable. This conclusion is based on AcSEC's belief that payment terms of such extended duration indicate that vendor refunds or concessions are more likely than not. AcSEC acknowledges that the one-year provision is arbitrary. However, AcSEC concluded that such a limitation is needed to provide greater comparability within the industry.

.114 In considering the “rolling twelve months” approach found in practice, AcSEC considered the guidance in Chapter 1A of ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, paragraph 1, which states that “Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured.” Accordingly, if a fee is considered fixed or determinable, it should be recognized as revenue when the sale is effected. If not, AcSEC believes that it should be recognized as revenue as payments from customers become due.

.115 In paragraph .08 of this SOP, AcSEC concluded that collectibility must be probable before revenue may be recognized. This conclusion is based on paragraph 84g of FASB Concepts Statement No. 5, which reads

If collectibility of assets received for product, services, or other assets is doubtful, revenues and gains may be recognized on the basis of cash received.

.116 AcSEC notes that requiring collectibility enhances the verifiability of the other revenue recognition criteria of paragraph .08, as discussed below.

- *Persuasive evidence of an arrangement*—AcSEC included this criterion in order to prevent revenue recognition on delivery of elements which, in fact, had not been ordered by a customer. AcSEC believes it is unlikely that a customer would pay for an element that had not been ordered. Therefore, AcSEC believes that requiring collectibility of a receivable related to the sale or license acts to verify that an arrangement does exist.
- *Delivery*—AcSEC believes that until delivery of an element has occurred (including delivery of all other items essential to the functionality of the element in question), the customer has not received full use of the element ordered. A customer that has not received full use of the element ordered is likely to withhold payment or require a refund. Therefore, AcSEC believes that requiring collectibility of a receivable related to the sale or license acts to verify that the element has been delivered.
- *Fixed or determinable fee*—Much of AcSEC’s concern related to fixed or determinable fees relates to arrangements with extended payment terms. In the software industry, requiring collectibility of a receivable prior to revenue recognition is important because of the frequency with which upgrades, enhancements, or new versions are released. As discussed elsewhere in this SOP, in certain instances it may be difficult to determine which version of an element induced a customer to enter into an arrangement. By requiring collectibility, AcSEC sought to prevent revenue recognition on sales or licenses of an element in situations in which circumstances may prompt the vendor to make subsequent adjustments to the price of a customer’s purchase or license of a subsequent version of that element.

The likelihood that subsequent versions will be released is greater over the long term than over the short term. Therefore, concerns related to concessions increase in arrangements with extended payment terms. AcSEC notes that prohibiting revenue recognition in circumstances in which the price adjustments discussed above could occur serves to ensure that the portion of the fee allocated to each element is fixed or determinable. That is, if the price on a subsequent element cannot be adjusted for concessions, and the amount allocated to the initial ele-

ment must be collected in full, neither amount is subject to adjustment. Therefore, AcSEC believes that requiring collectibility of a receivable related to the sale or license acts to verify that the fees are fixed or determinable.

## Multiple-Element Arrangements

### ***Additional Software Deliverables and Right to Exchange or Return Software***

**.117 Upgrades/enhancements.** In paragraph .37 of this SOP, AcSEC concluded that the portion of the arrangement fee allocated to an upgrade right should be based on the price for the upgrade/enhancement that would be charged to existing users of the software product being updated. AcSEC believes that in arrangements that include upgrade rights, it may be difficult to determine which version of the software induced the customer to enter into the arrangement. For example, a customer licensing an existing version of the software may have done so to facilitate obtaining the updated version upon its introduction. To eliminate the possibility of allocating too much revenue to the delivered software (and thereby accelerating recognition), AcSEC concluded that the upgrade price (without the allocation of any discount on the arrangement) should be used to determine the amount to be deferred. The residual amount, if any, is considered to be the fair value of the original product.

**.118** AcSEC believes that upgrades/enhancements do not necessarily contain improvements that all customers would desire. A customer may not exercise an upgrade right for various reasons, including any of the following.

- a. The benefits to be gained from the related upgrade/enhancement may not be important to that customer.
- b. The customer may not wish to learn new commands for what may be perceived by that customer as marginal improvements.
- c. The upgrade/enhancement would require more hardware functionality than the customer currently has.

Consequently, AcSEC concluded that amounts allocated to upgrade rights should be reduced to reflect the percentage of customers not expected to exercise the upgrade right, based on vendor-specific evidence.

**.119 Additional Software Products.** As stated in paragraph .118, AcSEC believes that not all customers entitled to an upgrade/enhancement will exercise their upgrade rights. AcSEC believes, however, that it is probable that all customers will choose to receive additional software products. Consequently, AcSEC concluded that the fee allocated to additional software products should not be reduced by the percentage of any customers not expected to exercise the right to receive the additional products.

**.120** Paragraphs .48 and .49 of this SOP discuss accounting for software arrangements in which vendors agree to deliver unspecified additional software products in the future. AcSEC concluded that such arrangements should be accounted for as subscriptions, and that the fee from the arrangement should be recognized ratably as revenue over the term of the arrangement. AcSEC notes that, because the vendor is obligated to deliver these items only if they become available during the term of the arrangement, in some situations, the delivery of additional products will not be required. AcSEC believes that because these items are unspecified, vendor-specific objective evidence of

fair value of each unspecified additional product cannot exist. However, AcSEC believes that requiring the deferral of all revenue until the end of the arrangement is too onerous because of the following.

- a. All other revenue-recognition conditions in paragraphs .08 through .14 of this SOP have been met.
- b. The additional software products in fact may never be delivered.

However, AcSEC also was concerned that if revenue recognition were permitted to begin at the inception of the arrangement, revenue may be recognized too early, particularly in arrangements in which the first product was not delivered for some time after inception. Accordingly, AcSEC concluded that revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with the delivery of the first product.

**.121 *Rights to Exchange or Return Software.*** AcSEC believes that the rights to exchange or return software (including platform transfer rights) are subject to the provisions of FASB Statement No. 48, even if the software is not returned physically. Accordingly, AcSEC concluded that the accounting for exchanges of software for products with no more than minimal differences in price, functionality, and features by users qualify for exchange accounting because, as discussed in footnote 3 to FASB Statement No. 48, (a) users are "ultimate customers" and (b) exchanges of software with no more than minimal differences in price, functionality, and features represent "exchanges ... of one item for another of the same kind, quality, and price." AcSEC concluded that because resellers are not "ultimate customers," such exchanges by resellers should be considered returns.

**.122** AcSEC reached similar conclusions related to certain platform-transfer rights. Additionally, AcSEC concluded that in situations in which customers are entitled to continue using the software that was originally delivered (in addition to the software that is to be delivered for the new platform), the customer has received additional software products, and the platform-transfer right should be accounted for as such. Other platform-transfer rights do not allow customers to continue to use the software on the original platform. Those platform-transfer rights should be accounted for as exchange rights or rights of return.

**.123** It is possible that exchange rights may be granted for software that has not been developed for other platforms at the time revenue from the arrangement is recorded. AcSEC did not address the issue of whether such future development costs related to deliverable software, for which no further revenue will be received, should be capitalized pursuant to FASB Statement No. 86 because it was believed that such costs would not be significant. Accordingly, AcSEC concluded that in the event of significant development costs, the vendor would not be likely to be able to demonstrate persuasively that the future software would have similar pricing, features, and functionality, and would be marketed as the same product (that is, qualify as an exchange for accounting purposes). In that event, the vendor has granted a return right that must be accounted for pursuant to FASB Statement No. 48.

### ***Postcontract Customer Support***

**.124** An obligation to perform PCS is incurred at the inception of a PCS arrangement and is discharged by delivering unspecified upgrades/enhancements, performing services, or both over the period of the PCS arrangement. The obligation also may be discharged by the passage of time. AcSEC concluded

that because estimating the timing of expenditures under a PCS arrangement usually is not practicable, revenue from PCS generally should be recognized on a straight-line basis over the period of the PCS arrangement. However, AcSEC also concluded that if there is sufficient vendor-specific historical evidence that costs to provide the support are incurred on other than a straight-line basis, the vendor should recognize revenue in proportion to the amounts expected to be charged to the PCS services rendered during the period.

.125 SOP 91-1 required that revenue from both the PCS and the initial licensing fee be recognized ratably over the period of the PCS arrangement if no basis existed to derive separate prices for the PCS and the initial licensing fee. Diversity in practice arose as to what constituted a sufficient basis in arrangements involving vendors that did not have a basis to derive a separate price for the PCS. In this SOP, AcSEC has concluded that arrangement fees must be allocated to elements of the arrangement based on vendor-specific objective evidence of fair value. Because AcSEC determined that the evidence should be limited to that which is specific to the vendor, AcSEC believes that vendors that do not sell PCS separately have no basis on which to allocate fair values. AcSEC concluded that the total arrangement fee should be recognized in accordance with the provisions on recognition of PCS revenues. AcSEC also believes that, because a substantial portion of the arrangement fee typically is represented by the delivered software (rather than the performance of support), requiring the deferral of all revenues until the PCS obligation is fully satisfied would be too onerous. Accordingly, AcSEC concluded that, as discussed in the previous paragraph, the total arrangement fee generally should be recognized ratably over the period of the PCS arrangement.

### Services

.126 Certain software arrangements include both a software element and an obligation to perform non-PCS services. SOP 91-1 provided guidance on the conditions that must be met in order to account for the obligation to provide services separately from the software component. AcSEC is aware that this guidance has been interpreted in varying ways, leading to a diversity in practice. During its deliberations on this SOP, AcSEC reached conclusions intended to clarify this issue, but did not redeliberate the other conclusions related to services that were included in SOP 91-1.

.127 AcSEC believes the service element should be accounted for separately if the following occur.

- a. All other revenue allocation provisions of this SOP are met.
- b. The services are not essential to the functionality of any other element in the arrangement.
- c. The service and product elements are stated separately such that the total price of the arrangement would vary as a result of inclusion or exclusion of the services.

Accordingly, AcSEC concluded that a service element need not be *priced* separately in an agreement in order to account for the services separately. AcSEC believes that this conclusion represents the original intent of SOP 91-1, and wishes to clarify the language at this time.

.128 Paragraphs .129 through .132 of this SOP are carried forward from SOP 91-1 with certain editorial changes.



**.129 Service Elements.** Footnote 1 to paragraph 11 of SOP 81-1 [section 10,330.11, footnote 1] excludes service transactions from the scope of the SOP, as follows.

This statement is not intended to apply to "service transactions" as defined in the FASB's October 23, 1978 Invitation to Comment, *Accounting for Certain Service Transactions*. However, it applies to separate contracts to provide services essential to the construction or production of tangible property, such as design . . . [and] engineering . . . .

**.130** The previously mentioned Invitation to Comment, which was based on an AICPA-proposed SOP, was issued in 1978. The FASB later included service transactions as part of its project to develop general concepts for revenue recognition and measurement. The resulting FASB Concepts Statement No. 5, however, does not address service transactions in detail. Nevertheless, some of the concepts on service transactions developed in the Invitation to Comment are useful in accounting for certain software transactions.

**.131** A service transaction is defined in paragraphs 7 and 8 of the Invitation to Comment as follows.

A transaction between a seller and a purchaser in which, for a mutually agreed price, the seller performs . . . an act or acts . . . that do not alone produce a tangible commodity or product as the principal intended result. . . A service transaction may involve a tangible product that is sold or consumed as an incidental part of the transaction or is clearly identifiable as secondary or subordinate to the rendering of the service.

The term *service transaction* is used in the same sense in this SOP but, as used in this SOP, does not apply to PCS. Items classified as tangible products in software service transactions generally should be limited to off-the-shelf software or hardware.

**.132** This SOP, like the Invitation to Comment, recommends the separation of such arrangements with discrete elements into their product and service elements. Paragraph 8(b) of the Invitation to Comment states the following.

If the seller of a product offers a related service to purchasers of the product but separately states the service and product elements in such a manner that the total transaction price would vary as a result of the inclusion or exclusion of the service, the transaction consists of two components: a product transaction that should be accounted for separately as such and a service transaction . . . .

## Contract Accounting

**.133** SOP 91-1 included guidance on the application of contract accounting to software transactions. Questions arose as to whether output measures could be used to measure progress-to-completion if the amounts recorded would differ from those that would have been reported had input measures been used. During its deliberations of this SOP, AcSEC reached conclusions intended to clarify this issue, but did not redeliberate the other conclusions related to services that were included in SOP 91-1.

**.134** AcSEC believes that the method chosen to measure progress-to-completion on an individual element of a contract should be the method that best approximates progress-to-completion on that element. Accordingly, AcSEC concluded that output measures may be used to measure progress-to-completion, provided that the use of output measures results in "the method that best approximates progress-to-completion."

.135 Paragraphs .136 through .142 of this SOP are carried forward from SOP 91-1 with certain editorial changes.

.136 ARB No. 45 established the basic principles for measuring performance on contracts for the construction of facilities or the production of goods or the provision of related services with specifications provided by the customer. Those principles are supplemented by the guidance in SOP 81-1 [section 10,330].

### ***Distinguishing Transactions Accounted for Using Contract Accounting From Product Sales***

.137 SOP 81-1 [section 10,330] suggests that transactions that normally are accounted for as product sales should not be accounted for using contract accounting merely to avoid the delivery requirements for revenue recognition normally associated with product sales. Paragraph 14 of SOP 81-1 [section 10,330.14] states the following:

Contracts not covered . . . include . . . [s]ales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels if such sales are normally recognized as revenue in accordance with the realization principle for sales of products and if their costs are accounted for in accordance with generally accepted principles of inventory costing.

### ***Application of ARB No. 45 and SOP 81-1***

.138 SOP 81-1 [section 10,330] provides guidance on the application of ARB No. 45 that applies to a broad range of contractual arrangements. Paragraph 1 of SOP 81-1 [section 10,330.01] describes contracts that are similar in nature to software arrangements, and paragraph 13 [section 10,330.13] includes the following kinds of contracts within the scope of that SOP:

- Contracts to design, develop, manufacture, or modify complex . . . electronic equipment to a buyer's specification or to provide services related to the performance of such contracts
- Contracts for services performed by . . . engineers . . . or engineering design firms

.139 ARB No. 45 presumes that percentage-of-completion accounting should be used when the contractor is capable of making reasonable estimates. Paragraph 15 of ARB No. 45 states the following:

[I]n general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable.

Evidence to consider in assessing the presumption that the percentage-of-completion method of accounting should be used includes the technological risks and the reliability of cost estimates, as described in paragraphs 25, 26, 27, 32, and 33 of SOP 81-1 [section 10,330.25, .26, .27, .32, and .33].

.140 Paragraph 24 of SOP 81-1 [section 10,330.24] specifies a further presumption that a contractor is capable of making reasonable estimates and states the following:

[T]he presumption is that [entities] . . . have the ability to make estimates that are sufficiently dependable to justify the use of the percentage-of-completion method of accounting. Persuasive evidence to the contrary is necessary to overcome that presumption. [Footnote omitted]

.141 Although cost-to-cost measures may be verified easily, they tend to attribute excessive profit to the hardware elements of arrangements with combined software and hardware elements for contracts under which segmentation is not permitted. Although the hardware elements of such arrangements have high cost bases, they generally yield relatively low profit margins to vendors. Furthermore, if excessive revenue is attributed to the hardware element, revenue recognition on the arrangement becomes overly dependent on when that element is included in the measurement of progress-to-completion.

.142 For off-the-shelf software elements, the application of the cost-to-cost method produces the opposite effect. The book basis of the software tends to be low, because most of the costs associated with software development frequently are charged to expense when incurred in conformity with FASB Statement No. 86. Although the profit margins associated with software are generally higher than those for other elements of the arrangement, the application of cost-to-cost measures with a single profit margin for the entire arrangement would attribute little or no profit to the off-the-shelf software. Similarly, the application of the cost-to-cost method to arrangements that include core software, which also has a relatively low cost basis, would attribute a disproportionately small amount of profit to the software.

## Effective Date and Transition

.143 AcSEC concluded that the provisions of this SOP should be applied prospectively and that retroactive application should be prohibited. AcSEC recognizes the benefits of comparable financial statements but is concerned that the application of the provisions of this SOP to contracts existing in prior periods would require a significant amount of judgment. The application of that judgment likely would be impacted by the hindsight a company would have, resulting in judgments based on information that did not exist at the time of the initial judgment but that would be called for if the SOP were to be applied retroactively.

.144 Additionally, AcSEC concluded that some entities would be required to incur large expenditures in determining restated amounts or the cumulative effect of adoption. AcSEC concluded that the cost of calculating such amounts likely would exceed the related benefit of that information. This SOP does not preclude an entity from disclosing in the notes to the financial statements the effect of initially applying this SOP if an entity believes it is practicable to do so.

## Items Not Retained From SOP 91-1

.145 AcSEC believes that the guidance included in SOP 91-1 related to discounting receivables and the collectibility of receivables (discussed in paragraphs 56 and 78, respectively, of SOP 91-1) is not specific to the software industry and thus does not need to be retained in this SOP.

## Appendix A

### Examples of the Application of Certain Provisions of This Statement of Position

#### Scope—Example 1

##### Facts

An automobile manufacturer installs software into an automobile model. This software is used solely in connection with operating the automobile and is not sold or marketed separately. Once installed, the software is not updated for new versions that the manufacturer subsequently develops. The automobile manufacturer's costs for the development of the software that are within the scope of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed* and the production costs of such software are insignificant relative to the other development and production costs of the automobile.

##### Applicability

The Statement of Position (SOP) is not applicable to such software because the software is deemed incidental to the product as a whole.

##### Discussion

Although the software may be critical to the operations of the automobile, the software itself is not the focus of the marketing effort, nor is it what the customer perceives he or she is obtaining. The development and production costs of the software as a component of the cost of the automobile is incidental.

#### Scope—Example 2

##### Facts

An entity develops interactive training courses for sale or licensing to customers. These courses are delivered on a compact disc, which is loaded onto a customer's computer. The courses are developed such that, based on the responses received to a particular question, different questions are generated and content of the course material that is displayed is determined in a manner that directs the user's learning experience in a more focused way. The course developer's costs for the development of the software content are within the scope of FASB Statement No. 86 and are significant. The interactive nature of the courses is mentioned prominently in the marketing efforts.

##### Applicability

The SOP is applicable because the software is not incidental to the product.

##### Discussion

Although some might say that the product is educational services, the marketing of the product focuses on the software-reliant interactive features. In addi-

tion, the course developer incurs significant costs that are within the scope of FASB Statement No. 86. The nature of the relationship between the vendor and the customer is not one in which the customer would have a need for postcontract services. Consequently, the absence of PCS is not presumptive that software is incidental to the product. Accordingly, a conclusion is reached that the software is not incidental to the product as a whole. Therefore, the provisions of this SOP apply.

## **Additional Software Products—Price per Copy—Example 1**

### **Facts**

A vendor enters into an arrangement under which a customer has the right to make copies of Product A at \$100 a copy, copies of Product B at \$200 a copy, or copies of Product C at \$50 a copy until such time as the customer has made copies aggregating \$100,000 based on the per copy prices. The customer is obligated to pay the \$100,000 whether or not the customer makes all the copies to which it is entitled under the arrangement. In all other respects, the \$100,000 is considered to meet the criteria of a fixed fee, as described in this Statement of Position.

Master copies of products A and B are available currently and have been delivered. Product C is not available yet; therefore, no master copy has been delivered. The contract is clear that no portion of the fee allocable to copies made of products A and B is refundable if Product C is not delivered, nor is there any further obligation to deliver product C if copies of products A and B aggregating \$100,000 have been made. The per copy prices included in the arrangement for Products A and B are the per copy prices included in the company's price list, and the company has already approved the per copy price list for Product C to be \$50 per copy. Product C is not essential to the functionality of Products A or B.

The maximum number of copies of Product C that can be made is 500.

### **Revenue Recognition**

The vendor should allocate \$25,000 of the arrangement fee to Product C. The remaining \$75,000 of revenue should be recognized when the master copies of Products A and B are delivered to the customer. The \$25,000 allocated to Product C would be recognized when the master copy of Product C is delivered to the customer. If the customer duplicates enough copies of Products A and B so that the revenue allocable to those products exceeds \$75,000, the additional revenue should be recognized as the additional copies are made.

### **Discussion**

As discussed in paragraph .43 of this SOP, in an arrangement in which a number of products are not deliverable or specified at the inception of the arrangement, an allocation of the arrangement fee generally cannot be made, because the total revenue allocable to each software product is unknown and depends on choices to be made by the customer and, sometimes, future devel-

opment activity. As discussed in paragraph .46 of this SOP however, if such an arrangement specifies a maximum number of copies of the undeliverable or unspecified product, a portion of the arrangement fee should be allocated to the undeliverable product(s). This allocation should be made assuming the customer elects to receive the maximum number of copies of the undeliverable product(s).

Because the arrangement states a maximum number of copies of Product C that can be made, a basis for allocating the fair value to each product of the arrangement exists. The amount allocated to the undelivered product is the maximum amount that can be allocable to that product, based on the maximum number of copies of Product C that can be made (500) and the fee per copy (\$50). Accordingly, \$25,000 should be allocated to Product C and deferred until delivery of the product master. Because all other conditions for revenue recognition in this SOP have been met, revenue related to Products A and B may be recognized upon delivery of the masters of those products as discussed in paragraph .44 of this SOP.

## **Additional Software Products—Price per Copy—Example 2**

### **Facts**

Assume the same facts as in the preceding example, except the arrangement does not state a maximum number of copies of Product C that can be made.

### **Revenue Recognition**

Revenue should be recognized as copies of Products A (\$100 of revenue per copy) and B (\$200 of revenue per copy) are made, until the master of Product C is delivered to the customer. Any remaining revenue should be recognized upon delivery of the master of Product C.

### **Discussion**

As discussed in paragraph .43 of this SOP, although the fee per copy is fixed at the inception of the arrangement and the cost of duplication is incidental, the total fee allocated to the undelivered software (Product C) is unknown and will depend on the choices made by the customers as to how many copies of each product will be utilized.

## **Authorization Codes—Example 1**

### **Facts**

A vendor includes ten optional functions on a compact disc (CD-ROM) on which its software product is licensed. Access to those optional functions is not available without a permanent key. Users can order the optional functions and receive permanent keys to enable the full use of those functions.

### **Revenue Recognition**

Revenue for each individual optional function should be recognized by the vendor when the user purchases it by placing an order, evidence of such order exists, and the key is delivered to the user.

## Discussion

Although the user has received a fully functional version (except for the keys) of the optional functions on the CD-ROM, the user has not agreed to license them. Because no evidence of an arrangement exists (as discussed in paragraphs .15 through .17 of this SOP), revenue for the optional functions may not be recognized when the CD-ROM is delivered.

## Authorization Codes—Example 2

### Facts

A software vendor's products run on two different levels of central processing units (CPU) of the same manufacturer—Model X and Model Y (both of which are on the same platform). The vendor enters into a license arrangement with a user whereby the user licenses the vendor's products to run on Model X but allows the user to move to Model Y at no additional charge. The vendor delivers the product in the form of a disc pack along with a CPU authorization code. At the time the user chooses to move to Model Y, the user does not receive a new disc pack; rather the vendor gives the user a new CPU authorization code.

### Revenue Recognition

Revenue should be recognized on the delivery of the disc pack.

### Discussion

Delivery of the authorization code to move to another CPU is not considered to be an additional software deliverable.

## Multiple Element Arrangements, Products—Example 1

### Facts

A vendor licenses a user one license covering a single copy of products A, B, C, and D for a nonrefundable fixed fee of \$80, with no stated price per product. Products A, B, and C are deliverable. Product D is not deliverable and is not essential to the functionality of products A, B, or C. Persuasive evidence exists that indicates that the revenue related to products A, B, or C is not subject to refund, forfeiture, other concessions if product D is not delivered. The vendor has a history of sales prices for products A, B, and C of \$25 each. The vendor's pricing committee has established a price for product D of \$25. It is probable that the price established by the pricing committee for product D will not change before introduction. Therefore, the vendor is able to derive its specific price for the undelivered software.

### Revenue Recognition

Revenue allocated to each product based on the existing prices for products A, B, and C and the probable price for product D should be recognized when each individual product is delivered. The revenue allocated to each of the products would be \$20.

### Discussion

Revenue allocated to each product should be recognized upon the delivery of that product if the criteria in paragraphs .08 through .14 of this SOP have been met.

The allocation of revenue to each product is based on the relative fair value of each product. As discussed in paragraph .12 of this SOP, sufficient vendor-specific objective evidence must exist to determine allocation. In this example, sufficient vendor-specific objective evidence exists to determine that the fair value of each product on a stand-alone basis is \$25. Therefore, in accordance with paragraph .41 of this SOP, the discount should be allocated evenly to each product, and revenue of \$20 per product should be recognized when each product is delivered.

## **Multiple Element Arrangements—Products—Example 2**

### **Facts**

The transaction is the same as that outlined in the prior example. The contract is silent about penalties for the nondelivery of product D, but the proposal and other communications indicate that it is a required capability of the offering and that the user does not want any of the vendor's products unless product D is delivered.

### **Revenue Recognition**

All revenue must be deferred until delivery of product D.

### **Discussion**

Because revenue allocable to the delivered software is subject to forfeiture, refund, or other concession if product D is not delivered, all revenue under the agreement should be deferred until product D is delivered, in accordance with paragraph .13 of this SOP.

## **Multiple Element Arrangements—Products—Example 3**

### **Facts**

A vendor licenses version 1.0 of a software product to 100 customers for \$300 per copy with a right to receive version 2.0 at no additional cost when it becomes available. The pricing committee has not yet decided whether version 2.0 will be offered to users of version 1.0 for \$100 or for \$200.

### **Revenue Recognition**

All revenue should be deferred until the pricing committee makes its decision and it is probable that the price established will be the price charged upon introduction.

### **Discussion**

Because the pricing committee has not yet decided whether version 2.0 will be offered at \$100 or at \$200, sufficient vendor-specific objective evidence does not yet exist supporting the price of the undelivered software. As discussed in paragraph .12 of this SOP, if sufficient vendor-specific objective evidence does not exist to determine the allocation of revenue, all revenue should be deferred until sufficient vendor-specific objective evidence exists.



## Multiple Element Arrangements—Products—Example 4

### Facts

In the preceding example, assume that the pricing committee determines that version 2.0 will be offered to users of version 1.0 as a specified upgrade/enhancement at a price of \$100. It is probable that such price will not change prior to introduction. Persuasive evidence exists indicating that the amount allocated to version 1.0 will not be subject to forfeiture, refund, or other concession. Also, the vendor's experience indicates that 40 percent of customers do not exercise upgrade rights.

### Revenue Recognition

The vendor should defer \$6,000 (upgrade price of \$100 multiplied by 100 copies, reduced by 40 percent to account for the customers expected not to exercise the upgrade right) until delivery of the upgrade/enhancement, and recognize the remaining \$24,000 on delivery of version 1.0.

### Discussion

The portion of the arrangement fee allocated to the upgrade right is equal to the price for the upgrade/enhancement determined pursuant to paragraph .37 of this SOP. This amount should be deferred and recognized on the delivery of version 2.0. The amount deferred for the specific upgrade/enhancement should be reduced to reflect the percentage of customers that, based on experience, are not expected to exercise the upgrade right (see paragraph .37 of this SOP). Accordingly, the \$10,000 revenue allocated to the upgrade right should be reduced by \$4,000 (40 percent of the allocated revenue).

If the vendor did not have information based on experience that indicates the percentage of customers that do not exercise the upgrade right, the vendor should defer the entire \$10,000 of revenue allocated to the upgrade right, under the assumption that, in the absence of vendor-specific objective evidence to the contrary, 100 percent of customers will exercise the upgrade right.

## Multiple Element Arrangements—Products and Services—Example 1

### Facts

A vendor has entered into an arrangement to provide a customer with its off-the-shelf software product and related implementation services. The software and service elements of the contract are stated separately and the company has a history of selling these services separately such that the revenue allocation criteria of paragraphs .08 through .14 of this SOP can be satisfied. The software license fees are due under the company's normal trade terms, which are net 30 days. The services are expected to be provided over the next 90 days and are of the type performed routinely by the vendor. The features and functionality of the software are not altered to more than a minor degree as a result of these services.

## Revenue Recognition

The vendor should recognize the license revenue allocated to the software element upon its delivery and the revenue allocated to the service element as such services are performed.

## Discussion

When license arrangements have multiple elements, revenue should be allocated to each of the elements and recognized when the related element is delivered and the following occur.

1. The undelivered elements are not essential to the functionality of the delivered elements.
2. The revenue allocated to the delivered elements is not subject to forfeiture, refund, or other concession if the undelivered elements are not delivered.
3. Sufficient company-specific objective evidence exists to allocate separate prices to each of the elements.

The service element in this arrangement is not deemed to be essential to the functionality of the software element because the features and functionality of the software are not altered to more than a minor degree as a result of the services.

## Multiple Element Arrangements—Products and Services—Example 2

### Facts

Assume the same transaction as described above except that the vendor agrees to make more than minor modifications to the functionality of the product to meet needs as defined by the user. Payment terms are 10 percent upon installation of the software, with the remainder according to a time line, and the final 25 percent withheld until acceptance. The desired modifications are not unusual; the vendor has made similar modifications to the product many times and is certain that the planned modifications will meet the user's needs.

### Revenue Recognition

This arrangement should be accounted for pursuant to the guidance on contract accounting (using either the percentage-of-completion or completed-contract method, depending on the facts and circumstances) included in paragraphs .74 through .91 of this SOP.

### Discussion

The new conditions would preclude service transaction accounting because the functionality of the software product is being altered in more than a minor way, the payment of the fees is coincident with the services being performed, and the software is subject to the user's unique acceptance criteria.

## Multiple Element Arrangements—Products and Services—Example 3

### Facts

Assume the same transaction as described in “Multiple-Element Arrangements—Products and Services—Example 1,” except that the vendor never sells implementation services separately. The implementation services do not involve significant customization of the software.

### Revenue Recognition

The vendor should recognize all revenue from the arrangement over the 90 day period during which the services are expected to be performed, commencing with delivery of the software product.

### Discussion

The criteria for vendor-specific objective evidence of the fair value require that the element be sold separately or be planned to be sold separately. Because implementation services are neither sold separately nor planned to be sold separately, and upon delivery of the software product such services are the only undelivered elements, paragraph .67 of this SOP requires that all revenue be recognized over the period during which the implementation services are expected to be provided.

## Multiple Element Arrangements—Products and Services—Example 4

### Facts

A vendor sells software product A for \$950. The license arrangement for product A always includes one year of “free” PCS. The annual renewal price of PCS is \$150.

### Revenue Recognition

Assuming that, apart from the lack of vendor-specific objective evidence of the fair value of the delivered software element, all applicable revenue recognition criteria in this SOP are met, revenue in the amount of \$150 should be deferred and recognized in income over the one-year PCS service period. Revenue of \$800 should be allocated to the software element and recognized upon delivery of the software.

### Discussion

Vendor-specific objective evidence of the fair value of the software does not exist because the software is never sold separately. Consequently, sufficient vendor-specific objective evidence of fair value does not exist for the allocation of revenue to the various elements based on their relative fair values. Paragraph .12 of this SOP states, however, that the residual method should be used when there is vendor-specific objective evidence of the fair values of *all* undelivered elements; all other applicable revenue recognition criteria in this SOP are met; and the fair value of all of the undelivered elements is less than the total arrangement fee.

If there had been vendor-specific objective evidence of the fair value of the delivered software but not of the undelivered PCS, the entire arrangement fee would be deferred and recognized ratably over the contractual PCS period in accordance with paragraphs .12 and .58 of this SOP.

# Multiple Element Arrangements—Products and Discounted PCS—Example 1

## Facts

A software vendor has entered into an arrangement under which it has licensed software that has a list price of \$1 million to a customer for \$600,000 (which is the price being charged for the software when sold separately under other arrangements). The arrangement also includes annual PCS, priced for the first year at 15 percent of the discounted license fee, or \$90,000 (rather than 15 percent of the list price of the licensed software). After the first year, the customer will have the right to renew annual maintenance on the licensed software at 15 percent of the list price of the software (or \$150,000).

There are no other undelivered elements. All revenue recognition conditions of this SOP have been satisfied.

The vendor does not have sufficient vendor-specific historical evidence that costs of providing PCS are incurred on other than a straight-line basis.

## Revenue Recognition

In Year 1, the total arrangement fee is \$690,000. Of this amount, \$552,000 should be allocated to the software element and recognized upon delivery of the software element. The remaining \$138,000 should be allocated to the PCS element and recognized ratably over the period during which the PCS services are expected to be performed. The allocation of the \$690,000 arrangement fee is determined as shown in the following table.

Fair value when sold separately:

Software element	\$600,000	80%
PCS element	<u>150,000</u>	<u>20</u>
	<u>\$750,000</u>	<u>100%</u>

## Allocation:

PCS element	$\$690,000 \times .20 = \$138,000$
Software element	$\$690,000 \times .80 = \$552,000$

## Discussion

In allocating the arrangement fee to the PCS element, the vendor should look first to the price the customer will pay for the PCS when it is sold separately as a renewal under the arrangement. In this example, that price is \$150,000. This price is considered the vendor-specific objective evidence of the fair value for the PCS element, as discussed in paragraph .10.

If the customer were entitled to the PCS in subsequent years at the same price at which it had been included in the initial year of the arrangement (that is, \$90,000), and the vendor's pricing practices were such that renewals of PCS were based on the discounted value of license fees, no additional fees would have been allocated from the software element to the PCS element. Therefore, the vendor would have allocated \$600,000 to the software element and \$90,000 to the PCS element.

[Appendix amended, effective for transactions entered into in fiscal years beginning after March 15, 1999, by Statement of Position 98-9.]

## Appendix B

### Response to Comments Received

**B.1.** An exposure draft of a proposed Statement of Position (SOP), *Software Revenue Recognition*, was issued for public comment on June 14, 1996.

**B.2.** The majority of the comments received related to the basic principles of the exposure draft, particularly the provisions requiring the allocation of the arrangement fee to individual elements in a multiple-element arrangement based on vendor-specific objective evidence of the fair value. Several commentators requested clarification of the wording in the exposure draft related to extended payment terms and the effect of such terms on the determination of whether a fee is fixed and determinable or collectible. Some commentators requested guidance on the application of the provisions of the SOP to marketing arrangements in which coupons or other price incentives are offered. Other commentators requested the reconsideration of the transition provisions of the exposure draft, which required a cumulative-effect adjustment.

**B.3.** These comments and the Accounting Standards Executive Committee's (AcSEC's) response to them are discussed below.

### Multiple-Element Arrangements

**B.4.** Several commentators responded that the limitations on what constitutes vendor-specific objective evidence of the fair value were too onerous. These commentators stated that many instances exist in which elements are not priced separately, and that because of these limitations, revenue related to delivered elements would be deferred even though the customer received the element. Additionally, several commentators expressed concern that the requirement to allocate revenue to all elements, particularly those deliverable "when and if available" was not meaningful. (Obligations to deliver "when and if available" elements were considered by the commentators to be either insignificant vendor obligations or not vendor obligations at all.)

**B.5.** AcSEC considered these comments but continues to support the provisions of the exposure draft. AcSEC noted that these comments had been considered in the process leading to the exposure draft. Although AcSEC agrees that the provisions of the SOP may be troublesome to some companies, AcSEC notes that commentators did not suggest alternatives that AcSEC considered adequate to meet the criteria of objective evidence of fair value.

**B.6.** AcSEC continues to believe that the allocation of the arrangement fee to all elements, including those deliverable on a when-and-if-available basis, is meaningful. AcSEC believes that these elements are bargained for by the customer and should be accounted for. Furthermore, AcSEC believes that the concept of significant versus insignificant obligations should not be used to determine whether revenue should be allocated to an element. This concept had been included in SOP 91-1 and had resulted in varying interpretations in practice. AcSEC further notes that these comments had been considered previously by AcSEC during the process leading to the exposure draft.

**B.7.** Several commentators stated that the limitations on vendor-specific objective evidence of fair value should be expanded to permit the use of prices in published price lists. AcSEC believes that the price for an element as included in a price list does not necessarily represent the fair value of that element.

## Extended Payment Terms

**B.8.** The exposure draft stated that a software licensing fee should not be considered fixed or determinable if the payment of a significant portion of the licensing fee is not due until after the expiration of the license or more than twelve months after delivery. Exceptions were permitted for vendors that have a business practice of using installment contracts and an extended history of entering into contracts with terms in excess of twelve months and successfully enforcing payment terms without making concessions. Several commentators requested clarification of these provisions.

**B.9.** AcSEC considered these comments and agreed that clarification was needed. Relevant clarifications were made to paragraphs .27 through .29 of the SOP. The revised provisions now state that *any* extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable, particularly if the use of extended payment terms is not the vendor's customary practice. Further, if the payment of a significant portion of the software licensing fee is not due until after the expiration of the license or more than twelve months after delivery, the licensing fee should be *presumed* not to be fixed or determinable. However, this presumption may be overcome by evidence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. Such a vendor should consider such fees fixed or determinable and should recognize revenue upon the delivery of the software, provided all other conditions for revenue recognition in this SOP have been satisfied.

**B.10.** Several commentators requested guidance on the application of the SOP to arrangements in which discounts are offered on subsequent licenses of software. The exposure draft did not have provisions addressing such arrangements.

**B.11.** AcSEC has added wording to the scope section (paragraph .03) of the SOP to address these questions. The new wording states that arrangements in which a vendor offers a small discount on additional licenses of the licensed product or other products that exist at the time of the offer represent marketing and promotional activities that are not unique to software and, therefore, are not included in the scope of this SOP. However, judgment will be required to assess whether price-off and other concessions are so significant that, in substance, additional elements are being offered in the arrangement.

## Transition

**B.12.** The exposure draft required a cumulative-effect adjustment for the adoption of the SOP. Several commentators noted that considerable effort would be required on the part of many vendors to measure the cumulative effect. Additionally, it was noted that in many instances, the application of the provisions of this SOP to contracts existing in prior periods would require a significant amount of judgment. AcSEC was concerned that the application of

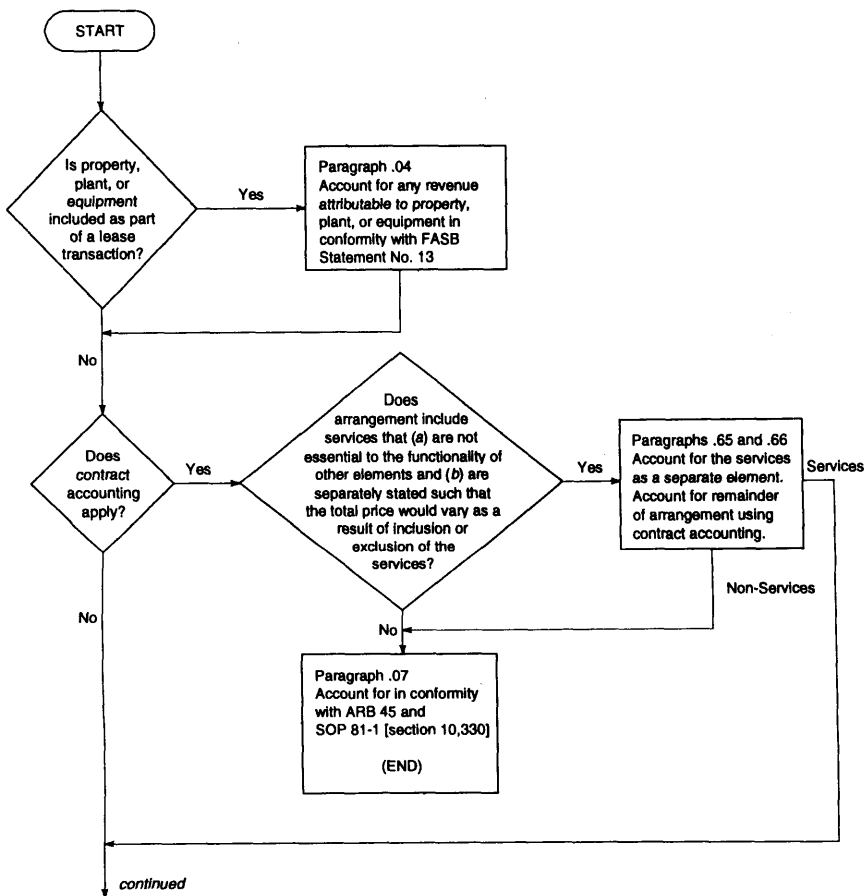
that judgment likely would be impacted by the hindsight a company would have, resulting in judgments based on information that did not exist at the time of the initial judgment but that would be called for if the SOP were to be applied retroactively.

**B.13.** AcSEC considered these issues and determined that the transition requirements of the SOP should be amended to require prospective application.

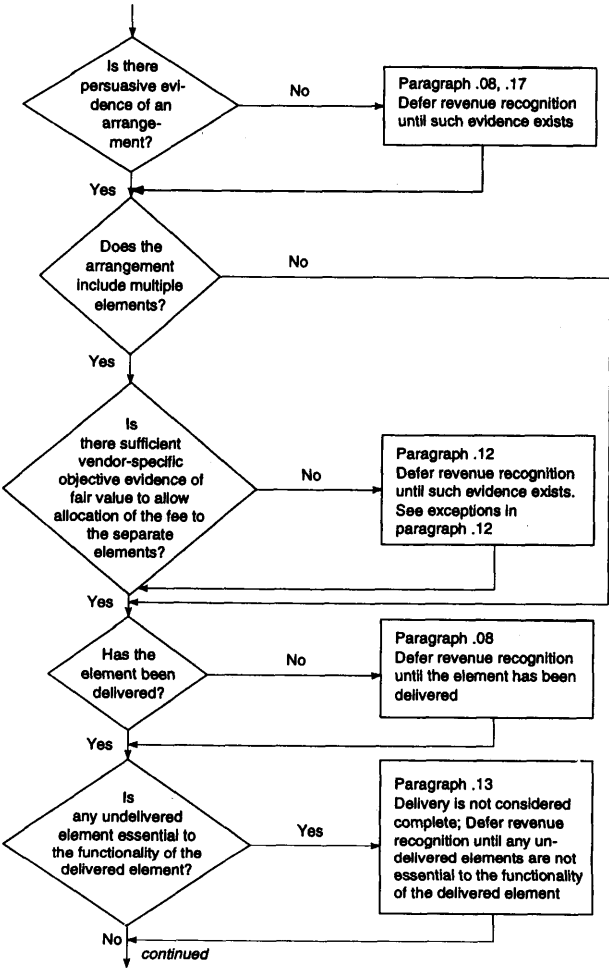
Appendix C

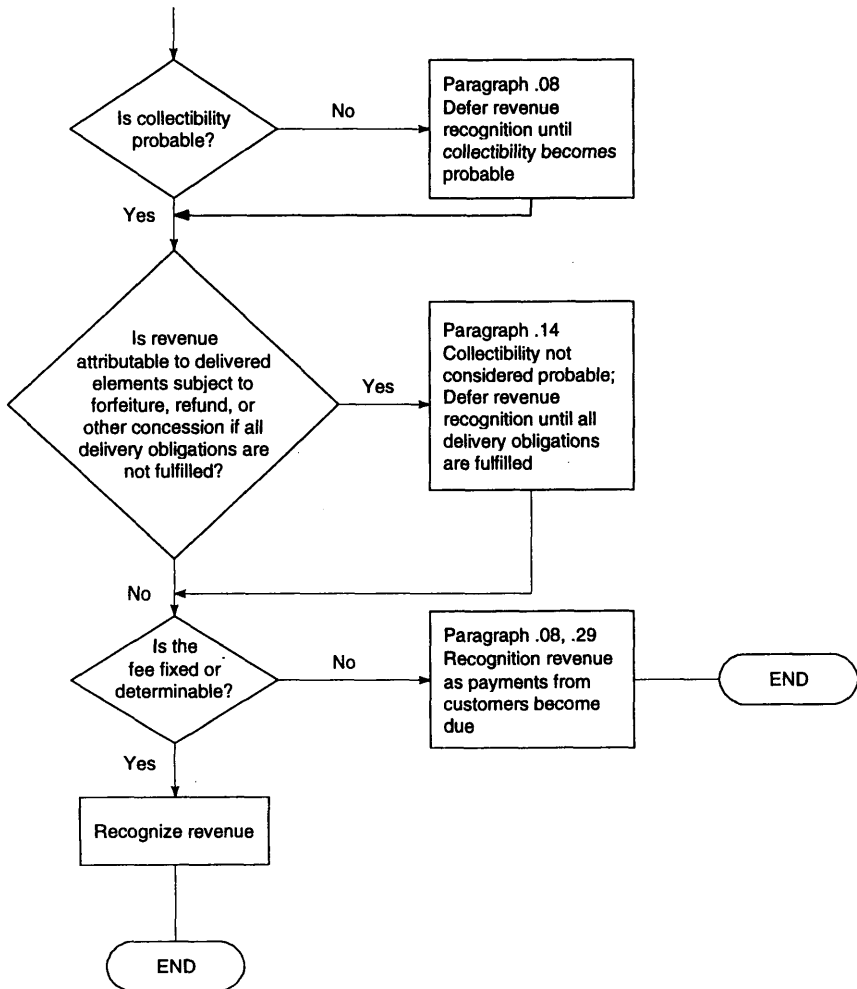
Revenue Recognition on Software Arrangements

The following flowchart illustrates a decision process for recognizing revenue on software arrangements. The flowchart is intended to illustrate the basic principle of revenue recognition and does not address the differences in accounting depending upon the type of element (services, upgrade rights, additional software products, or postcontract customer support) included in the arrangement. The flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.









## Glossary

**Authorization Codes (keys).** A vehicle used by vendors to permit customers access to, use of, or duplication of software that would otherwise be restricted.

**Core software.** An inventory of software that vendors use in creating other software. Core software is not delivered as is because customers cannot use it unless it is customized to meet system objectives or customer specifications.

**Customer.** A user or reseller.

**Delivery.** A transfer of software accompanied by documentation to the customer. The transfer may be by the following:

- a. A physical transfer of tape, disk, integrated circuit, or other medium
- b. Electronic transmission
- c. Making available to the customer software that will not be physically transferred, such as through the facilities of a computer service bureau
- d. Authorization for duplication of existing copies in the customer's possession

If a licensing agreement provides a customer with the right to multiple copies of a software product in exchange for a fixed fee, delivery means transfer of the product master, or the first copy if the product master is not to be transferred.

**Fixed fee.** A fee required to be paid at a set amount that is not subject to refund or adjustment. A fixed fee includes amounts designated as minimum royalties.

**Licensing.** Granting the right to use but not to own software through leases or licenses.

**Milestone.** A task associated with long-term contracts that, when completed, provides management with a reliable indicator of progress-to-completion on those contracts.

**Off-the-shelf software.** Software marketed as a stock item that customers can use with little or no customization.

**Platform.** The hardware architecture of a particular model or family of computers, the system software, such as the operating system, or both.

**Platform-transfer right.** A right granted by a vendor to transfer software from one hardware platform or operating system to one or more other hardware platforms or operating systems.

**Postcontract customer support (PCS).** The right to receive services (other than those separately accounted for as described in paragraphs .65 and .66 of this Statement of Position) or unspecified product upgrades/enhancements, or both, offered to users or resellers, after the software license period begins, or after another time as provided for by the PCS arrangement. Unspecified upgrades/enhancements are PCS only if they are offered on a when-and-if-available basis. PCS does not include the following:

- Installation or other services directly related to the initial license of the software

- Upgrade rights as defined in this Statement of Position
- Rights to additional software products

PCS may be included in the license fee or offered separately. PCS is generally referred to in the software industry as maintenance, a term that is defined, as follows, in paragraph 52 of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*:

Activities undertaken after the product is available for general release to customers to correct errors or keep the product updated with current information. Those activities include routine changes and additions.

However, the term *maintenance* is not used in this Statement of Position for the following reasons.

1. It has taken on a broader meaning in the industry than the one described in FASB Statement No. 86.
2. It may be confused with hardware maintenance as it is used elsewhere in accounting literature.
3. Its meaning varies from company to company.

The right to receive services and unspecified upgrades/enhancements provided under PCS is generally described by the PCS arrangement. Typical arrangements include services, such as telephone support and correction of errors (bug fixing or debugging), and unspecified product upgrades/enhancements developed by the vendor during the period in which the PCS is provided. PCS arrangements include patterns of providing services or unspecified upgrades/enhancements to users or resellers, although the arrangements may not be evidenced by a written contract signed by the vendor and the customer.

**Reseller.** Entity licensed by a software vendor to market the vendor's software to users or other resellers. Licensing agreements with resellers typically include arrangements to sublicense, reproduce, or distribute software. Resellers may be distributors of software, hardware, or turnkey systems, or they may be other entities that include software with the products or services they sell.

**Site license.** A license that permits a customer to use either specified or unlimited numbers of copies of a software product either throughout a company or at a specified location.

**Upgrade/Enhancement.** An improvement to an existing product that is intended to extend the life or improve significantly the marketability of the original product through added functionality, enhanced performance, or both. The terms upgrade and enhancement are used interchangeably to describe improvements to software products; however, in different segments of the software industry, those terms may connote different levels of packaging or improvements. This definition does not include platform-transfer rights.

**Upgrade right.** The right to receive one or more specific upgrades/enhancements that are to be sold separately. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice.

**User.** Party that ultimately uses the software in an application.

**When-and-if-available.** An arrangement whereby a vendor agrees to deliver software only when or if it becomes deliverable while the arrangement is in effect. When-and-if-available is an industry term that is commonly used to describe a broad range of contractual commitments. The use of the term when-and-if-available within an arrangement should not lead to a presumption that an obligation does not exist.

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The Accounting Standards Executive Committee and the Software Revenue Recognition Working Group gratefully acknowledge the contributions of the former Software Revenue Recognition Task Force members Joseph Lhotka, Naomi Erickson, James Gillespie, Francis O'Brien, and Paul Wilde in the development of this Statement of Position.

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[The next page is 20,381.]

## Section 10,710

### **Statement of Position 97-3 Accounting by Insurance and Other Enterprises for Insurance- Related Assessments**

December 10, 1997

#### **NOTE**

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## **Introduction**

.01 Insurance enterprises as well as noninsurance entities are subject to a variety of assessments related to insurance activities, including those by state guaranty funds and workers' compensation second-injury funds. Some entities may be subject to insurance-related assessments because they self-insure against loss or liability. Current accounting practice is diverse among entities subject to such insurance-related assessments and related recoveries. Some of the diversity is a result of fundamental differences in the methods for assessing entities. Nevertheless, similar assessments are not being accounted for comparably among entities. A number of entities account for assessments on a pay-as-you-go (cash) basis, whereas others account for assessments on an accrual basis. Furthermore, the methods for accrual are varied.

.02 As the prevalence and magnitude of guaranty-fund and other insurance-related assessments have increased, concern about the diversity in practice also has increased. This Statement of Position (SOP) provides guidance on accounting by entities subject to insurance-related assessments and was undertaken to reduce diversity in practice, improve the comparability of the amounts reported, and improve disclosures made by entities subject to guaranty-fund and other insurance-related assessments.

## Background Information

### Guaranty-Fund Assessments

.03 States have enacted legislation establishing guaranty funds. The state guaranty funds assess entities licensed to sell insurance in the state to provide for the payment of covered claims or to meet other insurance obligations, subject to prescribed limits, of insolvent insurance enterprises. The assessments are generally based upon premium volume for certain covered lines of business. Most state guaranty funds assess entities for costs related to a particular insolvency after the insolvency occurs. At least one state, however, assesses entities prior to insolvencies.

.04 State guaranty funds use a variety of methods for assessing entities. This SOP identifies the following four primary methods of guaranty-fund assessments.

- a. *Retrospective-premium-based assessments.* Guaranty funds covering benefit payments of insolvent **life, annuity, and health insurance enterprises** typically assess entities based on **premiums written** or received in one or more years *prior* to the year of insolvency.<sup>1</sup> Assessments in any year are generally limited to an established percentage of an entity's average premiums for the three years preceding the insolvency. Assessments for a given insolvency may take place over several years.
- b. *Prospective-premium-based assessments.* Guaranty funds covering claims of insolvent **property and casualty insurance enterprises** typically assess entities based on premiums written in one or more years *after* the insolvency. Assessments in any year are generally limited to an established percentage of an entity's premiums written or received for the year preceding the assessment. Assessments for a given insolvency may take place over several years.
- c. *Prefunded-premium-based assessments.* At least one state uses this kind of assessment to cover claims of insolvent property and casualty insurance enterprises. This kind of assessment is intended to pre-fund the costs of future insolvencies. Assessments are imposed prior to any particular insolvency and are based on the current level of written premiums. Rates to be applied to future premiums are adjusted as necessary.
- d. *Administrative-type assessments.* These assessments are typically a flat (annual) amount per entity to fund operations of the guaranty association, regardless of the existence of an insolvency. These assessments are generally expensed in the period assessed and are not addressed further in this SOP.

.05 State laws often allow for recoveries of guaranty-fund assessments by entities subject to assessments through such mechanisms as **premium tax offsets**, policy surcharges, and future premium rate structures.

### Other Insurance-Related Assessments

.06 Entities are subject to a variety of other insurance-related assessments. Many states and a number of local governmental units have established

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<sup>1</sup> Terms defined in the glossary [paragraph .55] are set in boldface type the first time they appear in this SOP.



other funds supported by assessments. The most prevalent uses for such assessments are (a) to fund operating expenses of state insurance regulatory bodies (for example, the state insurance department or workers' compensation board) and (b) to fund second-injury funds.<sup>2</sup>

.07 The primary methods used to assess for these other insurance-related assessments are the following.

- a. *Premium-based.* The assessing organization imposes the assessment based on the entity's written premiums.<sup>3</sup> The base year of premiums is generally either the current year or the year preceding the assessment.
- b. *Loss-based.* The assessing organization imposes the assessment based on the entity's **incurred losses** or paid losses in relation to that amount for all entities subject to that assessment in the particular jurisdiction.

## Scope

.08 This SOP applies to all entities that are subject to guaranty-fund and other insurance-related assessments.<sup>4,5</sup>

.09 Assessments covered by this SOP include any charge mandated by statute or regulatory authority that is related directly or indirectly to underwriting activities (including self-insurance), except for income taxes and premium taxes. This SOP does not apply to amounts payable or paid as a result of reinsurance contracts or arrangements that are in substance reinsurance, including assumed reinsurance activities and certain **involuntary pools** that are covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*.

## Conclusions

### Reporting Liabilities

.10 Entities subject to assessments should recognize liabilities for insurance-related assessments when all of the following conditions are met.

- a. An assessment has been imposed or information available prior to the issuance of the financial statements indicates it is probable that an assessment will be imposed.

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<sup>2</sup> Second-injury funds provide reimbursement to insurance carriers or employers for workers' compensation claims when the cost of a second injury combined with a prior accident or disability is greater than what the second accident alone would have produced. The employer of an injured or handicapped worker is responsible only for the workers' compensation benefit for the most recent injury; the second-injury fund would cover the cost of any additional benefits for aggravation of a prior condition or injury. The intent of the fund is to help insure that employers are not made to suffer a greater monetary loss or increased insurance costs because of hiring previously injured or handicapped employees.

<sup>3</sup> The assessing organization may be at the state, county, municipality, or other such level.

<sup>4</sup> Some entities are subject to insurance-related assessments because they self-insure against loss or liability. For example, one state specifies that self-insurers of workers' compensation should use as a base for assessment the amount of premium the self-insurer would have paid if it had insured its liability with an insurer for the previous calendar year.

<sup>5</sup> This SOP does not apply to assessments of depository institutions related to bank insurance and similar funds.

- b. The event obligating an entity to pay (underlying cause of) an imposed or probable assessment has occurred on or before the date of the financial statements.
- c. The amount of the assessment can be reasonably estimated.

### **Probability of Assessment**

.11 Premium-based guaranty-fund assessments, except those that are prefunded, are presumed probable when a formal determination of insolvency occurs, and presumed not probable prior to a formal determination of insolvency.<sup>6</sup> Prefunded guaranty-fund assessments and premium-based administrative-type assessments (as defined in paragraph .04), are presumed probable when the premiums on which the assessments are expected to be based are written. Loss-based administrative-type and second-injury fund assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

### **Obligating Event**

.12 Because of the fundamental differences in how assessment mechanisms operate, the event that makes an assessment probable (for example, an insolvency) may not be the event that obligates an entity. The following defines the event that obligates an entity to pay an assessment for each kind of assessment identified in this SOP.

.13 For premium-based assessments, the event that obligates the entity is generally writing the premiums or becoming **obligated to write** or renew (such as multiple-year, noncancelable policies) the premiums on which the assessments are expected to be based. Some states, through law or regulatory practice, provide that an insurance enterprise cannot avoid paying a particular assessment even if that insurance enterprise reduces its premium writing in the future. In such circumstances, the event that obligates the entity is a formal determination of insolvency or similar triggering event. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.

.14 For loss-based assessments, the event that obligates an entity is an entity's incurring the losses on which the assessments are expected to be based.

### **Ability to Reasonably Estimate the Liability**

.15 One of the conditions in FASB Statement No. 5, *Accounting for Contingencies*, for recognition of a liability is that the amount can be reasonably estimated. FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, provides that some amount of loss can be reasonably estimated when available information indicates that the estimated amount of the loss is within a range of amounts. When no amount within the range is a better estimate than any other amount, the minimum amount in the range shall be accrued.

.16 Entities subject to assessments may be able to obtain information to assist in estimating the total guaranty-fund cost or the following years' assessments, as appropriate, for an insolvency from organizations such as the state

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<sup>6</sup> For purposes of this SOP, a formal determination of insolvency occurs when an entity meets a state's (ordinarily the state of domicile of the insolvent insurer) statutory definition of an insolvent insurer. In most states, the entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation.

guaranty fund associations, the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) and the National Conference of Insurance Guaranty Funds (NCIGF). An entity need not be able to compute the exact amounts of the assessments or be formally notified of such assessments by a guaranty fund to make a reasonable estimate of its liability. Entities subject to assessments may have to make assumptions about future events, such as when the fund will incur costs and pay claims that will determine the amounts and the timing of assessments. The best available information about market share or premiums by state and premiums by line of business generally should be used to estimate the amount of an insurance enterprise's future assessments.

**.17** If a noninsurance entity's assessments are based on premiums, it may be necessary to consider the amount of premium the self-insurer would have paid if it had insured its liability with an insurer. If a noninsurance entity's assessments are based on losses, it should consider the losses that have been incurred by the company when determining the liability. Most often, assessments that have an impact of noninsurance entities that self-insure workers' compensation obligations are for second-injury funds. Second-injury funds generally assess insurance entities and self-insurers based on paid losses. A noninsurance entity may develop an accrual for its second-injury liability based on one or more of the following: (a) the ratio of the entity's prior period paid workers' compensation claims to aggregate workers' compensation claims in the state that was used as a basis for previous assessments, (b) total fund assessments in prior periods, or (c) known changes in the current period to either the number of employees self-insured by the entity or the number of workers who are the subject of recoveries from the second-injury fund that might alter total fund assessments and the entity's proportion of the total fund assessments.

**.18** Estimates of loss-based assessments should be consistent with estimates of the underlying incurred losses and should be developed based on enacted laws or regulations and expected assessment rates.

**.19** Estimates of some insurance-related assessment liabilities may be difficult to derive. The development or determination of estimates is particularly difficult for guaranty-fund assessments because of uncertainties about the cost of the insolvency to the guaranty fund and the portion that will be recovered through assessment. Examples of uncertainties follow:

- Limitations, as provided by statute, on the amount of individual contract liabilities that the guaranty fund will assume, that cause the guaranty fund associations' liability to be less than the amount by which the entity is insolvent
- Contract provisions (for example, credited rates) that may be modified at the time of the insolvency or alternative payout options that may be offered to contractholders that affect the level and payout of the guaranty fund's liability
- The extent and timing of available reinsurance recoveries may be subject to significant uncertainties
- Alternative strategies for the liquidation of assets of the insolvent company that affect the timing and level of assessments
- Certain liabilities of the insolvent insurer may be particularly difficult to estimate (for example, asbestos or environmental liabilities)

Because of the uncertainties surrounding some insurance-related assessments, the range of assessment liability may have to be reevaluated regularly during the assessment process. For some ranges, there may be amounts that appear to be better estimates than any other within the range. If this is the case, the liability recorded should be based on the best estimate within the range. For ranges in which there is no such best estimate, the liability that should be recorded should be based on the amount representing the minimum amount in the range.

## Application of Guidance

**.20** A discussion on applying the conclusions in paragraphs .10 through .19 to the methods used to address guaranty-fund assessments and other insurance-related assessments (as described in paragraphs .04 and .07) follows.

- a. *Retrospective-premium-based guaranty-fund assessments.* An assessment is probable of being imposed when a formal determination of insolvency occurs. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.
- b. *Prospective-premium-based guaranty-fund assessments.* The event that obligates the entity for the assessment liability generally is the writing of, or becoming obligated to write or renew, the premiums on which the expected future assessments are to be based.<sup>7</sup> Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency.

In states that, through law or regulatory practice, provide that an entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is a formal determination of insolvency or a similar event. An entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments that cannot be avoided related to a particular insolvency when a formal determination of insolvency occurs.

In states without such a law or regulatory practice, the event that obligates the entity is the writing of, or becoming obligated to write, the premiums on which the expected future assessments are to be based. An entity that has the ability to reasonably estimate the amount of the assessments should recognize a liability when the related premiums are written or when the entity becomes obligated to write the premiums.

- c. *Prefunded-premium-based guaranty-fund assessments.* A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related premiums are written.

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<sup>7</sup> For example, multiple-year contracts under which an insurance enterprise has no discretion to avoid writing future premiums.

- d. *Other premium-based assessments.* Other premium-based assessments, as described in paragraph .06, would be accounted for in the same manner as prefunded-premium-based guaranty-fund assessments.
- e. *Loss-based assessments.* An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related loss is incurred.

## Present Value

.21 Current practice in the insurance industry is to allow, but not require (with limited exceptions, such as pensions and postretirement benefits), the discounting of liabilities to reflect the time value of money when the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for a particular liability. Similarly, for assessments that meet those criteria, the liability may be recorded at its present value by discounting the estimated future cash flows at an appropriate interest rate.

## Reporting Assets for Premium Tax Offsets and Policy Surcharges

.22 When it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges, an asset should be recognized for that recovery in an amount that is determined based on current laws and projections of future premium collections or policy surcharges from **in-force policies**. In determining the asset to be recorded, in-force policies do not include expected renewals of short-duration contracts but do include assumptions as to persistency rates for long-duration contracts. The recognition of such assets related to prospective-premium-based assessments is limited to the amount of premium an entity has written or is obligated to write and to the amounts recoverable over the life of the in-force policies. This SOP requires an entity to recognize a liability for prospective-premium-based assessments as the premium is written or obligated to be written by the entity. Accordingly, the expected premium tax offset or policy surcharge asset related to the accrual of prospective-premium-based assessments should similarly be based on and limited to the amount recoverable as a result of premiums the insurer has written or is obligated to write.

.23 For retrospective-premium-based assessments, this SOP requires an entity to recognize a liability for such assessments at the time the insolvency has occurred. Accordingly, to the extent that it is probable that paid or accrued assessments will result in a recoverable amount in a future period from business currently in force considering appropriate persistency rates, an asset should be recognized at the time the liability is recorded.

.24 In all cases, the asset shall be subject to a valuation allowance to reflect any portion of the asset that is no longer probable of realization. Considering expected future premiums other than on in-force policies in evaluating the recoverability of premium tax offsets or policy surcharges is not appropriate. An asset shall not be established for paid or accrued assessments that are recoverable through future premium rate structures.

.25 The time value of money need not be considered in the determination of the recorded amount of the potential recovery if the liability is not discounted.

In instances in which the recovery period for the asset is substantially longer than the payout period for the liability, it may be appropriate to record the asset on a discounted basis regardless of whether the liability is discounted.

.26 The policy surcharges referred to in this SOP are those surcharges that are intended to provide an opportunity for assessed entities to recover some or all of the amounts assessed over a period of time. In some instances, there may be policy surcharges that are required as a pass-through to the state or other regulatory bodies, and these surcharges should be accounted for in a manner such that amounts collected or receivable are not recorded as revenues and amounts due or paid are not expensed (meaning, similar to accounting for sales tax).

## Disclosures

.27 FASB Statement No. 5, FASB Interpretation No. 14, and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640], address disclosures related to loss contingencies. That guidance is applicable to assessments covered by this SOP. Additionally, if amounts have been discounted, the entity should disclose in the financial statements the undiscounted amounts of the liability and any related asset for premium tax offsets or policy surcharges as well as the discount rate used. If amounts have not been discounted, the entity should disclose in the financial statements the amounts of the liability, any related asset for premium tax offsets or policy surcharges, the periods over which the assessments are expected to be paid, and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

## Effective Date and Transition

.28 This SOP is effective for financial statements for fiscal years beginning after December 15, 1998. Early adoption is encouraged. Previously issued annual financial statements should not be restated. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods should be restated). Entities subject to assessments should report the effect of initially adopting this SOP in a manner similar to the cumulative effect of a change in accounting principle. (Refer to paragraph 20 of Accounting Principles Board Opinion No. 20, *Accounting Changes*).

**The provisions of this Statement need  
not be applied to immaterial items.**

## Basis for Conclusions

.29 This section discusses considerations that were deemed significant by members of the AcSEC in reaching the conclusions in this SOP. It provides background information and includes reasons for accepting certain views and rejecting others.

.30 The authoritative financial reporting literature does not address explicitly accounting for guaranty-fund and other insurance-related assessments

and related premium tax offsets and policy surcharges of entities subject to assessments. AcSEC considered the following pertinent literature in reaching the conclusions in this SOP:

- FASB Statement No. 5, *Accounting for Contingencies*
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*
- FASB Statement No. 87, *Employers' Accounting for Pensions*
- FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*
- FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*
- AICPA SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640]
- AICPA SOP 96-1, *Environmental Remediation Liabilities* [section 10,680]
- Emerging Issues Task Force (EITF) Issue No. 87-22, *Prepayments to the Secondary Reserve of the FSLIC*
- EITF Issue No. 91-10, *Accounting for Special Assessments and Tax Increment Financing Entities*
- EITF Issue No. 92-13, *Accounting for Estimated Payments in Connection with the Coal Industry Retiree Health Benefit Act of 1992*
- EITF Issue No. 93-5, *Accounting for Environmental Liabilities*
- EITF Issue No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*
- EITF Topic D-47, *Accounting for the Refund of Bank Insurance Funds and Savings Association Insurance Fund Premiums*
- FASB Concepts Statement No. 6, *Elements of Financial Statements*
- Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 62, *Discounting by Property/Casualty Insurance Companies*
- SEC SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies*

## Reporting Liabilities

.31 FASB Statement No. 5, paragraph 8, requires the accrual of a liability when "a. Information available prior to issuance of the financial statements indicates that it is probable that . . . a liability has been incurred at the date of the financial statements" and "b. The amount of loss can be reasonably estimated." With respect to assessments, FASB Statement No. 5, paragraph 33, states, in part:

The following factors, among others, must be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:

- a. The period in which the underlying cause (i.e., the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred.

FASB Statement No. 5, paragraph 34, states, in part:

As a condition for accrual of a loss contingency, paragraph 8(a) requires that information available prior to the issuance of financial statements indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for . . . assessments whose underlying cause is an event or condition occurring after the date of financial statements . . . .

.32 Therefore, for a liability to be recognized in the financial statements, the underlying cause must have occurred on or before the date of the financial statements. The SOP identifies the obligating event for each kind of assessment, which is the underlying cause.

.33 In reaching the conclusions in this SOP concerning when to recognize liabilities for assessments, AcSEC considered the definition of liabilities in paragraph 35 of FASB Concepts Statement No. 6 and the concept of present obligation:

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. *[Footnote references omitted.]*

.34 To apply the definition of liabilities in paragraph 35 of FASB Concepts Statement No. 6 to assessments, AcSEC considered the underlying cause that creates a present obligation for entities subject to assessments to pay assessments. In order to have a present obligation, the entity must have little or no discretion to avoid the future sacrifice, and the event that obligates the entity must have occurred no later than the date of the financial statements.

.35 AcSEC concluded that the fundamental differences in the assessment mechanisms justified identifying different events, depending on the kind of assessment, that would obligate an entity and require recognition of a liability.

## Obligating Event

.36 More than one event may need to occur before there is a cause for an assessment. AcSEC believes that only when all of the events required to give rise to a cause for action have occurred has the event underlying a liability occurred. AcSEC concluded that the insolvency is the initial event that will give rise to a cause for an assessment, either currently or at some point in the future. The insolvency may or may not also be the final event.

.37 If, through the operation of law or regulatory practice, the enterprise has at the time of an insolvency an unavoidable obligation (subject only to the actual imposition of the assessment) to pay for some portion of the insolvency, no further events are required for there to be an underlying cause of a liability. However, if at the moment of the insolvency the enterprise does not, through the operation of law or regulatory practice, have an unavoidable obligation (subject only to the actual imposition of the assessment), then another event is the final event underlying the obligation.

## Assessments Based on Premiums

.38 For assessments based on premiums written after the insolvency, AcSEC concluded that the writing of premiums on which a potential assess-



ment is based generally should be considered the underlying cause of an entity's obligation to pay cash in the future.<sup>8</sup>

.39 In making its decision, AcSEC noted that entities generally have the option of reducing or eliminating their premium-writing activity, thereby reducing or eliminating their assessment. AcSEC was also influenced by the fact that entities subject to assessments that enter a new state or increase market share in a state will be required to pay assessments for insolvencies that occurred before they entered that state or increased their market share. The fact that such entities will have to pay assessments for insolvencies that occurred previously supports the conclusion that the writing of premiums is the underlying cause of the assessments.

.40 AcSEC believes that a number of analogies support the conclusions in this SOP. For example, in EITF Issue No. 93-6, a ceding enterprise would recognize a liability for obligatory retrospectively rated contracts only to the extent that it has an obligation to pay cash (or other consideration) to a reinsurer that would not have been required in the absence of experience under the contract. Furthermore, EITF Issue No. 93-6 specifically prohibits ceding companies from recognizing liabilities for amounts expected to be paid in the future that relate to prior catastrophe losses (for example, through increased costs of reinsurance) when no contractual obligation to make such payments exists. AcSEC believes that entities subject to assessments have no obligation to pay assessments unless the premiums on which the assessments are to be based are written.

.41 In EITF Issue No. 92-13, the EITF reached a consensus that allowed enterprises with operations in the coal industry to account for their obligations under the Coal Industry Retiree Health Benefit Act of 1992 (which created a fund to pay benefits related to certain coal-industry benefit trusts that were operating at deficits) as multiemployer pension plans. Guaranty funds are similar to multiemployer pension plans in that each insurance enterprise's payments to the fund are used to satisfy the general obligations of the fund and are not segregated for the benefit of any one enterprise.

.42 AcSEC also believes that accounting for claims-made insurance provides an appropriate analogy. In claims-made insurance, the insured event is the reporting, during the term of the policy or within a specified period following the coverage period, to the insurer of a claim for a covered loss. For such policies, entities subject to assessments estimate a liability for unpaid claims based only on claims reported, despite the fact that other losses may have been incurred that eventually may result in claims to that insurance enterprise. The agreement between the insurer and the insured is that the insurance enterprise is not obligated to cover those unreported losses, unless that insurance enterprise is providing coverage under a claims-made policy when the claim is made. Similarly, the substance of the arrangement for most premium-based assessment mechanisms is that an insurance enterprise is obligated to pay assessments only if the premiums on which the assessments are to be based are written.

### **Assessments Based on Losses**

.43 For loss-based assessments, AcSEC concluded that the event underlying an insurance enterprise's obligation to pay the assessment is the incur-

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<sup>8</sup> As discussed in paragraph .13, some states, through law or regulatory practice, provide that an insurance enterprise cannot avoid paying a particular assessment even if the insurance enterprise reduces premium writings in the future. For example, in certain states, an insurance enterprise may remain liable for assessments even though the insurance enterprise discontinues the writing of premiums. In this case, the underlying cause of the liability is not the writing of the premium, but the insolvency.

rence of losses on which the assessments are expected to be based (regardless of whether the assessment is based on paid or incurred losses). AcSEC believes that entities subject to assessments have little or no discretion to avoid the future sacrifice once the losses on which the assessments are expected to be based have been incurred. Unlike premium-based assessments, in which the insurance enterprise has the discretion to write or not to write premiums (even if it is unlikely that the insurance enterprise will not write such future premiums), an insurance enterprise is obligated to pay the loss-based assessments once those losses are incurred.

.44 AcSEC considered whether it is appropriate to recognize a liability for assessments for administrative-type state funds as the losses on which the assessments are based are incurred by entities. Some have indicated that it is not appropriate to accrue a liability for operating costs of a state fund that have not yet been incurred by the state fund. AcSEC concluded that loss-based assessments for administrative-type funds should be accrued as losses of an entity occur if it is probable that a related assessment will be made. AcSEC believes this is similar to the accounting in FASB Statement No. 60, whereby liabilities for claim adjustment expenses that relate to unpaid claims are accrued before the costs are incurred. Once the losses are incurred, insurance enterprises have little or no discretion to avoid paying the assessment.

### **Probability of Assessment**

.45 Although entities subject to assessments may be able to determine that future assessments are probable for some period before a formal determination of insolvency occurs, AcSEC concluded that assessments should not be considered probable until a formal determination of insolvency occurs, unless the assessments are being made by a prefunded guaranty fund. AcSEC believes that the formal determination date is the most objectively determinable measurement date and that requiring its use will foster comparability in reporting. Furthermore, AcSEC believes mere speculation about an insurance enterprise's insolvency should not be considered an accounting event.

### **Present Value**

.46 AcSEC believes that recognizing assessment liabilities at their present value provides the most representative measure of the economic substance of the situation. Nevertheless, AcSEC declined to mandate present-value-based measurements while the FASB is still considering the role of present-value-based measurements in financial reporting. For the same reason, this SOP provides no detailed guidance on present-value methodologies and discount rates.

### **Premium Tax Offsets, Policy Surcharges, and Future Rate Making**

.47 AcSEC believes that, when it is probable that paid or accrued assessments will result in premium tax offsets or policy surcharges, the recognition of an asset is appropriate based on current laws and projections of future premium collections from in-force policies. No asset should be recognized related to expected new business or renewal of in-force short-duration contracts. In making this determination, AcSEC considered the characteristics of an asset in paragraph 26 of FASB Concepts Statement No. 6, which states, in part:

An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

.48 Premium tax offsets, policy surcharges, and the incorporation of assessment costs in future premium rate structures have a similar purpose, that is, to allow entities subject to assessments to recoup some portion of assessment costs. Nevertheless, AcSEC concluded that the ability to include assessments in future premium rate structures should be treated differently from premium tax offsets and policy surcharges. Premium tax offsets and policy surcharges are statutorily provided and generally are not dependent on the ability or intent of an insurance enterprise to take any action. In contrast, there can be no assurance that the future competitive or regulatory environment will allow an insurance enterprise to include assessments in future premium rate structures in such a manner as to result in a recovery of costs. Thus, AcSEC concluded that the statutory ability to include assessment costs in future premium structures should not result in asset recognition and should not be used to reduce current assessment costs.

.49 To the extent that paid or accrued guaranty-fund costs are expected to result in premium tax offsets or policy surcharges, AcSEC believes that it is appropriate to consider the recognition of such recoveries as assets. AcSEC believes that the amount of the asset should be limited to expected future premiums related to policies in force at the measurement date. AcSEC considered whether it is appropriate to consider all expected future premiums in establishing such recoveries and concluded that this approach would introduce an inconsistency with AcSEC's decision not to recognize a liability for guaranty-fund and similar assessments that are based on future premiums. Therefore, AcSEC determined that considering all expected future premiums in evaluating the recoverability of premium tax offsets or policy surcharges is not appropriate.

.50 AcSEC also considered whether there was an inappropriate inconsistency between requiring the use of persistency assumptions in asset recognition and not for liability recognition in prospective-premium-based assessments (for example, for multiple-year contracts). AcSEC concluded that this treatment was appropriate due to the limited number of instances in which persistency assumptions would be applicable for liability measurement.

### ***Prefunded-Premium-Based Assessments***

.51 For prefunded-premium-based assessments, as long as such funds do not provide, either by statute or practice, for a return of excess assessments, no asset should be recorded.

### **Transition**

.52 AcSEC decided to prohibit the retroactive application of this SOP. AcSEC recognizes the benefits of comparative financial statements but believes that the necessary information for entities subject to assessments to create for prior periods the necessary estimates of liabilities for future assessments and of the timing and amounts of cash flows would not be readily available.

## Appendix A

### Illustration of Computation of Assessment Liabilities

#### Example 1—Prospective-Premium-Based Assessment<sup>9</sup>

##### Scenario

As a result of insolvencies in prior years, ABC Property & Liability Insurance Company (ABC) expects to be assessed in the future by the guaranty fund in a state where it writes premiums. Any such assessments will be limited to 2 percent of premium writings in the prior year and are recoverable through premium tax offsets on a ratable basis over the five-year period following the year of each assessment.

Although it does not expect to do so, ABC is free to cease writing the lines of business that are subject to the guaranty-fund assessments.

As of December 31, 19X0, ABC has neither paid nor received a notice of an assessment related to the insolvencies. Based on communications from the state guaranty association, ABC expects to receive an assessment in 19X1, which is allocated among entities based on 19X0 market share, for at least 1 percent of 19X0 premiums that are subject to the assessment. A best estimate cannot be determined, and no amount within the range of estimates (meaning, from 1 to 2 percent of 19X0 premiums) is a better estimate than any other amount, therefore the minimum amount in the range should be accrued.

##### Result

As of December 31, 19X0, ABC should recognize a liability equal to 1 percent of the premiums written in 19X0 that are subject to the assessment. No additional liability should be recognized, and no asset related to the premium tax offset should be recognized. Disclosure of the loss contingency of up to an additional 1 percent of the subject premiums should be considered.

##### Discussion

ABC would recognize a liability only for those future assessments it is obligated to pay as a result of the premiums written. Because ABC is not obligated to write any future premiums, its liability is limited to that related to premiums written in 19X0. Because no amount within the range of estimates is a better estimate than any other amount, the minimum amount in the range is accrued. Further, because the premium tax offset is realizable only on business that will be written in the future (that is, 19X2 and subsequent years), no asset or receivable is recognized as of December 31, 19X0.

#### Example 2—Retrospective-Premium-Based Assessment

##### Scenario

As a result of an insolvency that occurred during 19X0, DEF Life and Health Insurance Company (DEF) expects to be assessed in the future by the guaranty

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<sup>9</sup> This kind of assessment is considered prospective since the assessment relates to premium written subsequent to the insolvency.

fund in a state where it has written business. Any such assessment will be based on DEF's average market share, determined based on premiums that are subject to the assessment for the three years prior to the insolvency, and limited to 2 percent of the average annual subject premiums for the three years prior to the insolvency. Further, such assessments are recoverable through premium tax offsets over the five-year period following the year of payment for each assessment.

As of December 31, 19X0, DEF has not paid or received a notice of an assessment related to the insolvency. Based on initial input from the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) and experience with other insolvencies, DEF assumes that the first assessment will not be made until 19X3 and that it will take three to five annual assessments in order for the guaranty fund to be able to meet its obligations. Based on the estimated nationwide cost of the insolvency and the distribution of the insolvent company's business, DEF estimates that its assessment will be at least 1 percent of the average annual premiums that are subject to the assessment. No amount within the range of estimates (meaning, from 1 to 2 percent of the average annual premiums for three to five years) is a better estimate than any other amount, therefore the minimum amount in the range should be accrued.

## Result

As of December 31, 19X0, DEF should recognize a liability for three years of assessments at 1 percent of the average annual premiums that are subject to the assessment (that is, the assessments expected in 19X3, 19X4, and 19X5). Disclosure of the loss contingency for additional assessments (meaning, in 19X6 and 19X7) or assessment of greater than 1 percent of the average annual premiums that are subject to the assessment should be considered. An asset related to premium tax offsets that are available on accrued assessments would be recorded provided there were sufficient premium taxes based on business in force at December 31, 19X0 (with assumed levels of policy retention) to allow realization of the asset.

The resulting recognized liability and asset are as follows (shown on both a discounted and undiscounted basis, based on paragraphs .21 and .25, discounting is optional), assuming average annual subject premiums of \$100,000 for the three years prior to the insolvency.

Schedule of Assessments and Premium Tax Offsets

Assessments	Recorded At	Cash Payments									
		19X1	19X2	19X3	19X4	19X5	19X6	19X7	19X8	19X9	20X0
19X3 Assessment	12/31/19X0			1,000							
19X4 Assessment					1,000						
19X5 Assessment						1,000					
Total	3,000			1,000	1,000	1,000					
Premium Tax Offset											
19X3 Assessment (1)					200	200	200	200	200		
19X4 Assessment (1)						200	200	200	200	200	
19X5 Assessment (1)							200	200	200	200	200
Total	3,000				200	400	600	600	600	400	200
Present value of assessments at 12/31/19X0 (2)	2,470										
Present value of Premium Tax Offset at 12/31/19X0 (2)	2,139										

(1) Assumes that, based upon anticipated levels of policy retention from the business in force at December 31, 19X0, there will be sufficient premium to realize the premium tax offset.

(2) Discounted at 5 percent, assuming all assessments are paid and offsets realized at the end of each year.

## Discussion

DEF would record a liability for all future assessments related to the insolvency. Because no amount within the range of estimates (meaning, from 1 to 2 percent of the average annual premiums for three to five years) is a better estimate than any other amount, the minimum amount in the range (meaning, 1 percent per year for three years of assessments) is accrued.

Since it is assumed that based upon the anticipated levels of policy retention from the business in force at December 31, 19X0, there will be sufficient premium to realize the premium tax offset, the premium tax offset is recorded.

## Example 3—Loss-Based Assessment

### Scenario

GHI Industrial Company (GHI) is self-insured for workers' compensation and therefore participates in the second injury fund in the state where it conducts operations. GHI is entitled to recover from the fund for some or all of the indemnity claims for previously injured workers. GHI is also subject to annual assessments (maximum of 1 percent per year) on indemnity claims paid each year.

Assessment rates have been climbing steadily, from 0.6 percent five years ago to 0.75 percent in 19X0.

### Results

As of December 31, 19X0, GHI should have an assessment liability recognized for 0.75 percent of its liability for the payment of future indemnity claims, unless there was information to support the assessment rate being reduced or the assessments being eliminated in the future. Disclosure of the loss contingency of up to an additional 0.25 percent of the liability for the payment of future indemnity claims should be considered.

### Discussion

GHI would recognize a liability based on the current assessment rate, unless there was clear evidence that the rate would change. The liability would be based on the entire liability base that was subject to the assessment.

## Appendix B

### Discussion of Comments Received on the Exposure Draft

An exposure draft of a proposed statement of position (SOP), *Accounting by Insurance and Other Enterprises for Guaranty-Fund and Certain Other Insurance-Related Assessments*, was issued for public comment on December 5, 1996, and distributed to a variety of interested parties to encourage comment by those who would be affected by the proposal. Twenty-four comment letters were received in response on the exposure draft. The most significant and pervasive comments received were in the following four areas:

1. Reporting assets and policy surcharges
2. Estimation of the assessment liability
3. Accounting for prospective-premium-based assessments
4. Scope

### Reporting Assets and Policy Surcharges

The guidance in the exposure draft on reporting assets and policy surcharges caused some confusion. Several respondents requested clarification about the kind of entity that would recognize assets for premium tax offsets and policy surcharges. AcSEC clarified the guidance to explain how an asset should be accounted for when it is probable that a paid or accrued assessment will result in an amount that is expected to be recoverable.

### Estimation of the Assessment Liability

Several respondents commented that they do not believe a liability can be reasonably estimated by an entity for guaranty-fund assessments because the entity will not have the necessary information to estimate the amount of loss. These respondents commented that a determination of estimates is particularly difficult for guaranty-fund assessments because of uncertainties about the cost of the insolvency to the guaranty fund and the portion that will be recovered through assessment because of such factors as alternative strategies for the liquidation of assets of the insolvent company that affect the timing and level of assessments and certain liabilities of the insolvent insurer may be particularly difficult to estimate (for example, asbestos or environmental liabilities). AcSEC believes that, although it may be difficult to calculate a point estimate in certain circumstances (see paragraph .19), in the majority of cases, enough information is available to calculate a range of estimates. Further, in the case of prospective-premium-based assessments, the liability to be recorded is related only to premiums written or obligated to be written, rather than to all expected future premiums.

### Accounting for Prospective-Premium-Based Assessments

The exposure draft contained an alternative view on accounting for prospective-premium-based assessments, which discussed that a minority of AcSEC



believed that the insolvency should be considered the underlying cause of an entity's obligation to pay future assessments, irrespective of the basis used to determine the amount due from each insurance enterprise subject to the assessment. The majority of respondents did not support this minority view. AcSEC continues to believe that the writing of the premium on which potential assessments are expected to be based is the underlying cause of an entity's obligation to pay cash in the future.

## **Scope**

Because entities other than insurance enterprises are assessed insurance-related assessments, the scope of the exposure draft included all reporting entities. Although some noninsurance entities requested to be excluded from the scope, most of the respondents believe that both insurance enterprises and noninsurance enterprises would have sufficient information to recognize a liability for the assessments covered in the SOP.

## Glossary

**Incurred losses.** Losses paid or unpaid for which the company has become liable during a period.

**In-force policies.** Policies effective before a specified date that have not yet expired or been canceled.

**Involuntary pools.** A residual market mechanism for insureds who cannot obtain insurance in the voluntary market.

**Life, annuity, and health insurance enterprise.** An enterprise that may issue annuity, endowment, and accident and health insurance contracts as well as life insurance contracts. Life and health insurance enterprises may be either stock or mutual organizations.

**Obligated to write.** If an entity has no discretion to cancel a policy because of legal obligation under state statute or contract terms, or regulatory practice and is required to offer or issue insurance policies for a period in the future.

**Premium tax offsets.** Offsets against premium taxes levied on insurance companies by states.

**Premiums written.** The premiums on all policies a company has issued in a period.

**Property and casualty insurance enterprise.** An enterprise that issues insurance contracts providing protection against either (1) damage to or loss of property caused by various perils, such as fire and theft or (2) legal liability resulting from injuries to other persons or damage to their property. Property and liability insurance enterprises may be either stock or mutual organizations.

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The task force and staff gratefully acknowledge the contributions made to the development of this Statement of Position by David B. Greenfield and former members Joseph Zubretsky and John E. Schramm.

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[The next page is 20,411.]



**Section 10,720****Statement of Position 98-1  
Accounting for Costs of Computer Software  
Developed or Obtained for Internal Use****March 4, 1998****NOTE**

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

**Summary**

This Statement of Position (SOP) provides guidance on accounting for the costs of computer software developed or obtained for internal use. The SOP requires the following:

- Computer software meeting the characteristics specified in this SOP is internal-use software.
- Computer software costs that are incurred in the preliminary project stage should be expensed as incurred. Once the capitalization criteria of the SOP have been met, external direct costs of materials and services consumed in developing or obtaining internal-use computer software; payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software project (to the extent of the time spent directly on the project); and interest costs incurred when developing computer software for internal use should be capitalized. Training costs and data conversion costs, except as noted in paragraph .21, should be expensed as incurred.
- Internal costs incurred for upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20–.23. Internal costs incurred for maintenance should be expensed as incurred.

Entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.

- External costs incurred under agreements related to specified upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20–.23. However, external costs related to maintenance, unspecified upgrades and enhancements, and costs under agreements that combine the costs of maintenance and unspecified upgrades and enhancements should be recognized in expense over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the services received.
- Impairment should be recognized and measured in accordance with the provisions of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*.
- The capitalized costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software's use.
- If, after the development of internal-use software is completed, an entity decides to market the software, proceeds received from the license of the computer software, net of direct incremental costs of marketing, should be applied against the carrying amount of that software.

The SOP identifies the characteristics of internal-use software and provides examples to assist in determining when computer software is for internal use.

The SOP applies to all nongovernmental entities and is effective for financial statements for fiscal years beginning after December 15, 1998. The provisions of this SOP should be applied to internal-use software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of the SOP. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued. Costs incurred prior to initial application of this SOP, whether capitalized or not, should not be adjusted to the amounts that would have been capitalized had this SOP been in effect when those costs were incurred.

## Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

## Introduction and Background

.01 The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, in 1985. At that time, the FASB considered expanding the scope of that project to include costs incurred for the development of computer software for internal use. The FASB concluded, however, that accounting for the costs of software used internally was not a significant problem and, therefore, decided not to expand the scope of the project. The FASB stated that it recognized that at that time the majority of entities expensed all costs of developing software for internal use, and it was not convinced that the predominant practice was improper.

.02 Because of the absence of authoritative literature that specifically addresses accounting for the costs of computer software developed or obtained for internal use and the growing magnitude of those costs, practice became diverse. Some entities capitalize costs of internal-use computer software, whereas some entities expense costs as incurred. Still other entities capitalize costs of purchased internal-use computer software and expense costs of internally developed internal-use computer software as incurred.

.03 The staff of the Securities and Exchange Commission (SEC) and other interested parties have requested that standard setters develop authoritative guidance to eliminate the inconsistencies in practice. In a November 1994 letter, the Chief Accountant of the SEC suggested that the Emerging Issues Task Force (EITF) develop that guidance. However, the EITF and the Accounting Standards Executive Committee (AcSEC) agreed that AcSEC should develop the guidance.

.04 AcSEC issued an exposure draft of a proposed Statement of Position (SOP), *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, on December 17, 1996. AcSEC received about 130 comment letters in response to the exposure draft.

## Scope

.05 This SOP provides guidance on accounting by all nongovernmental entities, including not-for-profit organizations, for the costs of computer software developed or obtained for internal use and provides guidance for determining whether computer software is for internal use.

.06 This SOP clarifies that the costs of computer software developed or obtained are costs of either (a) software to be sold, leased, or otherwise mar-

keted as a separate product or as part of a product or process, subject to FASB Statement No. 86; (b) software to be used in research and development, subject to FASB Statement No. 2, *Accounting for Research and Development Costs*, and FASB Interpretation No. 6, *Applicability of FASB Statement No. 2 to Computer Software*; (c) software developed for others under a contractual arrangement, subject to contract accounting standards; or (d) internal-use software, subject to this SOP. This SOP does not change any of the provisions in FASB Statement Nos. 86, 2, or FASB Interpretation No. 6.

.07 Costs of computer software that is “sold, leased, or otherwise marketed as a separate product or as part of a product or process” are within the scope of FASB Statement No. 86. The Appendix of this SOP includes examples of computer software considered to be for internal use and thus not “part of a product or process.”

.08 This SOP provides guidance on when costs incurred for internal-use computer software are and are not capitalized.

.09 This SOP provides guidance on accounting for the proceeds of computer software developed or obtained for internal use that is marketed.

.10 This SOP provides guidance on accounting for computer software that consists of more than one component or module. For example, an entity may develop an accounting software system containing three elements: a general ledger, an accounts payable subledger, and an accounts receivable subledger. In this example, each element might be viewed as a component or module of the entire accounting software system. The guidance in this SOP should be applied to individual components or modules.

.11 Accounting for costs of reengineering activities, which often are associated with new or upgraded software applications, is not included within the scope of this SOP.<sup>1</sup>

## Conclusions

### Characteristics of Internal-Use Computer Software

.12 For purposes of this SOP, internal-use software is software having the following characteristics:

- a. The software is acquired, internally developed, or modified solely to meet the entity's internal needs.
- b. During the software's development or modification, no substantive plan exists or is being developed to market the software externally.

A substantive plan to market software externally could include the selection of a marketing channel or channels with identified promotional, delivery, billing, and support activities. To be considered a substantive plan under this SOP, implementation of the plan should be reasonably possible. Arrangements providing for the joint development of software for mutual internal use (for example, cost-sharing arrangements) are not substantive plans to market software for purposes of this SOP. Similarly, routine market feasibility studies are not substantive plans to market software for purposes of this SOP.

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<sup>1</sup> This SOP does not change the conclusions reached in Emerging Issues Task Force Issue No. 97-13, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*, which requires that the costs of reengineering activities be expensed as incurred.



.13 An entity must meet both characteristics in paragraph .12 for software to be considered for internal use.

.14 An entity's past practices related to selling software may help determine whether the software is for internal use or is subject to a plan to be marketed externally. For example, an entity in the business of selling computer software often both uses and sells its own software products. Such a past practice of both using and selling computer software creates a rebuttable presumption that any software developed by that entity is intended for sale, lease, or other marketing, and thus is subject to the guidance in FASB Statement No. 86.

.15 Computer software to be sold, leased, or otherwise marketed includes software that is part of a product or process to be sold to a customer and should be accounted for under FASB Statement No. 86. For example, software designed for and embedded in a semiconductor chip is included in the scope of FASB Statement No. 86 because it is an integral part of the product. By contrast, software for internal use, though it may be used in developing a product, is not part of or included in the actual product or service sold. If software is used by the vendor in the production of the product or providing the service but the customer does not acquire the software or the future right to use it, the software is covered by this SOP. For example, for a communications company selling telephone services, software included in a telephone switch is part of the internal equipment used to deliver a service but is not part of the product or service actually being acquired or received by the customer.

.16 The Appendix [paragraph .93] provides examples of when computer software is and is not for internal use.

## Stages of Computer Software Development

.17 The following table illustrates the various stages and related processes of computer software development.

<i>Preliminary Project Stage</i>	<i>Application Development Stage</i>	<i>Post-Implementation / Operation Stage</i>
Conceptual formulation of alternatives	Design of chosen path, including software configuration and software interfaces	Training
Evaluation of alternatives	Coding	Application maintenance
Determination of existence of needed technology	Installation to hardware	
Final selection of alternatives	Testing, including parallel processing phase	

The SOP recognizes that the development of internal-use computer software may not follow the order shown above. For example, coding and testing are often performed simultaneously. Regardless, for costs incurred subsequent to completion of the preliminary project stage, the SOP should be applied based on the nature of the costs incurred, not the timing of their incurrence. For example, while some training may occur in the application development stage, it should be expensed as incurred as required in paragraphs .21 and .23.

## Research and Development

**.18** The following costs of internal-use computer software are included in research and development and should be accounted for in accordance with the provisions of FASB Statement No. 2:

- a. Purchased or leased computer software used in research and development activities where the software does not have alternative future uses.
- b. All internally developed internal-use computer software<sup>2</sup> (including software developed by third parties, for example, programmer consultants) if (1) the software is a pilot project (that is, software of a nature similar to a pilot plant as noted in paragraph 9(h) of FASB Statement No. 2) or (2) the software is used in a particular research and development project, regardless of whether the software has alternative future uses.

## Capitalize or Expense

**.19 Preliminary Project Stage.** When a computer software project is in the preliminary project stage, entities will likely—

- a. Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers develop a new payroll system or direct their efforts toward correcting existing problems in an operating payroll system?
- b. Determine the performance requirements (that is, what it is that they need the software to do) and systems requirements for the computer software project it has proposed to undertake.
- c. Invite vendors to perform demonstrations of how their software will fulfill an entity's needs.
- d. Explore alternative means of achieving specified performance requirements. For example, should an entity make or buy the software? Should the software run on a mainframe or a client server system?
- e. Determine that the technology needed to achieve performance requirements exists.
- f. Select a vendor if an entity chooses to obtain software.
- g. Select a consultant to assist in the development or installation of the software.

**.20** Internal and external costs incurred during the preliminary project stage should be expensed as they are incurred.

**.21 Application Development Stage.** Internal and external costs incurred to develop internal-use computer software during the application development stage should be capitalized. Costs to develop or obtain software that allows for access or conversion of old data by new systems should also be capitalized. Training costs are not internal-use software development costs and, if incurred during this stage, should be expensed as incurred.

**.22** The process of data conversion from old to new systems may include purging or cleansing of existing data, reconciliation or balancing of the old data

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<sup>2</sup> FASB Interpretation No. 6 excludes from research and development costs computer software related to an entity's selling and administrative activities.

and the data in the new system, creation of new/additional data, and conversion of old data to the new system. Data conversion often occurs during the application development stage. Data conversion costs, except as noted in paragraph .21, should be expensed as incurred.

**.23 Post-Implementation/Operation Stage.** Internal and external training costs and maintenance costs should be expensed as incurred.

**.24 Upgrades and Enhancements.** For purposes of this SOP, upgrades and enhancements are defined as modifications to existing internal-use software that result in additional functionality—that is, modifications to enable the software to perform tasks that it was previously incapable of performing. Upgrades and enhancements normally require new software specifications and may also require a change to all or part of the existing software specifications. In order for costs of specified upgrades and enhancements to internal-use computer software to be capitalized in accordance with paragraphs .25 and .26, it must be probable<sup>3</sup> that those expenditures will result in additional functionality.<sup>4</sup>

**.25 Internal costs incurred for upgrades and enhancements** should be expensed or capitalized in accordance with paragraphs .20–.23.<sup>5</sup> Internal costs incurred for maintenance should be expensed as incurred. Entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.

**.26 External costs incurred under agreements related to specified upgrades and enhancements** should be expensed or capitalized in accordance with paragraphs .20–.23. (If maintenance is combined with specified upgrades and enhancements in a single contract, the cost should be allocated between the elements as discussed in paragraph .33 and the maintenance costs should be expensed over the contract period.) However, external costs related to maintenance, unspecified upgrades and enhancements, and costs under agreements that combine the costs of maintenance and unspecified upgrades and enhancements should be recognized in expense over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the services received.

**.27 Capitalization of costs** should begin when both of the following occur.

- a. Preliminary project stage is completed.
- b. Management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project and it is probable<sup>6</sup> that the project will be completed and the software will be used to perform the function intended. Examples of authorization include the execution of a contract with a third party to develop the software, approval of expenditures related to internal development, or a commitment to obtain the software from a third party.

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<sup>3</sup> See paragraph .62 of this SOP for meaning of “probable.”

<sup>4</sup> This SOP does not change the conclusions reached in Emerging Issues Task Force Issue No. 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*, which requires that external and internal costs associated with modifying internal-use software currently in use for the Year 2000 be charged to expense as incurred. New internal-use software developed or obtained that replaces previously existing internal-use software should be accounted for in accordance with this SOP.

<sup>5</sup> See footnote 4.

<sup>6</sup> See paragraph .62 of this SOP for meaning of “probable.”

.28 When it is no longer probable<sup>7</sup> that the computer software project will be completed and placed in service, no further costs should be capitalized, and guidance in paragraphs .34 and .35 on impairment should be applied to existing balances.

.29 Capitalization should cease no later than the point at which a computer software project is substantially complete and ready for its intended use. For purposes of this SOP, computer software is ready for its intended use after all substantial testing is completed.

.30 New software development activities should trigger consideration of remaining useful lives of software that is to be replaced. When an entity replaces existing software with new software, unamortized costs of the old software should be expensed when the new software is ready for its intended use.

### Capitalizable Costs

.31 Costs of computer software developed or obtained for internal use that should be capitalized include only the following:

- a. External direct costs of materials and services consumed in developing or obtaining internal-use computer software. Examples of those costs include but are not limited to fees paid to third parties for services provided to develop the software during the application development stage, costs incurred to obtain computer software from third parties, and travel expenses incurred by employees in their duties directly associated with developing software.
- b. Payroll and payroll-related costs (for example, costs of employee benefits) for employees who are directly associated with and who devote time to the internal-use computer software project, to the extent of the time spent directly on the project. Examples of employee activities include but are not limited to coding and testing during the application development stage.
- c. Interest costs incurred while developing internal-use computer software. Interest should be capitalized in accordance with the provisions of FASB Statement No. 34, *Capitalization of Interest Cost*.<sup>8</sup>

General and administrative costs and overhead costs should not be capitalized as costs of internal-use software.

.32 Entities often license internal-use software from third parties. Though FASB Statement No. 13, *Accounting for Leases*, excludes licensing agreements from its scope, entities should analogize to that Statement when determining the asset acquired in a software licensing arrangement.

### Multiple-Element Software Arrangements Included in Purchase Price

.33 Entities may purchase internal-use computer software from a third party. In some cases, the purchase price includes multiple elements, such as training for the software, maintenance fees for routine maintenance work to be

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<sup>7</sup> See paragraph .62 of this SOP for meaning of "probable."

<sup>8</sup> Paragraph 17 of FASB Statement No. 34, *Capitalization of Interest Cost*, states, "If the enterprise suspends substantially all activities related to acquisition of the asset, interest capitalization shall cease until activities are resumed."

performed by the third party, data conversion costs, reengineering costs, and rights to future upgrades and enhancements. Entities should allocate the cost among all individual elements. The allocation should be based on objective evidence of fair value of the elements in the contract, not necessarily separate prices stated within the contract for each element. Those elements included in the scope of this SOP should be accounted for in accordance with the provisions of this SOP.

## Impairment

.34 Impairment should be recognized and measured in accordance with the provisions of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. Paragraph 8 of FASB Statement No. 121 requires that assets should be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. FASB Statement No. 121 guidance is applicable, for example, when one of the following occurs related to computer software being developed or currently in use:

- a. Internal-use computer software is not expected to provide substantive service potential,
- b. A significant change occurs in the extent or manner in which the software is used or is expected to be used,
- c. A significant change is made or will be made to the software program,
- d. Costs of developing or modifying internal-use computer software significantly exceed the amount originally expected to develop or modify the software.

.35 Paragraph 10 of FASB Statement No. 121 requires that “if the asset is not expected to provide any service potential to the entity, the asset shall be accounted for as if abandoned or held for disposal in accordance with the provisions of paragraph 15 of [FASB Statement No. 121].” When it is no longer probable<sup>9</sup> that computer software being developed will be completed and placed in service, the asset should be reported at the lower of the carrying amount or fair value, if any, less costs to sell. The rebuttable presumption is that such uncompleted software has a fair value of zero. Indications that the software may no longer be expected to be completed and placed in service include the following:

- a. A lack of expenditures budgeted or incurred for the project
- b. Programming difficulties that cannot be resolved on a timely basis
- c. Significant cost overruns
- d. Information has been obtained indicating that the costs of internally developed software will significantly exceed the cost of comparable third-party software or software products, so that management intends to obtain the third-party software or software products instead of completing the internally developed software
- e. Technologies are introduced in the marketplace, so that management intends to obtain the third-party software or software products instead of completing the internally developed software

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<sup>9</sup> See paragraph .62 of this SOP for meaning of “probable.”

- f. Business segment or unit to which the software relates is unprofitable or has been or will be discontinued.

## Amortization

.36 The costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software's use.

.37 In determining and periodically reassessing the estimated useful life over which the costs incurred for internal-use computer software will be amortized, entities should consider the effects of obsolescence, technology, competition, and other economic factors. Entities should consider rapid changes that may be occurring in the development of software products, software operating systems, or computer hardware and whether management intends to replace any technologically inferior software or hardware. Given the history of rapid changes in technology, software often has had a relatively short useful life.

.38 For each module or component of a software project, amortization should begin when the computer software is ready for its intended use, regardless of whether the software will be placed in service in planned stages that may extend beyond a reporting period. For purposes of this SOP, computer software is ready for its intended use after all substantial testing is completed. If the functionality of a module is entirely dependent on the completion of other modules, amortization of that module should begin when both that module and the other modules upon which it is functionally dependent are ready for their intended use.

## Internal-Use Computer Software Marketed

.39 If, after the development of internal-use software is completed, an entity decides to market the software, proceeds received from the license of the computer software, net of direct incremental costs of marketing, such as commissions, software reproduction costs, warranty and service obligations, and installation costs, should be applied against the carrying amount of that software. No profit should be recognized until aggregate net proceeds from licenses and amortization have reduced the carrying amount of the software to zero. Subsequent proceeds should be recognized in revenue as earned.

.40 If, during the development of internal-use software, an entity decides to market the software to others, the entity should follow FASB Statement No. 86. Amounts previously capitalized under this SOP should be evaluated at each balance sheet date in accordance with paragraph 10 of FASB Statement No. 86. Capitalized software costs should be amortized in accordance with paragraph 8 of FASB Statement No. 86. A pattern of deciding to market internal-use software during its development creates a rebuttable presumption that any software developed by that entity is intended for sale, lease, or other marketing, and thus is subject to the guidance in FASB Statement No. 86.

## Disclosures

.41 This SOP does not require any new disclosures; disclosure should be made in accordance with existing authoritative literature, including Accounting Principles Board (APB) Opinion No. 12, *Disclosure of Depreciable Assets and*

*Depreciation*; APB Opinion No. 22, *Disclosure of Accounting Policies* (for example, amortization methods); FASB Statement Nos. 2 and 121; and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

## Effective Date and Transition

.42 This SOP is effective for financial statements for fiscal years beginning after December 15, 1998, and should be applied to internal-use computer software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of this SOP. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued.

.43 Costs incurred prior to initial application of this SOP, whether capitalized or not, should not be adjusted to the amounts that would have been capitalized had this SOP been in effect when those costs were incurred. However, the provisions of this SOP concerning amortization and impairment should be applied to any unamortized costs capitalized prior to initial application of this SOP that continue to be reported as assets after the effective date. In accordance with paragraph 33 of APB Opinion No. 20, *Accounting Changes*, the effect on income before extraordinary items, net income, and related per share amounts of the current period should be disclosed for the change in accounting.

.44 Initial application of this SOP should be as of the beginning of the fiscal year in which the SOP is first adopted (that is, if the SOP is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods of that fiscal year should be restated).

<p><b>The provisions of this Statement need not be applied to immaterial items.</b></p>
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## Basis for Conclusions

### Characteristics of Internal-Use Computer Software

.45 AcSEC recognizes that entities may develop computer software for internal use and also plan to sell, lease, or otherwise market the software to recover some costs. AcSEC believes that the presence of a substantive plan to market software externally before or during software development indicates an intent to sell, lease, or otherwise market software, which requires accounting prescribed by FASB Statement No. 86. AcSEC believes that it is impractical to allocate costs between internal-use software and software to be marketed.

.46 AcSEC considered whether one of the characteristics of internal-use computer software should be that during the software's development, no substantive plan or intent to market the software externally exists. AcSEC decided that it could not provide operational guidance to help entities define intent. For example, many entities will consider opportunities to recover some of the software development costs through subsequent sales of the product. AcSEC believes that it cannot provide guidance to distinguish between a true intent to market software and routine inquiries and studies about the possibility of recovering some costs.

.47 Because FASB Statement No. 86 does not define “part of a product or process,” many entities have difficulty determining whether computer software is for internal use and subject to the SOP or “part of a product or process” and subject to the accounting prescribed by FASB Statement No. 86. A FASB staff article (which Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Accordance With Generally Accepted Accounting Principles in the Independent Auditor's Report*, subordinates to an SOP) *Computer Software: Guidance on Applying Statement No. 86* that appeared in a 1986 FASB Status Report attempted to clarify that term as follows: “Indications that the software in question falls under the Statement's scope include the dependence of the company on the software to provide the service. In other words, could the company earn revenue from providing the service without the software? Would the service be as timely or accurate without the software? If the answer to any of these questions is no, that may indicate that the software is part of a product or process and is included in the scope of Statement No. 86.”

.48 In this SOP, AcSEC provides what it believes to be operational guidance that will help entities determine if computer software is for internal use. AcSEC believes that the distinction can be based on what the customer is buying. If the customer is acquiring the software or the future right to use it, the costs of that software are accounted for in accordance with the provisions of FASB Statement No. 86. However, if the software is used by the vendor in production of the product or in providing the service but the customer does not acquire the software or the future right to use it, the software is for internal use. The Appendix [paragraph .93] provides examples of when computer software is and is not for internal use.

.49 AcSEC believes that the guidance in this SOP should be applied at the component or module level. One computer software project may result in several different working modules, which with appropriate software interfaces can be used independently of other modules. AcSEC analogized to an entity that constructs a building complex. Though several buildings are ultimately constructed, each building is an asset and may function without the others.

## Research and Development

.50 Some respondents to the exposure draft believe that the costs of computer software developed or obtained for internal use should be charged to expense when incurred as research and development until technological feasibility has been established for the software. They believe that, like the costs of computer software to be sold, leased, or otherwise marketed, the costs of internal-use computer software are within the scope of paragraph 9(i) of FASB Statement No. 2, which states that “engineering activity required to advance the design of a product to the point that it meets specific functional and economic requirements and is ready for manufacture,” and therefore those costs should be included within research and development.

.51 AcSEC considered whether this SOP should require entities to meet some technological feasibility threshold before they could capitalize costs of internal-use computer software. AcSEC decided and most respondents to the exposure draft agreed that technological feasibility should not apply to this SOP. AcSEC reasoned that the technological feasibility criteria applied in FASB Statement No. 86 to software that is sold, leased, or otherwise marketed were appropriate to an inventory model. That inventory model includes an implicit marketability test, a notion that is not applicable to this SOP.

.52 FASB Interpretation No. 6 states that the costs of computer software that is developed or obtained for use in an entity's selling and administrative



activities are not research and development costs. In addition, it states that, "costs incurred to purchase or lease computer software developed by others are not research and development costs under FASB Statement No. 2 unless the software is for use in research and development activities." Further, FASB Interpretation No. 6 states, "costs incurred by an enterprise in developing computer software internally for use in its research and development activities are research and development costs . . . , " regardless of whether the software has alternative future uses.

.53 AcSEC also considered the guidance of paragraphs 9(h) and 10(h) of FASB Statement No. 2 to determine whether other costs of internal-use software are excluded from research and development. Paragraph 10(h) of FASB Statement No. 2 states that "activity, including design and construction engineering, related to the construction, relocation, rearrangement, or start-up of facilities or equipment other than (1) pilot plants and (2) facilities or equipment whose sole use is for a particular research and development project" are excluded from research and development.

.54 Because of the guidance in FASB Statement No. 2 and FASB Interpretation No. 6, AcSEC concluded that not all internal-use software costs are research and development costs (see paragraph 52). However, AcSEC evaluated the process of developing internal-use software within the context of FASB Statement No. 2 because that statement is either directly relevant or is a reasonable basis for determining which costs of internal-use software development activities should be expensed. Consistent with FASB Statement No. 2, AcSEC did not specify the income statement classifications of expensed internal-use software development costs.

.55 Paragraphs 9(c) and 9(d), respectively, of FASB Statement No. 2 include "conceptual formulation and design of possible product or process alternatives" and "testing in search for or evaluation of product or process alternatives" as examples of activities that are research and development and therefore are expensed as incurred. AcSEC believes paragraphs 9(c) and 9(d) are relevant to the process of developing internal-use computer software. AcSEC believes that as part of these activities an entity will determine whether the needed technology exists. If the technology does not exist, then research and development-type activities have not yet been completed, and therefore those costs should be expensed as incurred.

.56 AcSEC also believes that development risks associated with creating internal-use computer software are conceptually no different from development risks associated with creating other assets such as high-tech automated plants. Entities, at the start of both kinds of projects, often expect that existing technology will allow the entity to complete projects that will provide future benefits.

## Capitalize or Expense

.57 About two-thirds of the respondents to the exposure draft believe that the internal and external costs of computer software developed or obtained for internal use should be reported as assets. However, certain representatives of the financial statement user community oppose capitalization of internal costs incurred to develop or obtain internal-use software.

.58 Those users and some others oppose the exposure draft's provisions for capitalization because they believe that the benefits of capitalizing internal

costs are limited. They believe that capitalized internal costs related to developing or obtaining internal-use software are often unrelated to the software's actual value and that such capitalized costs are often irrelevant in the investment and credit evaluation process. In addition, some who oppose the exposure draft believe that external costs of developing or obtaining internal-use software are a more reliable measure of the software asset than internal costs.

.59 Some respondents to the exposure draft believe that costs of computer software developed or obtained for internal use should be expensed as incurred. They believe that such costs should not be capitalized because they do not result in demonstrable probable future economic benefits. They believe that capitalization would result in assets that have arbitrary amortization periods. They cite paragraph 148 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, which states that some "costs are also recognized as expenses in the period in which they are incurred because the period to which they otherwise relate is indeterminable or not worth the effort to determine."

.60 Some respondents to the exposure draft believe that capitalizing the costs of computer software developed or obtained for internal use frequently results in a subsequent writeoff of those costs when they are eventually determined to not be recoverable. Thus, they believe that readers of financial statements can be misled by the initial capitalization and subsequent writeoff of those costs.

.61 AcSEC considered all of these views. AcSEC believes that entities develop or obtain internal-use computer software often for the same end-purposes that they develop or obtain other assets. Examples are to reduce costs, operate more efficiently, improve internal controls, service customers better, and gain competitive advantages.

.62 Paragraph 25 in FASB Concepts Statement No. 6 defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." Footnote 18 to FASB Concepts Statement No. 6 states that "probable is used with its general meaning, rather than in a specific accounting or technical sense, . . . and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved . . . ." Paragraph 26 states: "An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred."

.63 Paragraph 63 in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, sets forth the following criteria that should be met to recognize an item in the financial statements:

- **Definitions**—The item meets the definition of an element of financial statements.
- **Measurability**—It has a relevant attribute measurable with sufficient reliability.
- **Relevance**—The information about it is capable of making a difference in user decisions.
- **Reliability**—The information is representationally faithful, verifiable, and neutral.

.64 Some proponents of capitalization of internal-use software observe that paragraph 24 of APB Opinion 17, *Intangible Assets*, requires that entities capitalize acquired intangible assets. Paragraph 24 also states that “costs of developing, maintaining, or restoring intangible assets which are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole—such as goodwill—should be deducted from income when incurred.” AcSEC believes that the costs of computer software developed or obtained for internal use are specifically identifiable, have determinate lives, relate to probable future economic benefits (FASB Concepts Statement No. 6), and meet the recognition criteria of definitions, measurability, relevance, and reliability (FASB Concepts Statement No. 5).

.65 AcSEC decided that it was not necessary to characterize computer software as either intangible assets or tangible assets when similar characterizations have not been made for most other assets.

.66 One of the characteristics of an asset in FASB Concepts Statement No. 6 is that it must contribute directly or indirectly to future net cash inflows, thus providing probable future economic benefits. AcSEC recognizes that the specific future economic benefits related to the costs of computer software will sometimes be difficult to identify. However, AcSEC believes that this is also true for some other assets. For example, computer hardware or furniture used in back-office operations are indirectly related to future benefits. Likewise, corporate office facilities do not result in identifiable future benefits, but the facilities do support the operations of the company.

.67 AcSEC also recognizes that costs of computer software developed or obtained for internal use reported as assets may be subsequently written-off due to lack of adequate funding or lack of management’s continued commitment to a project. However, AcSEC believes similar changes in direction also occur for long-lived-asset projects. Regardless, AcSEC has established guidance to determine when capitalization should cease and when impairment should be recognized and measured.

.68 *Preliminary Project Stage.* AcSEC believes that activities performed during the preliminary project stage of development for internal-use software are analogous to research and development activities, and costs incurred during this stage should be expensed as they are incurred.

.69 *Application Development Stage.* AcSEC believes that software development activities performed during the application development stage create probable future economic benefits. Therefore, software development costs incurred during this stage should be capitalized.

.70 AcSEC believes that paragraph 24 of APB Opinion No. 17 applies to the costs of data conversion. Therefore, AcSEC believes that data conversion costs, as discussed in paragraph .22, should be expensed as they are incurred. However, AcSEC also believes that computer software developed or obtained for old and new systems interface is internal-use software that is subject to the guidance in this SOP.

.71 *Post-Implementation/Operation Stage.* AcSEC believes that training costs are not software development costs and should be expensed as they are incurred because entities do not control the continued employment of the trained employees, are not able to identify the specific future period benefitted, and amortization periods would be arbitrary.

.72 A number of respondents to the exposure draft said that they could not distinguish between internal costs of maintenance and upgrades/enhancements; many of those respondents requested further guidance from AcSEC. AcSEC decided that it could not provide examples that would adequately distinguish between all possible activities related to maintenance and upgrades/enhancements. As a result, AcSEC concluded that entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.

.73 AcSEC acknowledges that SOP 97-2, *Software Revenue Recognition*, defines an upgrade and enhancement, in part, as an extension of useful life. AcSEC concluded that, from the perspective of the user of the software, solely extending the software's useful life without adding additional functionality is a maintenance activity rather than an activity for which the costs should be capitalized. Accordingly, AcSEC's criteria for determining capitalizable upgrades and enhancements focus on providing additional functionality.

.74 AcSEC believes and most respondents to the exposure draft agree that entities should not have the option to expense or capitalize costs of computer software developed or obtained for internal use as those costs are incurred. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, states: "Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark."

.75 Capitalization should begin when (a) the preliminary project stage is completed and (b) management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project and it is probable that the project will be completed and the software will be used to perform the function intended. Capitalization should cease when it is no longer probable that the computer software project will be completed and placed in service. Capitalization should cease no later than the point at which a computer software project is substantially complete and ready for its intended use. *Probable* does not require absolute certainty. *Probable* is used in the same context as it is in FASB Concepts Statement No. 6, which states that "probable is used with its general meaning, rather than in a specific accounting or technical sense, . . . and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved . . . ."

.76 AcSEC used paragraph 18 of FASB Statement No. 34 as a basis for concluding that capitalization should cease no later than the point at which a computer software project is substantially complete and ready for its intended use.

.77 AcSEC considered whether it should provide guidance to limit the amount of costs that could be capitalized to the amount an entity would spend to purchase a viable alternative software product from a third party. AcSEC concluded that it could not provide practicable guidance other than the ability to recover the capitalized costs as discussed in FASB Statement No. 121. AcSEC believes that many entities will not be able to identify a third-party software product that is comparable to the entity's internal-use software. In addition, AcSEC believes that many entities would incur undue costs in trying to determine what is a viable alternative software product.

.78 AcSEC believes that it would be desirable for the costs of internally developed computer software (whether developed by employees or per diem independent contractors) that are capitalized to be accounted for no differently than the capitalized costs of purchased software (whether the software is obtained retail or developed by outside consultants for a flat fee or price). AcSEC acknowledges, however, that certain costs of internally developed software will be expensed as research and development whereas a portion of the research and development costs incurred by a third party will be capitalized by the purchasing entity because the third party's research and development costs are implicitly part of the acquisition price of the software. AcSEC noted that similar differences exist elsewhere; for example, the costs of acquiring a patent are usually capitalized and the costs of developing a patent are usually expensed as incurred.

.79 AcSEC believes that users of financial information will find the results of this SOP useful. AcSEC believes that the marketplace inherently considers the technological capabilities, including software, of many entities when it establishes market values. This SOP provides a reasonable methodology to record the costs of internal-use software. In addition, AcSEC believes that the disclosures required by existing authoritative literature are sufficient to help users make informed decisions.

## Capitalizable Costs

.80 AcSEC used SOP 93-7, *Reporting on Advertising Costs*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, as a basis for determining the kinds of costs of computer software developed or obtained for internal use that should be included in amounts reported as assets. AcSEC recognizes that the costs of some activities, such as allocated overhead, may be part of the overall cost of assets, but it excluded such costs because it believes that, as a practical matter, costs of accumulating and assigning overhead to software projects would generally exceed the benefits that would be derived from a "full costing" accounting approach. AcSEC considered that costing systems for inventory and plant construction activities, while sometimes complex, were necessary costs given the routine activities that such systems support. Overhead costs associated with a particular internal-use software development project could be even more complex to measure than production overhead and, as they most often represent an allocation among capitalizable and expensed functions, may not be sufficiently reliable. Moreover, certain users commented that they believe that overhead costs had little relationship to the value of software. In light of such apparently high costs, modest benefits, and the view of some users that such costs should be expensed, AcSEC chose to analogize to advertising costs and FASB Statement No. 91 and to require such costs to be expensed as incurred.

## Multiple-Element Software Arrangements Included in Purchase Price

.81 This SOP requires that, when a software arrangement includes multiple elements, entities should estimate the fair value of those multiple elements and exclude the fair value of the appropriate elements from the capitalized cost of the software. This approach is consistent with the treatment of executory costs that are included in a lease payment to a lessor, but which

are not specified in the lease agreement. Paragraph 10 of FASB Statement No. 13, *Accounting for Leases*, requires the lessee to make an estimate of the executory costs and exclude that amount from the minimum lease payments. The treatment of the costs of the multiple elements specified here is consistent with those provisions.

.82 In addition, AcSEC believes that the guidance related to recognizing combined maintenance and unspecified upgrade/enhancement fees over the contract period is consistent with paragraph 3 in FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*.

.83 The SOP requires that entities allocate costs based on relative fair values. AcSEC decided that the SOP should be consistent with SOP 97-2, *Software Revenue Recognition*, though vendor-specific information is not as relevant to this SOP.

## Impairment

.84 AcSEC considered whether there were any alternatives to following FASB Statement No. 121 for impairment of internal-use computer software. AcSEC concluded that internal-use computer software is a long-lived asset covered by FASB Statement No. 121.

.85 Paragraphs 7, 8, 10, and 15 of FASB Statement No. 121 are the basis for the guidance in this SOP on accounting for internal-use computer software that is not expected to provide substantive future service potential to an entity.

.86 AcSEC concluded that when it is no longer probable that computer software being developed will be completed and placed in service, the asset should be reported at the lower of carrying amount or fair value, if any, less costs to sell, in accordance with FASB Statement No. 121. AcSEC believes that uncompleted internal-use computer software is not likely to have any fair value (measured in accordance with paragraph 7 of FASB Statement No. 121).

.87 A number of respondents to the exposure draft requested that AcSEC provide more guidance and/or examples of how to recognize and measure impairment of internal-use computer software. AcSEC concluded that there are broader implications to this request and that if further guidance on impairment is to be provided, it should be provided by the FASB.

## Amortization

.88 AcSEC used Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapter 9, section C, and APB Opinion 17 as a basis for its conclusions on amortization. AcSEC decided not to specify a maximum amortization period because each entity is better able to determine an appropriate useful life.

## Internal-Use Computer Software Marketed

.89 The SOP requires that entities use the cost recovery method of accounting for internal-use computer software subsequently marketed. AcSEC believes that this method will provide a reasonable reporting outcome for instances in which enterprises find that internally developed software can meet a market demand.

## Disclosures

.90 In the spirit of minimizing less relevant disclosures, AcSEC decided not to include any new disclosures in the exposure draft (though entities are

required to follow disclosure requirements set forth in existing authoritative literature). AcSEC continues to believe that existing authoritative literature requires adequate disclosures to help meet financial statement user needs.

### **Effective Date and Transition**

.91 AcSEC believes that the transition guidance in the SOP should be comparable to that contained in FASB Statement No. 86. Some enterprises that develop or purchase software for internal use currently expense those costs as incurred. AcSEC believes that the costs of developing the information that would be necessary to determine the amounts that would be capitalized if this SOP were to be applied retroactively would exceed the benefits retroactive application might offer and that such a retroactive determination should not be made. However, AcSEC decided to permit but not require application in financial statements for a fiscal year for which annual financial statements have not been issued. AcSEC further concluded that costs capitalized before the application of this SOP should be subject to the impairment and amortization provisions in this SOP, but should not otherwise be adjusted to an amount that would have been capitalized had this SOP been applied. Amortization and impairment of previously capitalized costs in accordance with the provisions of this SOP should result in an acceptable level of comparability and understandability.

.92 AcSEC considered whether it should provide materiality thresholds to determine when an entity should follow the guidance in this SOP. AcSEC decided not to do so because it believes an entity can best determine the materiality of internal-use computer software costs in its individual circumstances.

## Appendix

### Examples Illustrating When Computer Software Is for Internal Use

1. A manufacturing entity purchases robots and customizes the software that the robots use to function. The robots are used in a manufacturing process that results in finished goods.
2. An entity develops software that helps it improve its cash management, which may allow the entity to earn more revenue.
3. An entity purchases or develops software to process payroll, accounts payable, and accounts receivable.
4. An entity purchases software related to the installation of an online system used to keep membership data.
5. A travel agency purchases a software system to price vacation packages and obtain airfares.
6. A bank develops software that allows a customer to withdraw cash, inquire about balances, make loan payments, and execute wire transfers.
7. A mortgage loan servicing entity develops or purchases computer software to enhance the speed of services provided to customers.
8. A telecommunications company develops software to run its switches that are necessary for various telephone services such as voice mail and call forwarding.
9. An entity is in the process of developing an accounts receivable system. The software specifications meet the company's internal needs and the company did not have a marketing plan before or during the development of the software. In addition, the company has not sold any of its internal-use software in the past. Two years after completion of the project, the company decided to market the product to recoup some or all of its costs.
10. A broker-dealer entity develops a software database and charges for financial information distributed through the database.
11. An entity develops software to be used to create components of music videos (for example, the software used to blend and change the faces of models in music videos). The entity then sells the final music videos, which do not contain the software, to another entity.
12. An entity purchases software to computerize a manual catalog and then sells the manual catalog to the public.
13. A law firm develops an intranet research tool that allows firm members to locate and search the firm's databases for information relevant to their cases. The system provides users with the ability to print cases, search for related topics, and annotate their personal copies of the database.

### Examples Illustrating When Computer Software Is Not Internal Use

14. An entity sells software required to operate its products, such as robots, electronic game systems, video cassette recorders, automobiles, voice-mail systems, satellites, and cash registers.



15. A pharmaceutical company buys machines and writes all of the software that allows the machines to function. The pharmaceutical company then sells the machines, which help control the dispensation of medication to patients and help control inventory, to hospitals.
16. A semiconductor entity develops software embedded in a microcomputer chip used in automobile electronic systems.
17. An entity purchases software to computerize a manual catalog and then sells the computer version and the related software to the public.
18. A software company develops an operating system for sale and for internal use. Though the specifications of the software meet the company's internal needs, the company had a marketing plan before the project was complete. In addition, the company has a history of selling software that it also uses internally and the plan has a reasonable possibility of being implemented.
19. An entity is developing software for a point-of-sale system. The system is for internal use; however, a marketing plan is being developed concurrently with the software development. The plan has a reasonable possibility of being implemented.
20. A telecommunications entity purchases computer software to be used in research and development activities.
21. An entity incurs costs to develop computer software for another entity under a contract with that other entity.

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## Section 10,730

# **Statement of Position 98-2 Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising**

March 11, 1998

### **NOTE**

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by either the Financial Accounting Standards Board (for financial statements of nongovernmental entities) or the Governmental Accounting Standards Board (for financial statements of state and local governmental entities), as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## **Summary**

This Statement of Position (SOP) applies to all nongovernmental not-for-profit organizations (NPOs) and all state and local governmental entities that solicit contributions.

This SOP requires—

- If the criteria of purpose, audience, and content as defined in this SOP are met, the costs of joint activities that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function.
- If any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.

- Certain financial statement disclosures if joint costs are allocated.
- Some commonly used and acceptable allocation methods are described and illustrated although no methods are prescribed or prohibited.

This SOP amends existing guidance in AICPA Audit and Accounting Guides *Health Care Organizations*, *Not-for-Profit Organizations* (which was issued in August 1996 and supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into the Guide), and *Audits of State and Local Governmental Units*.

This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

## Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB and the GASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members and three of the five GASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.\*

The criteria applied by the FASB and the GASB in their review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB and the GASB will propose suggestions, many of which are included in the documents.

## Introduction

.01 Some nongovernmental not-for-profit organizations (NPOs) and some state and local governmental entities,<sup>1</sup> such as governmental colleges and universities and governmental health care providers, solicit support through a

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\* This document was cleared prior to July 1, 1997. In July 1997, the GASB increased to seven members. Documents considered by the GASB after July 1, 1997 are cleared if at least four of the seven GASB members do not object.

<sup>1</sup> This Statement of Position (SOP) uses the term *entity* to refer to both nongovernmental not-for-profit organizations (NPOs) and state and local governments.

variety of **fund-raising activities**.<sup>2</sup> These activities include direct mail, telephone solicitation, door-to-door canvassing, telethons, special events, and others. Sometimes fund-raising activities are conducted with activities related to other functions, such as **program activities** or supporting services, such as **management and general activities**.<sup>3</sup> Sometimes fund-raising activities include components that would otherwise be associated with program or supporting services, but in fact support fund raising.

**.02** External users of financial statements—including contributors, creditors, accreditation agencies, and regulators—want assurance that fund-raising costs, as well as program costs and management and general costs, are stated fairly.

**.03** In 1987, the AICPA issued Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*.<sup>4</sup> SOP 87-2 required that all circumstances concerning informational materials and activities that include a fund-raising appeal be considered in accounting for **joint costs** of those materials and activities and that certain criteria be applied in determining whether joint costs of those materials and activities should be charged to fund raising or allocated to program or management and general. Those criteria include requiring verifiable indications of the reasons for conducting the activity, such as the content, audience, and action, if any, requested of the participant, as well as other corroborating evidence. Further, SOP 87-2 required that all joint costs of those materials and activities be charged to fund raising unless the appeal is designed to motivate its audience to action other than providing financial support to the organization.

**.04** The provisions of SOP 87-2 have been difficult to implement and have been applied inconsistently in practice. (Appendix B [paragraph .22], "Background," discusses this further.)

**.05** This SOP establishes financial accounting standards for accounting for **costs of joint activities**. In addition, this SOP requires financial statement

<sup>2</sup> Terms that appear in the Glossary [paragraph .30] are set in **boldface type** the first time they appear.

<sup>3</sup> The functional classifications of fund raising, program, and management and general are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Some entities have a functional structure that does not include fund raising, program, or management and general, or that includes other functional classifications, such as **membership development**. This SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. In circumstances in which entities that have a functional structure that includes other functional classifications conduct joint activities, all costs of those joint activities should be charged to fund raising (or the category in which fund raising is reported—see the following two parenthetical sentences), unless the purpose, audience, and content of those joint activities are appropriate for achieving those other functions. (An example of an entity that reports fund raising in a category other than fund raising is a state and local governmental entity applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8. As discussed in paragraph D-5 of this SOP [paragraph .24], those entities are required to report fund raising as part of the "institutional support" function.)

<sup>4</sup> In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*. The Guide supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*. *Not-for-Profit Organizations* applies to all nongovernmental NPOs other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*. Also, SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*.

disclosures about the nature of the activities for which joint costs have been allocated and the amounts of joint costs. Appendix F [paragraph .26] provides explanations and illustrations of some acceptable allocation methods.

## Scope

.06 This SOP applies to all nongovernmental NPOs and all state and local governmental entities that solicit **contributions**.

## Conclusions

### Accounting for Joint Activities

.07 If the criteria of purpose, audience, and content are met, the costs of a **joint activity** that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.

### Purpose

.08 The purpose criterion is met if the purpose of the joint activity includes accomplishing program or management and general functions. (Paragraphs .09 and .10 provide guidance that should be considered in determining whether the purpose criterion is met. Paragraph .09 provides guidance pertaining to program functions only. Paragraph .10 provides guidance pertaining to both program and management and general functions.)

.09 *Program functions.* To accomplish program functions, the activity should call for specific action by the audience that will **help accomplish the entity's mission**. For purposes of applying the guidance in this SOP, the following are examples of activities that do and do not call for specific action by the audience that will help accomplish the entity's mission:

- An entity's mission includes improving individuals' physical health. For that entity, motivating the audience to take specific action that will improve their physical health is a call for specific action by the audience that will help accomplish the entity's mission. An example of an activity that motivates the audience to take specific action that will improve their physical health is sending the audience a brochure that urges them to stop smoking and suggests specific methods, instructions, references, and resources that may be used to stop smoking.
- An entity's mission includes educating individuals in areas other than the causes, conditions, needs, or concerns that the entity's programs are designed to address (referred to hereafter in this SOP as "causes"). For that entity, educating the audience in areas other than causes or

motivating the audience to otherwise engage in specific activities that will educate them in areas other than causes is a call for specific action by the audience that will help accomplish the entity's mission. Examples of entities whose mission includes educating individuals in areas other than causes are universities and possibly other entities. An example of an activity motivating individuals to engage in education in areas other than causes is a university inviting individuals to attend a lecture or class in which the individuals will learn about the solar system.

- Educating the audience about causes or motivating the audience to otherwise engage in specific activities that will educate them about causes is not a call for specific action by the audience that will help accomplish the entity's mission. Such activities are considered in support of fund raising. (However, some educational activities that might otherwise be considered as educating the audience about causes may implicitly call for specific action by the audience that will help accomplish the entity's mission. For example, activities that educate the audience about environmental problems caused by not recycling implicitly call for that audience to increase recycling. If the need for and benefits of the specific action are clearly evident from the educational message, the message is considered to include an implicit call for specific action by the audience that will help accomplish the entity's mission.)
- Asking the audience to make contributions is not a call for specific action by the audience that will help accomplish the entity's mission.

If the activity calls for specific action by the audience that will help accomplish the entity's mission, the guidance in paragraph .10 should also be considered in determining whether the purpose criterion is met.

**.10 Program and management and general functions.** The following factors should be considered, in the order in which they are listed,<sup>5</sup> to determine whether the purpose criterion is met:

- a. **Whether compensation or fees for performing the activity are based on contributions raised.** The purpose criterion is *not* met if a majority of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.<sup>6, 7</sup>

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<sup>5</sup> In considering the guidance in paragraph .10, the factor in paragraph .10a (the compensation or fees test) is the preeminent guidance. If the factor in paragraph .10a is not determinative, the factor in paragraph .10b (whether a similar program or management and general activity is conducted separately and on a similar or greater scale) should be considered. If the factor in paragraph .10b is not determinative, the factor in paragraph .10c (other evidence) should be considered.

<sup>6</sup> Some compensation contracts provide that compensation for performing the activity is based on a factor other than contributions raised, but not to exceed a specified portion of contributions raised. For example, a contract may provide that compensation for performing the activity is \$10 per contact hour, but not to exceed 60 percent of contributions raised. In such circumstances, compensation is not considered based on amounts raised, unless the stated maximum percentage is met. In circumstances in which it is not yet known whether the stated maximum percentage is met, compensation is not considered based on amounts raised, unless it is probable that the stated maximum percentage will be met.

<sup>7</sup> The *compensation or fees test* is a negative test in that it either (a) results in failing the purpose criterion or (b) is not determinative of whether the purpose criterion is met. Therefore, if the activity fails the purpose criterion based on this factor (the compensation or fees test), the activity fails the purpose criterion and the factor in paragraph .10b should not be considered. If the purpose criterion is not failed based on this factor, this factor is not determinative of whether the purpose criterion is met and the factor in paragraph .10b should be considered.

- b. *Whether a similar program or management and general activity is conducted separately and on a similar or greater scale.* The purpose criterion is met if either of the following two conditions is met:

(1) *Condition 1:*

- The program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and
- A similar program component is conducted without the fund-raising component using the same **medium** and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.<sup>8</sup>

(2) *Condition 2:*

A management and general activity that is similar to the management and general component of the joint activity being accounted for is conducted without the fund-raising component using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the fund raising.

If the purpose criterion is met based on the factor in paragraph .10b, the factor in paragraph .10c should not be considered.

- c. *Other evidence.* If the factors in paragraph .10a or .10b do not determine whether the purpose criterion is met, other evidence may determine whether the criterion is met. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

.11 The following are examples of indicators that provide evidence for determining whether the purpose criterion is met:

- a. Evidence that the purpose criterion may be met includes—

- *Measuring program results and accomplishments of the activity.* The facts may indicate that the purpose criterion is met if the entity measures program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes).
- *Medium.* The facts may indicate that the purpose criterion is met if the program component of the joint activity calls for specific action by the recipient that will help accomplish the entity's mission and if the entity conducts the program component without a significant fund-raising component in a different medium. Also, the facts may indicate that the purpose criterion is met if the entity conducts the management and general component of the joint activity without a significant fund-raising component in a different medium.

- b. Evidence that the purpose criterion may not be met includes—

- *Evaluation or compensation.* The facts may indicate that the purpose criterion is not met if (a) the evaluation of any party's

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<sup>8</sup> Determining the scale on which an activity is conducted may be a subjective determination. Factors to consider in determining the scale on which an activity is conducted may include dollars spent, the size of the audience reached, and the degree to which the characteristics of the audience are similar to the characteristics of the audience of the activity being evaluated.



performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity or (b) some, but less than a majority, of compensation or fees for any party's performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity.

- c. Evidence that the purpose criterion may be either met or not met includes—
  - *Evaluation of measured results of the activity.* The entity may have a process to evaluate measured program results and accomplishments of the activity (other than measuring the extent to which the public was educated about causes). If the entity has such a process, in evaluating the effectiveness of the joint activity, the entity may place significantly greater weight on the activity's effectiveness in accomplishing program goals or may place significantly greater weight on the activity's effectiveness in raising contributions. The former may indicate that the purpose criterion is met. The latter may indicate that the purpose criterion is not met.
  - *Qualifications.* The qualifications and duties of those performing the joint activity should be considered.
    - If a third party, such as a consultant or contractor, performs part or all of the joint activity, such as producing brochures or making telephone calls, the third party's experience and the range of services provided to the entity should be considered in determining whether the third party is performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity.
    - If the entity's employees perform part or all of the joint activity, the full range of their job duties should be considered in determining whether those employees are performing fund-raising, program (other than educating the public about causes), or management and general activities on behalf of the entity. For example, (a) employees who are not members of the fund-raising department and (b) employees who are members of the fund-raising department but who perform non-fund-raising activities are more likely to perform activities that include program or management and general functions than are employees who otherwise devote significant time to fund raising.
  - *Tangible evidence of intent.* Tangible evidence indicating the intended purpose of the joint activity should be considered. Examples of such tangible evidence include
    - The entity's written mission statement, as stated in its fund-raising activities, bylaws, or annual report.
    - Minutes of board of directors', committees', or other meetings.
    - Restrictions imposed by donors (who are not related parties) on gifts intended to fund the joint activity.

- Long-range plans or operating policies.
- Written instructions to other entities, such as script writers, consultants, or list brokers, concerning the purpose of the joint activity, audience to be targeted, or method of conducting the joint activity.
- Internal management memoranda.

### **Audience**

**.12** A rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for one or more of the reasons in paragraph .13a, .13b, or .13c. In determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for one or more of the reasons in paragraph .13a, .13b, or .13c. For example, if the audience's ability or likelihood to contribute is a significant factor in its selection and it has a need for the action related to the program component of the joint activity, but having that need is an insignificant factor in its selection, the presumption would not be overcome.

**.13** In circumstances in which the audience includes no prior donors and is not otherwise selected based on its ability or likelihood to contribute to the entity, the audience criterion is met if the audience is selected for one or more of the following reasons:

- a. The audience's need to use or reasonable potential for use of the specific action called for by the program component of the joint activity
- b. The audience's ability to take specific action to assist the entity in meeting the goals of the program component of the joint activity
- c. The entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component

### **Content**

**.14** The content criterion is met if the joint activity supports program or management and general functions, as follows:

- a. *Program.* The joint activity calls for specific action by the recipient that will help accomplish the entity's mission. If the need for and benefits of the action are not clearly evident, information describing the action and explaining the need for and benefits of the action is provided.
- b. *Management and general.* The joint activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity.<sup>9</sup>

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<sup>9</sup> Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. For purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities.

.15 Information identifying and describing the entity, causes, or how the contributions provided will be used is considered in support of fund raising.

## Allocation Methods

.16 The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances.

## Incidental Activities

.17 Some fund-raising activities conducted in conjunction with program or management and general activities are incidental to such program or management and general activities. For example, an entity may conduct a fund-raising activity by including a generic message, "Contributions to Organization X may be sent to [address]" on a small area of a message that would otherwise be considered a program or management and general activity based on its purpose, audience, and content. That fund-raising activity likely would be considered incidental to the program or management and general activity being conducted. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. For example, an entity may conduct a program activity by including a generic program message such as "Continue to pray for [a particular cause]" on a small area of a message that would otherwise be considered fund raising based on its purpose, audience, and content. That program activity would likely be considered incidental to the fund-raising activity being conducted. Similarly, an entity may conduct a management and general activity by including a brief management and general message—"We recently changed our phone number. Our new number is 123-4567"—on a small area of a message that would otherwise be considered a program or fund-raising activity based on its purpose, audience, and content. That management and general activity would likely be considered incidental to the program or fund-raising activity being conducted. In circumstances in which a fund-raising, program, or management and general activity is conducted in conjunction with another activity and is incidental to that other activity, and the conditions in this SOP for allocation are met, joint costs are permitted but not required to be allocated and may therefore be charged to the functional classification related to the activity that is not the incidental activity. However, in circumstances in which the program or management and general activities are incidental to the fund-raising activities, it is unlikely that the conditions required by this SOP to permit allocation of joint costs would be met.

## Disclosures

.18 Entities that allocate joint costs should disclose the following in the notes to their financial statements:

- a. The types of activities for which joint costs have been incurred
- b. A statement that such costs have been allocated
- c. The total amount allocated during the period and the portion allocated to each functional expense category

.19 This SOP encourages, but does not require, that the amount of joint costs for each kind of joint activity be disclosed, if practical.

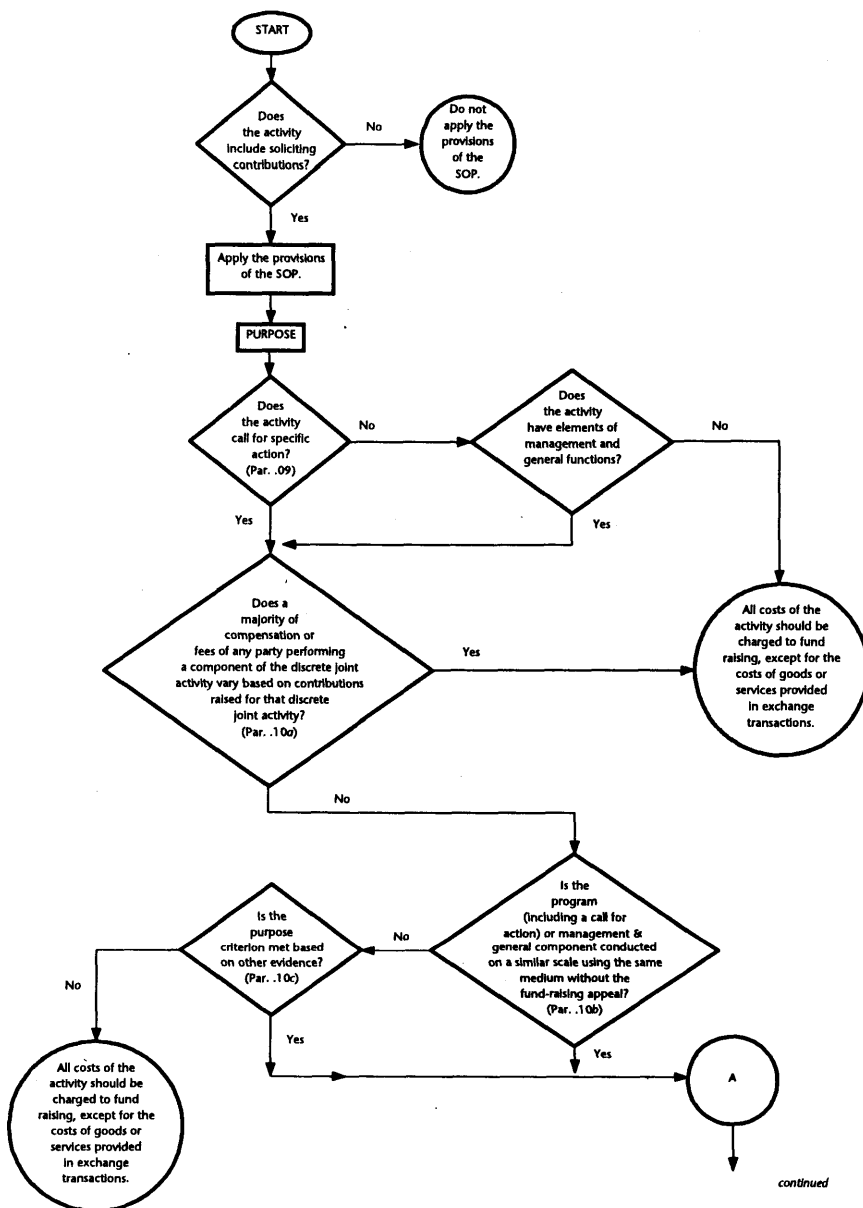
**Effective Date**

.20 This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

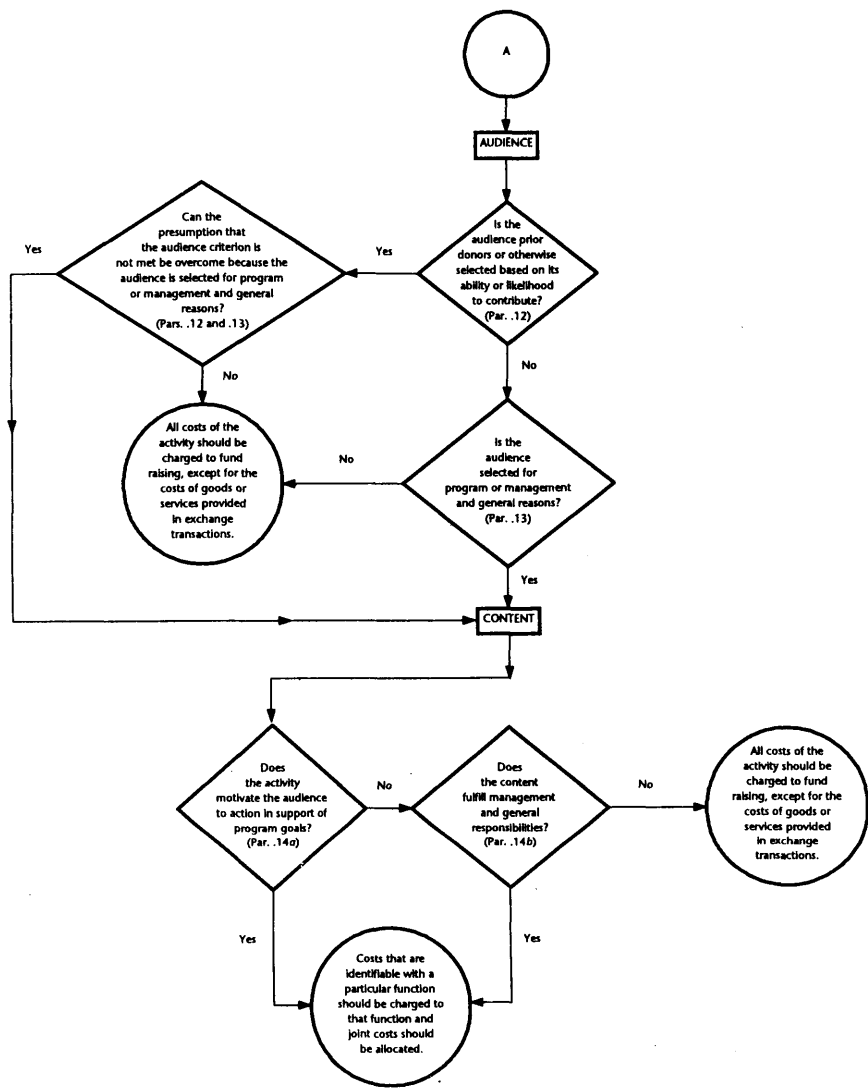
<p><b>The provisions of this Statement of Position need not be applied to immaterial items.</b></p>
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.21

## Appendix A

Accounting for Joint Activities<sup>10</sup>

<sup>10</sup> **Note:** This flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.



## Appendix B

### Background

**B.1.** As stated in paragraph .04, the provisions of Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, have been difficult to implement and applied inconsistently in practice. That difficulty has been due in part to the following:

- The second sentence of paragraph 1 of SOP 87-2 stated that “some of the costs incurred by such organizations are clearly identifiable with fundraising, such as the cost of fund-raising consulting services.” It is unclear whether activities that would otherwise be considered program activities should be characterized as program activities if they are performed or overseen by professional fund raisers. Also, it is unclear whether activities would be reported differently (for example, as program rather than fund raising) depending on whether the fund-raising consultant is compensated by a predetermined fee or by some other method, such as a percentage of contributions raised.
- SOP 87-2 was unclear about whether allocation of costs to fund-raising expense is required if the activity for which the costs were incurred would not have been undertaken without the fund-raising component.
- SOP 87-2 defined joint costs through examples, and it is therefore unclear what kinds of costs were covered by SOP 87-2. For example, it is unclear whether salaries and indirect costs can be joint costs.
- Some believe the guidance in SOP 87-2 was inadequate to determine whether joint activities, such as those that request contributions and also list the warning signs of a disease, are designed to motivate their audiences to action other than to provide contributions to the entity. It is unclear what attributes the targeted audience should possess in order to conclude that a program function is being conducted.

**B.2.** In 1992, the Accounting Standards Executive Committee (AcSEC) undertook a project to supersede SOP 87-2, to provide clearer guidance than that provided by SOP 87-2, as well as to provide guidance that would improve on the guidance in SOP 87-2. In September 1993, AcSEC released an exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, for public comment. AcSEC received more than 300 comment letters on the exposure draft. AcSEC redeliberated the issues based on the comments received.

**B.3.** In 1996, after redeliberating the issues based on the comments received and making certain revisions to the draft SOP, AcSEC conducted a field test of the draft SOP. The objectives of the field test were to determine whether the provisions of the draft SOP were sufficiently clear and definitive to generate consistent and comparable application of the SOP. Based on the field test results, AcSEC concluded that the provisions of the draft SOP, with certain revisions, were sufficiently clear and definitive to generate consistent and comparable application of the SOP.

**B.4.** Some respondents who commented on the exposure draft, as well as some interested parties who followed the project through its due process subsequent to the exposure draft, commented that the SOP should be reexposed for public comment. Reasons cited include:

- Approximately three years had passed between the end of the comment period and AcSEC's decision to issue the SOP.
- AcSEC made significant revisions to the SOP subsequent to releasing the exposure draft for comment.

Considering whether a proposed standard should be reexposed for public comment is inherently a subjective process. Factors that AcSEC considered include—

- The significance of changes made to the exposure draft and whether those changes result in guidance that the public did not have an opportunity to consider.
- Whether the scope was revised in such a way that affected entities did not have an opportunity to comment.
- New information about or changes in the nature of the transactions being considered, practice, or other factors.

AcSEC believes that the length of time between exposure and final issuance is not pertinent to whether the SOP should be reexposed for public comment.

**B.5.** Based on consideration of the factors identified, AcSEC believes that the SOP should not be reexposed for public comment. AcSEC notes that although the SOP has been revised based on comments received on the exposure draft, those revisions do not change the overall model in the SOP. Those revisions were made primarily to clarify the SOP and improve its operationality. Further, AcSEC believes that the project received a high level of attention from interested parties. AcSEC provided working drafts to interested parties and those parties provided input throughout the process, up to and including the Financial Accounting Standard Board's and the Governmental Accounting Standards Board's clearance of the SOP for issuance.

**B.6.** Appendix C [paragraph .23] discusses the key issues in the exposure draft and comments received on those issues, as well as the basis for AcSEC's conclusions on those and certain other issues.



## Appendix C

### Basis for Conclusions

**C.1.** This section discusses considerations that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this Statement of Position (SOP). It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

### Overall Framework

**C.2.** This SOP uses the model in SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, as a starting point and clarifies guidance that was unclear, provides more detailed guidance, revises some guidance, and expands the scope of costs covered to include all costs of joint activities. The model established by SOP 87-2 was to account for joint costs as fund raising unless an entity could demonstrate that a program or management and general function had been conducted. SOP 87-2 used verifiable indications of the reasons for conducting the activity, such as content, audience, the action requested, if any, and other corroborating evidence as a basis for determining whether a program or management and general function had been conducted.

**C.3.** On an overall basis, the majority of respondents who commented on the September 1993 exposure draft of a proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, opposed it, for various reasons, including the following:

- The guidance in SOP 87-2 is operational, results in sound financial reporting, and should be retained.
- The guidance in SOP 87-2 should be retained but clarified.
- The guidance proposed in the exposure draft should be revised. (Some commented that it overstates fund raising; others commented that it understates fund raising.)

**C.4.** AcSEC concluded that it supports the model in the exposure draft, subject to certain revisions. AcSEC believes that this SOP provides clear, detailed accounting guidance that, when applied, will increase comparability of financial statements. Those statements will also include more meaningful disclosures without incurring increased costs.

**C.5.** Some respondents commented that the model in the exposure draft would adversely affect entities both financially and operationally. Various reasons were given, including the following:

- It would inhibit the ability of entities, particularly small entities and entities that raise contributions through direct solicitations, to generate the necessary revenue to perform their program services.
- Most entities would not meet the criteria in this SOP for reporting costs of joint activities as program or management and general, because they must combine their mission statements, public informa-

tion and education, and fund-raising appeals due to a lack of resources. Some noted that this may result in unsatisfactory ratings from public watchdog groups.

AcSEC did not find these arguments compelling. This SOP provides accounting guidance; it provides no guidance concerning how entities should undertake their activities. Also, this SOP does not prohibit allocation merely because activities carrying out different functions are combined. In fact, this SOP provides guidance for reporting costs as program or management and general in circumstances in which those activities are combined with fund-raising. Moreover, actions taken by financial statement users are not the direct result of the requirements of this SOP. Rather, those actions may result from more relevant and useful information on which to base decisions.

**C.6.** Some respondents commented that the exposure draft is biased toward reporting expenses as fund raising. AcSEC believes that determining whether the costs of joint activities should be classified as program, management and general, or fund raising sometimes is difficult, and such distinctions sometimes are subject to a high degree of judgment. AcSEC believes that external financial statement users focus on and have perceptions about amounts reported as program, management and general, and fund raising. That focus and those perceptions provide incentives for entities to report expenses as program or management and general rather than fund raising. Therefore, in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. The criteria in this SOP provide guidance for entities to overcome that presumption.

## Accounting for Joint Activities

**C.7.** This SOP requires that if any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund raising, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising. (This SOP expands on the model established by SOP 87-2 by including all costs of joint activities other than costs of goods or services provided in exchange transactions, rather than merely joint costs.) AcSEC believes that the criteria of purpose, audience, and content are each relevant in determining whether a joint activity should be reported as fund raising, program, or management and general because each provides significant evidence about the benefits expected to be obtained by undertaking the activity.

**C.8.** Some respondents commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising is misleading and that the scope of the SOP should include only joint costs of joint activities. Some commented that reporting costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity as fund raising conflicts with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, which defines fund raising, program, and management and general and requires not-for-profit organizations (NPOs) to report information about expenses using those functional classifications.

**C.9.** AcSEC believes that the purpose for which costs other than joint costs are incurred may be fund raising, program, or management and general, depending on the context in which they are used in the activity undertaken. For example, a program-related pamphlet may be sent to an audience in need of the program. In that context, the pamphlet is used for program purposes. However, in order to demonstrate to potential donors that the entity's programs are worthwhile, that same pamphlet may be sent to an audience that is likely to contribute, but that has no need or reasonable potential for use of the program. In that context, the pamphlet is used for fund raising. AcSEC believes this broader scope will result in more comparability and more meaningful financial reporting by covering all costs of activities that include fund raising and by assigning those costs to the function for which they are incurred, consistent with the guidance in Statement No. 117.

**C.10.** AcSEC believes that costs of goods or services provided in exchange transactions should not be charged to fund raising because those costs are incurred in exchange for revenues other than contributions.

## **Criteria of Purpose, Audience, and Content**

### ***Call For Action***

**C.11.** The definition of *program* in FASB Statement No. 117 includes public education. As noted in paragraph C.6, AcSEC believes that in circumstances in which joint activities are conducted, a presumption exists that expenses should be reported as fund raising rather than as program or management and general. AcSEC believes that in order to overcome that presumption, it is not enough that (a) the purpose of the activity include educating the public about causes, (b) the audience has a need or reasonable potential for use of any educational component of the activity pertaining to causes, or (c) the audience has the ability to assist the entity in meeting the goals of the program component of the activity by becoming educated about causes. Therefore, AcSEC concluded that for purposes of this SOP, in order to conclude that the criteria of purpose, audience, and content are met program activities are required to call for specific action by the recipient (other than becoming educated about causes) that will help accomplish the entity's mission. As discussed in paragraph .09, in certain circumstances educational activities may call for specific action by the recipient that will help accomplish the entity's mission.

### ***Purpose***

**C.12.** AcSEC believes meeting the purpose criterion demonstrates that the purpose of the activity includes accomplishing program or management and general functions. Inherent in the notion of a joint activity is that the activity has elements of more than one function. Accordingly, the purpose criterion provides guidance for determining whether the purpose of the activity includes accomplishing program or management and general functions in addition to fund raising.

### ***Compensation and Evaluation Tests***

**C.13.** The exposure draft proposed that all costs of the joint activity should be charged to fund raising if (a) substantially all compensation or fees for performing the activity are based on amounts raised or (b) the evaluation of the party performing the activity is based on amounts raised. Some respondents

commented that basing the method of compensation or evaluating the performance of the party performing the activity based on contributions raised should not lead to the conclusion that all costs of the activity should be charged to fund raising. Others commented that the method of compensation is unrelated to whether the purpose criterion is met. The reasons given included the following:

- It is counterintuitive to imply that those performing multipurpose activities that include fund raising would not be compensated or evaluated based on amounts raised.
- Such guidance would create a bias toward entities that use employees to raise contributions and against entities that hire professional fund raisers and public relations firms and is therefore not neutral.

Some respondents gave examples of circumstances in which substantially all compensation is based on contributions raised and asserted that the activity was nevertheless a program activity. In each of those examples, AcSEC considered all the facts presented and concluded that the activity was fund raising.

**C.14.** AcSEC continues to support the spirit of the proposed guidance, because AcSEC believes that basing a majority of compensation on funds raised is persuasive evidence that the activity is a fund-raising activity. Nevertheless, AcSEC believes that the proposed guidance was unclear and would be difficult to implement, primarily because of the broad definition of “based on contributions raised” included in the glossary of the exposure draft. In connection with that issue, AcSEC was concerned that any joint activities performed by a fund-raising department or by individuals whose duties include fund raising, such as executive officers of small NPOs who are employed based on their ability to raise contributions, would be required to be reported as fund raising because the compensation of the parties performing those activities is based on amounts raised. Also, AcSEC had concerns that it would be difficult to determine whether fixed contract amounts were negotiated based on expected contributions. Therefore, AcSEC concluded that the compensation test should be revised to provide that the purpose criterion is not met if a majority of compensation or fees for any party’s performance of any component of the discrete joint activity varies based on contributions raised for that discrete joint activity. AcSEC believes that guidance is sound and is operational.

**C.15.** AcSEC believes that the guidance in paragraph .10a is not biased against entities that hire professional fund raisers, because it applies to the entity’s employees as well as professional fund raisers. For example, if a majority of an employee’s compensation or fees for performing a component of a discrete joint activity varies based on contributions raised for that discrete joint activity, the purpose criterion is not met.

### ***Similar Function-Similar Medium Test***

**C.16.** Some respondents misinterpreted the exposure draft as providing that, in order to meet the purpose criterion, the program or management and general activity must be conducted without the fund-raising component, using the same medium and on a scale that is similar to or greater than the program or management and general component of the activity being accounted for. That was not a requirement proposed by the exposure draft. The exposure draft proposed that meeting that condition would result in meeting the purpose criterion. Failing the criterion merely leads to consideration of other evidence, such as the indicators in paragraph .11. AcSEC has revised the SOP to state this more clearly.

## **Other Evidence**

**C.17.** The compensation test and the similar function-similar medium test may not always be determinative because the attributes that they consider may not be present. Therefore, this SOP includes indicators that should be considered in circumstances in which the compensation test and the similar function-similar medium test are not determinative. The nature of those indicators is such that they may be present in varying degrees. Therefore, all available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, the purpose criterion is met.

## **Audience**

**C.18.** The exposure draft proposed that if the audience for the materials or activities is selected principally on its ability or likelihood to contribute, the audience criterion is not met and all the costs of the activity should be charged to fund raising. Further, the exposure draft proposed that if the audience is selected principally based on its need for the program or because it can assist the entity in meeting its program goals other than by financial support provided to the entity, the audience criterion is met. Some respondents commented that that audience criterion is too narrow, because it is based on the principal reason for selecting the audience. They asserted that for some activities no principal reason exists for selecting an audience; entities select the audience for those activities for multiple reasons, such as both the audience's ability to contribute and its ability to help meet program goals. Some commented that for some activities, entities select audiences that have provided past financial support because, by providing financial support, those audiences have expressed an interest in the program.

**C.19.** AcSEC believes that meeting the audience criterion should demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions. Therefore, the reasons for selecting the audience should be consistent with the program or management and general content of the activity. However, AcSEC believes it is inherent in the notion of joint activities that the activity has elements of more than one function, including fund raising, and acknowledges that it may be difficult to determine the principal reason for selecting the audience. Accordingly, AcSEC concluded that if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute, a rebuttable presumption should exist that the audience was selected to raise funds. AcSEC believes that the reasons for selecting the audience that can overcome that presumption, which are included in paragraph .13 of this SOP, demonstrate that the audience is selected because it is a suitable audience for accomplishing the activity's program or management and general functions based on the program or management and general content of the activity.

## **Content**

**C.20.** AcSEC believes that meeting the content criterion demonstrates that the content of the activity supports program or management and general functions. AcSEC believes that accounting guidance should not impose value judgments about whether the entity's mission, programs, and responsibilities are worthwhile. Therefore, whether the content criterion is met depends on the relationship of the content to the entity's mission, programs, and management and general responsibilities.

**C.21.** Paragraph .14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accom-

plish the entity's mission. The exposure draft proposed that slogans, general calls to prayer, and general calls to protest do not meet the content criterion; some respondents disagreed. AcSEC concluded that this SOP should be silent concerning whether slogans, general calls to prayer, and general calls to protest are calls to action that meet the content criterion. AcSEC believes that determining whether those items are calls to action that meet the content criterion requires judgments based on the particular facts and circumstances.

**C.22.** Some respondents commented that educating the public about causes without calling for specific action should satisfy the content criterion. They noted that this is particularly relevant for NPOs subject to Internal Revenue Code (IRC) Section 501(c)4, because those NPOs are involved in legislative reform. Also, some noted that it may be the entity's mission or goal to educate the public about causes. They believe that, in those cases, the NPO's program is to educate the public about causes without necessarily calling for specific action by the recipient.

**C.23.** As discussed in paragraph C.11, AcSEC concluded that education that does not motivate the audience to action is in fact done in support of fund raising. However, this SOP acknowledges that some educational messages motivate the audience to specific action, and those messages meet the content criterion. AcSEC believes that that provision will result in the activities of some NPOs subject to IRC Section 501(c)4 (and some other entities, whose mission or goal is to educate the public) meeting the content criterion.

**C.24.** Paragraph .13c provides that one way that the audience criterion is met is if the entity is required to direct the management and general component of the activity to the particular audience. Further, as discussed in paragraph D.13, in *Discussion of Conclusions*, an audience that includes prior donors and is selected because the entity is required to send them certain information to comply with requirements of the Internal Revenue Service (IRS) is an example of an audience that is selected because the entity is required to direct the management and general component of the activity to that audience. Paragraph .14b provides that one way that the content criterion is met is if the activity fulfills one or more of the entity's management and general responsibilities through a component of the joint activity. However, footnote 9 to paragraph .14b provides that disclosures made when soliciting contributions to comply with requirements of states or other regulatory bodies are considered fund-raising activities, and are not considered management and general activities. AcSEC considered whether it is inconsistent to conclude both that (a) activities conducted to comply with requirements of regulatory bodies concerning contributions that have been received are management and general activities, and that (b) activities conducted to comply with requirements of regulatory bodies concerning soliciting contributions are fund-raising activities. AcSEC believes that those provisions are not inconsistent. AcSEC believes there is a distinction between (a) requirements that must be met as a result of receiving contributions and (b) requirements that must be met in order to solicit contributions. AcSEC believes that activities that are undertaken as a result of receiving contributions are management and general activities while activities that are undertaken in order to solicit contributions are fund-raising activities.

## Incidental Activities

**C.25.** Many entities conduct fund-raising activities in conjunction with program or management and general activities that are incidental to such pro-

gram or management and general activities. Similarly, entities may conduct program or management and general activities in conjunction with fund-raising activities that are incidental to such fund-raising activities. Such efforts may be a practical and efficient means for entities to conduct activities, although the principal purpose of the activity may be to fulfill either fund-raising, program, or management and general functions. The exposure draft proposed that incidental activities need not be considered in applying this SOP. Some respondents disagreed with that guidance, while others commented that it was confusing. AcSEC continues to support that guidance. AcSEC believes that guidance is necessary to avoid requiring complex allocations in circumstances in which the criteria of purpose, audience, and content are met but the activity is overwhelmingly either fund raising, program, or management and general.

## Allocation Methods

**C.26.** Respondents had various comments concerning allocation methods, including the following:

- The SOP should focus on allocation methods rather than on circumstances in which entities should allocate.
- The SOP should prescribe allocation methods.
- The approach taken in the SOP—discussing, rather than requiring or prohibiting allocation methods—is sound.
- Certain allocation methods should be prohibited.
- The SOP should set maximum allocation percentages.

AcSEC believes that no particular allocation method or methods are necessarily more desirable than other methods in all circumstances. Therefore, this SOP neither prescribes nor prohibits any particular allocation methods. AcSEC believes entities should apply the allocation methods that result in the most reasonable cost allocations for their activities. Appendix F [paragraph .26] of this SOP illustrates several allocation methods, any one of which may result in a reasonable or unreasonable allocation of costs in particular circumstances. The methods illustrated are not the only acceptable methods. However, AcSEC believes that the methods illustrated in this SOP are among those most likely to result in meaningful cost allocations.

**C.27.** Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, states in paragraph 7 that “the term *accounting principle* includes ‘not only accounting principles and practices but also the methods of applying them.’” APB Opinion 20 also states in paragraphs 15 and 16 that

... In the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type . . . . The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle [*allocation method*] on the basis that it is preferable.

A change in cost allocation methodology may be a change in accounting principle for entities covered by this SOP. Accordingly, paragraph .16 of this SOP provides that the cost allocation methodology used should be applied consistently, given similar facts and circumstances.

## Disclosures

**C.28.** Respondents made various comments concerning the required and encouraged disclosures, including recommendations for additional disclosures and recommendations that certain disclosures be deleted. AcSEC was not persuaded that the costs of the other disclosures recommended by respondents are justified by their benefits. AcSEC believes that, with the exception of one disclosure, the disclosures prescribed by the exposure draft provide relevant information about the kinds of activities for which joint costs have been incurred and the manner in which those costs are reported in the financial statements. In considering disclosures proposed by the exposure draft about the allocation method, AcSEC observed that there are no requirements to disclose methods of allocating other expenses and questioned the utility of disclosing the allocation method in this circumstance. AcSEC concluded that the requirement to disclose the allocation method should be deleted.

**C.29.** Paragraph .19 encourages, but does not require, certain disclosures. AcSEC believes those disclosures provide useful information but that they should be encouraged rather than required because the costs of making them may not be justified by the benefits in all cases.

## Effective Date

**C.30.** Some respondents commented that the effective date should be deferred. AcSEC believes that the accounting systems required to implement this SOP are already in place and that implementation should be relatively straightforward. However, AcSEC acknowledges that some entities may change their operations based on the reporting that would result from this SOP. Therefore, AcSEC concluded that this SOP should be effective for financial statements for years beginning on or after December 15, 1998.

## Cost-Benefit

**C.31.** Some respondents commented that the guidance would increase record keeping costs. AcSEC believes that implementing this SOP will not significantly increase record keeping costs, which are primarily the costs of documenting reasons for undertaking joint activities. Further, AcSEC believes that the costs of making the disclosures required by this SOP should be minimal, because entities should already have the information that is required to be disclosed. AcSEC believes that implementing this SOP will result in more relevant, meaningful, and comparable financial reporting and that the cost of implementing this SOP will be justified by its benefits.



## Appendix D

### Discussion of Conclusions

#### Scope

**D.1.** This Statement of Position (SOP) applies only to costs of joint activities. It does not address allocations of costs in other circumstances.

#### Reporting Models and Related Requirements

**D.2.** Paragraph 26 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*, specifies that a statement of activities or notes to the financial statements should provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities. Paragraph 13.35 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* provides that the financial statements of not-for-profit organizations (NPOs) should disclose the total fund-raising expenses.

**D.3.** Governmental Accounting Standards Board (GASB) Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, provides that governmental entities should not change their accounting and financial reporting to apply the provisions of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made*, and No. 117. GASB Statement No. 29 permits governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable FASB pronouncements issued through November 30, 1989, and by most applicable GASB pronouncements) to continue to do so, pending GASB pronouncements on the accounting and financial reporting model for governmental entities. Alternatively, those governmental entities are permitted to change to the current governmental financial reporting model.

**D.4.** GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, requires governmental colleges and universities to use one of two accounting and financial reporting models. One model, referred to as the "AICPA College Guide Model," encompasses the accounting and financial reporting guidance in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements. (The other model, referred to as the "Governmental Model," is based on the pronouncements of the National Council on Governmental Accounting [NCGA] and the GASB.)

**D.5.** For state and local governmental entities, some are required to report expenses by function using the functional classifications of program, manage-

ment and general, and fund raising. Other state and local governmental entities that report expenses or expenditures by function have a functional structure that does not include fund raising, program, or management and general. Still other state and local governmental entities do not report expenses or expenditures by function. Examples of those various reporting requirements are as follows:

- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations*, as well as those that follow SOP 78-10 and that receive significant amounts of contributions from the public, are required to report separately the costs of the fund-raising, program, and management and general functions.
- Entities applying the accounting and financial reporting principles in the AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, are required to report fund raising as part of the "institutional support" function.

**D.6.** As discussed in footnote 3 to paragraph .01 of this SOP, this SOP is not intended to require reporting the functional classifications of fund raising, program, and management and general. Rather, those functional classifications are discussed throughout this SOP for purposes of illustrating how the guidance in this SOP would be applied by entities that use those functional classifications. Entities that do not use the functional classifications of fund raising, program, and management and general should apply the guidance in this SOP for purposes of accounting for joint activities, using their reporting model. For example, some entities may conduct membership-development activities. As discussed in the Glossary [paragraph .30] of this SOP, if there are no significant benefits or duties connected with membership, the substance of the membership-development activities may, in fact, be fund raising. In such circumstances, the costs of those activities should be charged to fund raising. To the extent that member benefits are received, membership is an exchange transaction. In circumstances in which membership development is in part soliciting revenues from exchange transactions and in part soliciting contributions and the purpose, audience, and content of the activity are appropriate for achieving membership development, joint costs should be allocated between fund raising and the exchange transaction.

## Assigning Costs of Joint Activities

**D.7.** Paragraph .07 provides: "If the criteria of purpose, audience, and content are met, the costs of a joint activity that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity. . . ." For example, if the criteria are met, the costs of materials that accomplish program goals and that are unrelated to fund raising, such as the costs of a program-related pamphlet included in a joint activity, should be charged to program, while joint costs, such as postage, should be allocated between fund raising and program. However, if the pamphlet is used in fund-raising packets and the criteria are not met, the costs of the pamphlets used in the fund-raising packets, as well as the joint costs, should be charged to fund raising. (If some pamphlets are used in program activities

that include no fund raising, the cost of the pamphlets used in those separate program activities that include no fund raising should be charged to program.)

## **Educational Activities**

**D.8.** Some entities have missions that include educating the public (students) in areas other than causes. Paragraph .09 provides that, for those entities, educating the audience in areas other than causes or motivating the audience to engage in specific activities, such as attending a lecture or class, that will educate them in areas other than causes is considered a call for specific action by the recipients that will help accomplish the entity's mission. Educating the audience about causes or motivating the audience to engage in specific activities that will educate them about causes without educating them in other subjects is not considered a call for specific action by the audience that will help accomplish the entity's mission. An example of a lecture or class that will educate students in an area other than causes is a lecture on the nesting habits of the bald eagle, given by the Save the Bald Eagle Society, an NPO whose mission is to save the bald eagle from extinction and educate the public about the bald eagle. An example of a lecture or class that will address particular causes is a lecture by the Bald Eagle Society on the potential extinction of bald eagles and the need to raise contributions to prevent their extinction. For purposes of applying the guidance in this SOP, motivating the audience to attend a lecture on the nesting habits of the bald eagle is a call for specific action that will help accomplish the entity's mission. If the lecture merely addresses the potential extinction of bald eagles and the need to raise contributions to prevent their extinction, without addressing the nesting habits of the bald eagle, motivating the audience to attend the lecture is not considered a call for specific action by the recipient that will help accomplish the entity's mission.

**D.9.** AcSEC notes that most transactions in which a student attends a lecture or class are exchange transactions and are not joint activities. Such transactions are joint activities only if the activity includes fund raising.

## **Audience**

**D.10.** Paragraph .12 provides that a rebuttable presumption exists that the audience criterion is not met if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the entity. That presumption can be overcome if the audience is also selected for the program or management and general reasons specified in paragraph .13. Further, paragraph .12 provides that in determining whether that presumption is overcome, entities should consider the extent to which the audience is selected based on its ability or likelihood to contribute to the entity and contrast that with the extent to which it is selected for the reasons that may overcome that presumption. Some organizations conduct joint activities that are special events, such as symposia, dinners, dances, and theater parties, in which the attendee receives a direct benefit (for example, a meal or theater ticket) and for which the admission price includes a contribution. For example, it may cost \$500 to attend a dinner with a fair value of \$50. In that case, the audience is required to make a \$450 contribution in order to attend. In circumstances in which the audience is required to make a contribution to participate in a joint activity, such as attending a special event, the audience's ability or likelihood to contribute is a significant factor in its selection. Therefore, in circumstances in which the audience is required to make a contribution to participate in a joint activity, the extent to which the audience is selected for the program or

management and general reasons in paragraph .13 must be overwhelmingly significant in order to rebut the presumption that the audience criterion is not met.

**D.11.** The source of the names and the characteristics of the audience should be considered in determining the reason for selecting the audience. Some entities use lists compiled by others to reach new audiences. The source of such lists may indicate the purpose or purposes for which they were selected. For example, lists acquired from entities with similar or related programs are more likely to meet the audience criterion than are lists acquired from entities with dissimilar or unrelated programs. Also, the characteristics of those on the lists may indicate the purpose or purposes for which they were selected. For example, a list based on a consumer profile of those who buy environmentally friendly products may be useful to an entity whose mission addresses environmental concerns and could therefore indicate that the audience was selected for its ability to take action to assist the entity in meeting program goals. However, a list based on net worth would indicate that the audience was selected based on its ability or likelihood to contribute, unless there was a correlation between net worth and the program or management and general components of the activity.

**D.12.** Some audiences may be selected because they have an interest in or affinity to the program. For example, homeowners may have an interest in the homeless because they are sympathetic to the plight of the homeless. Nevertheless, including homeowners in the audience of a program activity to provide services to the homeless would not meet the audience criterion, because they do not have a need or reasonable potential for use of services to the homeless.

**D.13.** Paragraph .13c provides that the audience criterion is met if the entity is required to direct the management and general component of the joint activity to the particular audience or the audience has reasonable potential for use of the management and general component. An example of a joint activity in which the audience is selected because the entity is required to direct the management and general component of the joint activity to the particular audience is an activity in which the entity sends a written acknowledgment or other information to comply with requirements of the Internal Revenue Service to prior donors and includes a request for contributions. An example of a joint activity in which the audience is selected because the audience has reasonable potential for use of the management and general component is an activity in which the entity sends its annual report to prior donors and includes a request for contributions.

## Content

**D.14.** Paragraph .14 provides that, to meet the content criterion, program activities should call for specific action by the recipient that will help accomplish the entity's mission. As discussed in the Glossary [paragraph .30], the action should benefit the recipient or society. Examples of actions that benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or society (such as by addressing societal problems) include the following:

- a. Actions that benefit the recipient:
  - *Stop smoking.* Specific methods, instructions, references, and resources should be suggested.
  - *Do not use alcohol or drugs.* Specific methods, instructions, references, and resources should be suggested.

b. Actions that benefit society:

- *Write or call.* The party to communicate with and the subject matter to be communicated should be specified.
- *Complete and return the enclosed questionnaire.* The results of the questionnaire should help the entity achieve its mission. For example, if the entity discards the questionnaire, it does not help the entity achieve its mission.
- *Boycott.* The particular product or company to be boycotted should be specified.

**D.15.** Paragraph .14b provides that to meet the content criterion, management and general functions are required to fulfill one or more of the entity's management and general responsibilities through a component of the joint activity. Some states or other regulatory bodies require that certain disclosures be included when soliciting contributions. Paragraph .14, footnote 9, of this SOP provides that for purposes of applying the guidance in this SOP, communications that include such required disclosures are considered fund-raising activities and are not considered management and general activities. Some examples of such disclosures include the following:

- Information filed with the attorney general concerning this charitable solicitation may be obtained from the attorney general of [the state] by calling 123-4567. Registration with the attorney general does not imply endorsement.
- A copy of the registration and financial information may be obtained from the Division of Consumer Services by calling toll-free, within [the state], 1-800-123-4567. Registration does not imply endorsement, approval, or recommendation by [the state].
- Information about the cost of postage and copying, and other information required to be filed under [the state] law, can be obtained by calling 123-4567.
- The organization's latest annual report can be obtained by calling 123-4567.

## Allocation Methods

**D.16.** Paragraph .16 of this SOP states, "The cost allocation methodology used should be rational and systematic, it should result in an allocation of joint costs that is reasonable, and it should be applied consistently given similar facts and circumstances." The allocation of joint costs should be based on the degree to which costs were incurred for the functions to which the costs are allocated (that is, program, management and general, or fund raising). For purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities, facts and circumstances that may be considered include factors related to the content and relative costs of the components of the activity. The audience should not be considered in determining whether the facts and circumstances are similar for purposes of determining whether the allocation methodology for a particular joint activity should be consistent with methodologies used for other particular joint activities.

## Practicability of Measuring Joint Costs

**D.17.** The Glossary [paragraph .30] of this SOP includes a definition of joint costs. Some costs, such as utilities, rent, and insurance, commonly referred

to as indirect costs, may be joint costs. For example, the telephone bill for a department that, among other things, prepares materials that include both fund-raising and program components may commonly be referred to as an indirect cost. Such telephone bills may also be joint costs. However, for some entities, it is impracticable to measure and allocate the portion of the costs that are joint costs. Considerations about which joint costs should be measured and allocated, such as considerations about materiality and the costs and benefits of developing and providing the information, are the same as considerations about cost allocations in other circumstances.

## Appendix E

### Illustrations of Applying the Criteria of Purpose, Audience, and Content to Determine Whether a Program or Management and General Activity Has Been Conducted

#### Illustration 1

##### *Facts*

**E.1.** Entity A's mission is to prevent drug abuse. Entity A's annual report states that one of its objectives in fulfilling that mission is to assist parents in preventing their children from abusing drugs.

**E.2.** Entity A mails informational materials to the parents of all junior high school students explaining the prevalence and dangers of drug abuse. The materials encourage parents to counsel children about the dangers of drug abuse and inform them about how to detect drug abuse. The mailing includes a request for contributions. Entity A conducts other activities informing the public about the dangers of drug abuse and encouraging parents to counsel their children about drug abuse that do not include requests for contributions and that are conducted in different media. Entity A's executive director is involved in the development of the informational materials as well as the request for contributions. The executive director's annual compensation includes a significant bonus if total annual contributions exceed a predetermined amount.

##### *Conclusion*

**E.3.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.4.** The activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. (Although Entity A's executive director's annual compensation varies based on annual contributions, the executive director's compensation does not vary based on contributions raised for this discrete joint activity.) Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the program component of this activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse) that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (b) performing such programs helps accomplish Entity A's mission. (Note that had Entity A conducted the activity using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions, the purpose criterion would have been met under paragraph .10b.)

**E.5.** The audience criterion is met because the audience (parents of junior high school students) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**E.6.** The content criterion is met because the activity calls for specific action by the recipient (encouraging parents to counsel children about the dangers of drug abuse and informing them about how to detect drug abuse) that will help accomplish the entity's mission (assisting parents in preventing their children from abusing drugs), and it explains the need for and benefits of the action (the prevalence and dangers of drug abuse).

## Illustration 2

### Facts

**E.7.** Entity B's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity B's objectives in fulfilling that mission is to inform the public about the effects and early warning signs of the disease and specific action that should be taken to prevent the disease.

**E.8.** Entity B maintains a list of its prior donors and sends them donor renewal mailings. The mailings include messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it. That information is also sent to a similar-sized audience but without the request for contributions. Also, Entity B believes that recent donors are more likely to contribute than nondonors or donors who have not contributed recently. Prior donors are deleted from the mailing list if they have not contributed to Entity B recently, and new donors are added to the list. There is no evidence of a correlation between recent contributions and participation in the program component of the activity. Also, the prior donors' need to use or reasonable potential for use of the messages about the effects and early warning signs of the disease and specific action that should be taken to prevent it is an insignificant factor in their selection.

### Conclusion

**E.9.** The purpose and content criteria are met. The audience criterion is not met.<sup>11</sup> All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, should be charged to fund raising.

**E.10.** The activity calls for specific action by the recipient (action that should be taken to prevent ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (to reduce the incidence of illness from the disease), and (b) the program is also

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<sup>11</sup> Paragraph .07 of this SOP provides that all costs of joint activities, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should be charged to fund raising if any of the criteria of purpose, audience, or content are not met. Accordingly, if one or more criteria are not met, the other criteria need not be considered. However, the illustrations in this Appendix provide conclusions about whether each of the criteria would be met in circumstances in which one or more criteria are not met in order to provide further guidance.



conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (a similar mailing is done without the request for contributions, to a similar-sized audience).

**E.11.** The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is not overcome in this illustration. Although the audience has a need to use or reasonable potential for use of the program component, that was an insignificant factor in its selection.

**E.12.** The content criterion is met because the activity calls for specific action by the recipient (actions to prevent ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

### **Illustration 3**

#### **Facts**

**E.13.** Entity C's mission is to reduce the incidence of illness from ABC disease, which afflicts a broad segment of the population. One of Entity C's objectives in fulfilling that mission is to increase governmental funding for research about ABC disease.

**E.14.** Entity C maintains a list of its prior donors and its employees call them on the telephone reminding them of the effects of ABC disease, asking for contributions, and encouraging them to contact their elected officials to urge increased governmental funding for research about ABC disease. The callers are educated about ABC, do not otherwise perform fund-raising functions, and are not compensated or evaluated based on contributions raised. Entity C's research indicates that recent donors are likely to contact their elected officials about such funding while nonrecent donors are not. Prior donors are deleted from the calling list if they have not contributed to Entity C recently, and new donors are added to the list.

#### **Conclusion**

**E.15.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.16.** The activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the callers are educated about ABC and do not otherwise perform fund-raising functions), (b) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised), and (c) performing such programs helps accomplish Entity C's mission.

**E.17.** The audience criterion is met because the audience (recent donors) is selected based on its ability to assist Entity C in meeting the goals of the program component of the activity (recent donors are likely to contact their elected officials about such funding while nonrecent donors are not).

**E.18.** The content criterion is met because the activity calls for specific action by the recipient (contacting elected officials concerning funding for research about ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

## Illustration 4

### Facts

**E.19.** Entity D's mission is to improve the quality of life for senior citizens. One of Entity D's objectives included in that mission is to increase the physical activity of senior citizens. One of Entity D's programs to attain that objective is to send representatives to speak to groups about the importance of exercise and to conduct exercise classes.

**E.20.** Entity D mails a brochure on the importance of exercise that encourages exercise in later years to residents over the age of sixty-five in three zip code areas. The last two pages of the four-page brochure include a perforated contribution remittance form on which Entity D explains its program and makes an appeal for contributions. The content of the first two pages of the brochure is primarily educational; it explains how seniors can undertake a self-supervised exercise program and encourages them to undertake such a program. In addition, Entity D includes a second brochure on various exercise techniques that can be used by those undertaking an exercise program.

**E.21.** The brochures are distributed to educate people in this age group about the importance of exercising, to help them exercise properly, and to raise contributions for Entity D. These objectives are documented in a letter to the public relations firm that developed the brochures. The audience is selected based on age, without regard to ability to contribute. Entity D believes that most of the recipients would benefit from the information about exercise.

### Conclusion

**E.22.** The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the second brochure should be charged to program because all the costs of the brochure are identifiable with the program function.)

**E.23.** The activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) performing such programs helps accomplish Entity D's mission, and (b) the objectives of the program are documented in a letter to the public relations firm that developed the brochure.

**E.24.** The audience criterion is met because the audience (residents over sixty-five in certain zip codes) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**E.25.** The content criterion is met because the activity calls for specific action by the recipient (exercising) that will help accomplish the entity's mission

(increasing the physical activity of senior citizens), and the need for and benefits of the action are clearly evident (explains the importance of exercising).

## Illustration 5

### **Facts**

**E.26.** The facts are the same as those in Illustration 4, except that Entity E employs a fund-raising consultant to develop the first brochure and pays that consultant 30 percent of contributions raised.

### **Conclusion**

**E.27.** The content and audience criteria are met. The purpose criterion is not met, however, because a majority of compensation or fees for the fund-raising consultant varies based on contributions raised for this discrete joint activity (the fund-raising consultant is paid 30 percent of contributions raised). All costs should be charged to fund raising, including the costs of the second brochure and any other costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity.

## Illustration 6

### **Facts**

**E.28.** Entity F's mission is to protect the environment. One of Entity F's objectives included in that mission is to take action that will increase the portion of waste recycled by the public.

**E.29.** Entity F conducts a door-to-door canvass of a community that recycles a low portion of its waste. The purpose of the activity is to help increase recycling by educating the community about environmental problems created by not recycling, and to raise contributions. Based on the information communicated by the canvassers, the need for and benefits of the action are clearly evident. The ability or likelihood of the residents to contribute is not a basis for communities selected, and all neighborhoods in the geographic area are covered if their recycling falls below a predetermined rate. The canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns. The canvassers have not previously participated in fund-raising activities.

### **Conclusion**

**E.30.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.31.** The activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the canvassers are selected from individuals who are well-informed about the organization's environmental concerns and programs and who previously participated as volunteers in program activities

such as answering environmental questions directed to the organization and developing program activities designed to influence legislators to take actions addressing those concerns), and (b) performing such programs helps accomplish Entity F's mission (to protect the environment).

**E.32.** The audience criterion is met because the audience (neighborhoods whose recycling falls below a predetermined rate) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**E.33.** The content criterion is met because the activity calls for specific action by the recipient (implicitly—to help increase recycling) that will help accomplish the entity's mission (to protect the environment), and the need for and benefits of the action are clearly evident (increased recycling will help alleviate environmental problems).

## Illustration 7

### Facts

**E.34.** Entity G's mission is to provide summer camps for economically disadvantaged youths. Educating the families of ineligible youths about the camps is not one of the program objectives included in that mission.

**E.35.** Entity G conducts a door-to-door solicitation campaign for its camp programs. In the campaign, volunteers with canisters visit homes in middle-class neighborhoods to collect contributions. Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute. The volunteers explain the camp's programs, including why the disadvantaged children benefit from the program, and distribute leaflets to the residents regardless of whether they contribute to the camp. The leaflets describe the camp, its activities, who can attend, and the benefits to attendees. Requests for contributions are not included in the leaflets.

### Conclusion

**E.36.** The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

**E.37.** The activity does not include a call for specific action because it only educates the audience about causes (describing the camp, its activities, who can attend, and the benefits to attendees). Therefore, the purpose criterion is not met.

**E.38.** The audience criterion is not met, because the audience is selected based on its ability or likelihood to contribute, rather than based on (a) its need to use or reasonable potential for use of the action called for by the program component, or (b) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (Entity G believes that people in those neighborhoods would not need the camp's programs but may contribute.)

**E.39.** The content criterion is not met because the activity does not call for specific action by the recipient. (The content educates the audience about causes that the program is designed to address without calling for specific action.)

## Illustration 8

### Facts

**E.40.** Entity H's mission is to educate the public about lifesaving techniques in order to increase the number of lives saved. One of Entity H's objec-

tives in fulfilling that mission, as stated in the minutes of the board's meetings, is to produce and show television broadcasts including information about lifesaving techniques.

**E.41.** Entity H conducts an annual national telethon to raise contributions and to reach the American public with lifesaving educational messages, such as summary instructions concerning dealing with certain life-threatening situations. Based on the information communicated by the messages, the need for and benefits of the action are clearly evident. The broadcast includes segments describing Entity H's services. Entity H broadcasts the telethon to the entire country, not merely to areas selected on the basis of giving potential or prior fund raising results. Also, Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising.

### **Conclusion**

**E.42.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.43.** The activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish Entity H's mission (to save lives by educating the public), and (b) a similar program activity is conducted without the fund raising using the same medium and on a scale that is similar to or greater than the scale on which it is conducted with the appeal (Entity H uses national television broadcasts devoted entirely to lifesaving educational messages to conduct program activities without fund raising).

**E.44.** The audience criterion is met because the audience (a broad segment of the population) is selected based on its need to use or reasonable potential for use of the action called for by the program activity.

**E.45.** The content criterion is met because the activity calls for specific action by the recipient (implicitly—to save lives) that will help accomplish the entity's mission (to save lives by educating the public), and the need for and benefits of the action are clearly evident (saving lives is desirable).

## **Illustration 9**

### **Facts**

**E.46.** Entity I's mission is to provide food, clothing, and medical care to children in developing countries.

**E.47.** Entity I conducts television broadcasts in the United States that describe its programs, show the needy children, and end with appeals for contributions. Entity I's operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries and to raise contributions. The employees producing the programs are trained in audiovisual production and are familiar with Entity I's programs. Also, the executive producer is paid \$25,000 for this activity, with a \$5,000 bonus if the activity raises over \$1,000,000.

### **Conclusion**

**E.48.** The purpose, audience, and content criteria are not met. All costs should be charged to fund raising.

**E.49.** The activity does not include a call for specific action because it only educates the audience about causes (describing its programs and showing the needy children). Therefore, the purpose criterion is not met. (Also, note that if the factor in paragraph .10a were considered, it would not be determinative of whether the purpose criterion is met. Although the executive producer will be paid \$5,000 if the activity raises over \$1,000,000, that amount would not be a majority of the executive producer's total compensation for this activity, because \$5,000 would not be a majority of the executive producer's total compensation of \$30,000 for this activity. Also, note that if other evidence, such as the indicators in paragraph .11, were considered, the purpose criterion would not be met based on the other evidence. Although the qualifications and duties of the personnel performing the activity indicate that the employees producing the program are familiar with Entity I's programs, the facts that some, but less than a majority, of the executive producer's compensation varies based on contributions raised, and that the operating policies and internal management memoranda state that these programs are designed to educate the public about the needs of children in developing countries [with no call for specific action by recipients] and to raise contributions, indicate that the purpose is fund raising.)

**E.50.** The audience criterion is not met because the audience is selected based on its ability or likelihood to contribute, rather than based on (a) its need to use or reasonable potential for use of the action called for by the program component, or (b) its ability to take action to assist the entity in meeting the goals of the program component of the activity. (The audience is a broad segment of the population of a country that is not in need of or has no reasonable potential for use of the program activity.)

**E.51.** The content criterion is not met because the activity does not call for specific action by the recipient that will help accomplish the entity's mission. (The content educates the audience about the causes without calling for specific action.)

## Illustration 10

### Facts

**E.52.** Entity J is a university that distributes its annual report, which includes reports on mission accomplishments, to those who have made significant contributions over the previous year, its board of trustees, and its employees. The annual report is primarily prepared by management and general personnel, such as the accounting department and executive staff. The activity is coordinated by the public relations department. Internal management memoranda indicate that the purpose of the annual report is to report on how management discharged its stewardship responsibilities, including the university's overall performance, goals, financial position, cash flows, and results of operations. Included in the package containing the annual report are requests for contributions and donor reply cards.

### Conclusion

**E.53.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.54.** The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be

considered. The purpose criterion is met based on the other evidence, because (a) the employees performing the activity are not members of the fund-raising department and perform other non-fund-raising activities and (b) internal management memoranda indicate that the purpose of the annual report is to fulfill one of the university's management and general responsibilities.

**E.55.** The audience criterion is met because the audience is selected based on its reasonable potential for use of the management and general component. Although the activity is directed primarily at those who have previously made significant contributions, the audience was selected based on its presumed interest in Entity J's annual report (prior donors who have made significant contributions are likely to have an interest in matters discussed in the annual report).

**E.56.** The content criterion is met because the activity (distributing annual reports) fulfills one of the entity's management and general responsibilities (reporting concerning management's fulfillment of its stewardship function).

## Illustration 11

### Facts

**E.57.** Entity K is an NPO. In accordance with internal management memoranda documenting its policies requiring it to comply with Internal Revenue Service (IRS) regulations, it mails prior donors who have made quid pro quo payments in excess of \$75 documentation required by the IRS. The documentation is included on a perforated piece of paper. The information above the perforation line pertains to the documentation required by the IRS. The information below the perforation line includes a request for contributions and may be used as a donor reply card.

### Conclusion

**E.58.** The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that the costs of the information below the perforation line are identifiable with fund raising and therefore should be charged to fund raising.)

**E.59.** The activity has elements of management and general functions. Therefore, no call for specific action is required. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because internal management memoranda indicate that the purpose of the activity is to fulfill one of Entity K's management and general responsibilities.

**E.60.** The audience criterion is met because the entity is required to direct the management and general component of the activity to the particular audience. Although the activity is directed at those who have previously contributed, the audience was selected based on its need for the documentation.

**E.61.** The content criterion is met because the activity (sending documentation required by the IRS) fulfills one of the entity's management and general responsibilities (complying with IRS regulations).

## Illustration 12

### Facts

**E.62.** Entity L is an animal rights organization. It mails a package of material to individuals included in lists rented from various environmental and

other organizations that support causes that Entity L believes are congruent with its own. In addition to donor response cards and return envelopes, the package includes (a) materials urging recipients to contact their legislators and urge the legislators to support legislation to protect those rights, and (b) postcards addressed to legislators urging support for legislation restricting the use of animal testing for cosmetic products. The mail campaign is part of an overall strategy that includes magazine advertisements and the distribution of similar materials at various community events, some of which are undertaken without fund-raising appeals. The advertising and community events reach audiences similar in size and demographics to the audience reached by the mailing.

### **Conclusion**

**E.63.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.64.** The activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the program component of this activity calls for specific action by the recipient that will help accomplish the entity's mission, and it otherwise conducts the program activity in this illustration without a request for contributions, and (b) performing such programs helps accomplish Entity L's mission.

**E.65.** The audience criterion is met because the audience (individuals included in lists rented from various environmental and other organizations that support causes that Entity L believes are congruent with its own) is selected based on its ability to take action to assist the entity in meeting the goals of the program component of the activity.

**E.66.** The content criterion is met because the activity calls for specific action by the recipient (mailing postcards to legislators urging support for legislation restricting the use of animal testing for cosmetic products) that will help accomplish the entity's mission (to protect animal rights), and the need for and benefits of the action are clearly evident (to protect animal rights).

### **Illustration 13**

#### **Facts**

**E.67.** Entity M is a performing arts organization whose mission is to make the arts available to residents in its area. Entity M charges a fee for attending performances and sends advertisements, including subscription forms, for the performances to residents in its area. These advertisements include a return envelope with a request for contributions. Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received. In performing that evaluation, Entity M places more weight on the number of subscriptions sold than on the contributions received. Also, Entity M advertises the performances on local television and radio without a request for contributions but on a smaller scale than the mail advertising.



## Conclusion

**E.68.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.69.** The activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) the entity measures program results and accomplishments of the joint activity and in evaluating the effectiveness of the activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity M evaluates the effectiveness of the advertising based on the number of subscriptions sold as well as contributions received and places more weight on the number of subscriptions sold than on the contributions received), (b) it otherwise conducts the program activity without a request for contributions, and (c) performing such programs helps accomplish Entity M's mission (to make the arts available to residents in its area).

**E.70.** The audience criterion is met because the audience (a broad segment of the population in Entity M's area) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**E.71.** The content criterion is met because the activity calls for specific action by the recipient (attending the performances) that will help accomplish the entity's mission (making the arts available to area residents), and the need for and benefits of the action are clearly evident (attending the performance is a positive cultural experience). (Note that the purchase of subscriptions is an exchange transaction and, therefore, is not a contribution.)

## Illustration 14

### Facts

**E.72.** Entity N is a university whose mission is to educate the public (students) in various academic pursuits. Entity N's political science department holds a special lecture series in which prominent world leaders speak about current events. The speakers command relatively high fees and, in order to cover costs and make a modest profit, the university sets a relatively expensive fee to attend. However, the tickets are priced at the fair value of the lecture and no portion of the ticket purchase price is a contribution. Entity N advertises the lectures by sending invitations to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. At some of the lectures, including the lecture being considered in this illustration, deans and other faculty members of Entity N solicit significant contributions from attendees. Other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions. Entity N's records indicate that historically 75 percent of the attendees have attended prior lectures. Of the 75 percent who have attended prior lectures, 15 percent have made prior contributions to Entity N. Of the 15 percent who have made prior contributions to Entity N, 5 percent have made contributions in response to solicitations made at the events. (Therefore, one-half of one percent of attendees make contribu-

tions in response to solicitations made at the events. However, those contributions are significant.) Overall, the audience's ability or likelihood to contribute is an insignificant factor in its selection. Entity N evaluates the effectiveness of the activity based on the number of tickets sold, as well as contributions received. In performing that evaluation, Entity N places more weight on the number of tickets sold than on the contributions received.

### **Conclusion**

**E.73.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.74.** The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without requesting contributions).

**E.75.** The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience includes prior donors is overcome in this illustration because the audience (those who have shown prior interest in the lecture series, prior donors, a broad segment of the population in Entity N's area, and those attending the lecture) is also selected for its reasonable potential for use of the program component (attending the lecture). Although the audience may make significant contributions, that was an insignificant factor in its selection.

**E.76.** The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph .07 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.<sup>12</sup>)

## **Illustration 15**

### **Facts**

**E.77.** Entity O is a university whose mission is to educate the public (students) in various academic pursuits. Entity O's political science department holds a special lecture series in which prominent world leaders speak about current events. Admission is priced at \$250, which is above the \$50 fair value of the lecture and, therefore, \$200 of the admission price is a contribution. Therefore, the audience's likelihood to contribute to the entity is a significant factor in its selection. Entity O advertises the lectures by sending invitations

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<sup>12</sup> Paragraphs 13.22 to 13.27 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events.

to prior attendees and to prior donors who have contributed significant amounts, and by placing advertisements in local newspapers read by the general public. Entity O presents similar lectures that are priced at the fair value of those lectures.

### **Conclusion**

**E.78.** The purpose and content criteria are met. The audience criterion is not met. All costs, including those that might otherwise be considered program or management and general costs if they had been incurred in a different activity, except for the costs of the direct donor benefit (the lecture), should be charged to fund raising.

**E.79.** The activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (other lectures in the series are conducted on a scale similar to the scale of the lecture in this illustration without including a contribution in the admission price.)

**E.80.** The audience criterion is not met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute to the entity is not overcome in this illustration. The fact that the \$250 admission price includes a \$200 contribution leads to the conclusion that the audience's ability or likelihood to contribute is an overwhelmingly significant factor in its selection, whereas there is no evidence that the extent to which the audience is selected for its need to use or reasonable potential for use of the action called for by the program component (attending the lecture) is overwhelmingly significant.

**E.81.** The content criterion is met because the activity calls for specific action by the recipient (attending the lecture) that will help accomplish the entity's mission (educating the public [students] in various academic pursuits), and the need for and benefits of the action are clearly evident (attending the lecture is a positive educational experience). (Note that the purchase of the tickets is an exchange transaction and, therefore, is not a contribution. As discussed in paragraph .07 of this SOP, costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event, should not be reported as fund raising.<sup>13</sup>)

## **Illustration 16**

### **Facts**

**E.82.** Entity P's mission is to reduce the incidence of illness from ABC disease, which primarily afflicts people over sixty-five years of age. One of Entity P's objectives in fulfilling that mission is to have all persons over sixty-five screened for ABC disease.

**E.83.** Entity P rents space at events attended primarily by people over sixty-five years of age and conducts free screening for ABC disease. Entity P's

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<sup>13</sup> Paragraphs 13.22 to 13.27 of the Audit and Accounting Guide *Not-for-Profit Organizations* provide guidance concerning reporting special events.

employees, who are educated about ABC disease and screening procedures and do not otherwise perform fund-raising functions, educate interested parties about the effects of ABC disease and the ease and benefits of screening for it. Entity P also solicits contributions at the events. The effectiveness of the activity is evaluated primarily based on how many screening tests are performed, and only minimally based on contributions raised. The employees are not compensated or evaluated based on contributions raised.

### **Conclusion**

**E.84.** The purpose, audience, and content criteria are met, and the joint costs should be allocated.

**E.85.** The activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. Neither of the factors in paragraph .10a or .10b is determinative of whether the purpose criterion is met. Therefore, other evidence, such as the indicators in paragraph .11, should be considered. The purpose criterion is met based on the other evidence, because (a) a process exists to evaluate measured program results and accomplishments and in evaluating the effectiveness of the joint activity, the entity places significantly greater weight on the activity's effectiveness in accomplishing program goals than on the activity's effectiveness in raising contributions (Entity P evaluates the effectiveness of the activity based on the number of screening tests conducted as well as contributions received and places more weight on the number of tests conducted than on the contributions received); (b) the qualifications and duties of the personnel performing the activity indicate that it is a program activity (the employees are educated about ABC disease and the testing procedures and do not otherwise perform fund-raising functions); (c) the method of compensation for performing the activity does not indicate that it is a fund-raising activity (the employees are not compensated or evaluated based on contributions raised); and (d) performing such programs helps accomplish Entity P's mission (to prevent ABC disease).

**E.86.** The audience criterion is met because the audience (people over sixty-five years of age) is selected based on its need to use or reasonable potential for use of the action called for by the program component.

**E.87.** The content criterion is met because the activity calls for specific action by the recipient (being screened for ABC disease) that will help accomplish the entity's mission (to reduce the incidence of ABC disease), and it explains the need for and benefits of the action (to prevent ABC disease).

### **Illustration 17**

#### **Facts**

**E.88.** Entity Q's mission is to provide cultural and educational television programming to residents in its area. Entity Q owns a public television station and holds a membership drive in which it solicits new members. The drive is conducted by station employees and consists of solicitations that are shown during long breaks between the station's regularly scheduled programs. Entity Q's internal management memoranda state that these drives are designed to raise contributions. Entity Q evaluates the effectiveness of the activity based on the amount of contributions received. Entity Q shows the programs on a

similar scale, without the request for contributions. The audience is members of the general public who watch the programs shown during the drive. Station member benefits are given to those who contribute and consist of tokens of appreciation with a nominal value.

### **Conclusion**

**E.89.** The purpose, audience, and content criteria are met, and the joint costs should be allocated. (Note that there would be few, if any, joint costs. Costs associated with the fund-raising activities, such as costs of airtime, would be separately identifiable from costs of the program activities, such as licensing costs for a particular television program. Also, note that because no significant benefits or duties are associated with membership, member dues are contributions. Therefore, the substance of the membership-development activities is, in fact, fund raising.)

**E.90.** The activity calls for specific action by the recipient (watching the television program) that will help accomplish the entity's mission. Therefore, the guidance in paragraph .10 should be considered. The purpose criterion is met because (a) the program component of the activity calls for specific action by the recipient that will help accomplish the entity's mission, and (b) the program is also conducted using the same medium on a scale that is similar to or greater than the scale on which it is conducted with the request for contributions (Entity Q shows the television programs on a similar scale, without the request for contributions).

**E.91.** The audience criterion is met. The rebuttable presumption that the audience criterion is not met because the audience is selected based on its likelihood to contribute is overcome in this illustration because the audience (members of the general public who watch the television programs shown during the drive) is also selected for its reasonable potential for use of the program component (watching the television programs). Although the audience may make contributions, that was an insignificant factor in its selection.

**E.92.** The content criterion is met because the activity calls for specific action by the recipient (watching the television programs) that will help accomplish the entity's mission (providing cultural and educational television programming to residents in its area), and the need for and benefits of the action are clearly evident (watching the programs is a positive cultural and educational experience).

## Appendix F

### Illustrations of Allocation Methods

**F.1.** Some commonly used cost allocation methods follow.

#### Physical Units Method

**F.2.** Joint costs are allocated to materials and activities in proportion to the number of units of output that can be attributed to each of the materials and activities. Examples of units of output are lines, square inches, and physical content measures. This method assumes that the benefits received by the fund-raising, program, or management and general component of the materials or activity from the joint costs incurred are directly proportional to the lines, square inches, or other physical output measures attributed to each component of the activity. This method may result in an unreasonable allocation of joint costs if the units of output, for example, line counts, do not reflect the degree to which costs are incurred for the joint activity. Use of the physical units method may also result in an unreasonable allocation if the physical units cannot be clearly ascribed to fund raising, program, or management and general. For example, direct mail and telephone solicitations sometimes include content that is not identifiable with fund raising, program, or management and general; or the physical units of such content are inseparable.

#### *Illustration*

**F.3.** Assume a direct mail campaign is used to conduct programs of the entity and to solicit contributions to support the entity and its programs. Further, assume that the appeal meets the criteria for allocation of joint costs to more than one function.

**F.4.** The letter and reply card include a total of one hundred lines. Forty-five lines pertain to program because they include a call for action by the recipient that will help accomplish the entity's mission, while fifty-five lines pertain to the fund-raising appeal. Accordingly, 45 percent of the costs are allocated to program and 55 percent to fund-raising.

#### Relative Direct Cost Method

**F.5.** Joint costs are allocated to each of the components on the basis of their respective direct costs. Direct costs are those costs that are incurred in connection with the multipurpose materials or activity and that are specifically identifiable with a function (program, fund raising, or management and general). This method may result in an unreasonable allocation of joint costs if the joint costs of the materials and activity are not incurred in approximately the same proportion and for the same reasons as the direct costs of the materials and activity. For example, if a relatively costly booklet informing the reader about the entity's mission (including a call for action by the recipient that will help accomplish the entity's mission) is included with a relatively inexpensive fund-raising letter, the allocation of joint costs based on the cost of these pieces may be unreasonable, particularly if the booklet and letter weigh approximately the same and therefore contribute equally to the postage costs.

**Illustration**

**F.6.** The costs of a direct mail campaign that can be specifically identified with program services are the costs of separate program materials and a postcard which calls for specific action by the recipient that will help accomplish the entity's mission. They total \$20,000. The direct costs of the fund-raising component of the direct mail campaign consist of the costs to develop and produce the fund-raising letter. They total \$80,000. Joint costs associated with the direct mail campaign total \$40,000 and would be allocated as follows under the relative direct cost method:

Program	$\$20,000/\$100,000 \times \$40,000 = \$8,000$
Fund raising	$\$80,000/\$100,000 \times \$40,000 = \$32,000$

**Stand-Alone Joint-Cost-Allocation Method**

**F.7.** Joint costs are allocated to each component of the activity based on a ratio that uses estimates of costs of items included in joint costs that would have been incurred had the components been conducted independently. The numerator of the ratio is the cost (of items included in joint costs) of conducting a single component independently; the denominator is the cost (of items included in joint costs) of conducting all components independently. This method assumes that efforts for each component in the stand-alone situation are proportionate to the efforts actually undertaken in the joint cost situation. This method may result in an unreasonable allocation because it ignores the effect of each function, which is performed jointly with other functions, on other such functions. For example, the programmatic impact of a direct mail campaign or a telemarketing phone message may be significantly lessened when performed in conjunction with a fund-raising appeal.

**Illustration**

**F.8.** Assume that the joint costs associated with a direct mail campaign including both program and fund-raising components are the costs of stationery, postage, and envelopes at a total of \$100,000. The costs of stationery, postage, and envelopes to produce and distribute each component separately would have been \$90,000 for the program component and \$70,000 for the fund-raising component. Under the stand-alone joint-cost-allocation method, the \$100,000 in joint costs would be allocated as follows:  $\$90,000/\$160,000 \times \$100,000 = \$56,250$  to program services and  $\$70,000/\$160,000 \times \$100,000 = \$43,750$  to fund raising.

Appendix G

Illustrations of Disclosures

G.1. The disclosures discussed in paragraphs .18 and .19 are illustrated below. Alternative 1 reports the required and encouraged information in narrative format. Alternative 2 reports that information in tabular format, as well as information concerning joint costs incurred for each kind of activity by functional classification, which is neither required nor encouraged, but which is not prohibited.

Alternative 1

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included requests for contributions, as well as program and management and general components. Those activities included direct mail campaigns, special events, and a telethon. The costs of conducting those activities included a total of \$310,000 of joint costs, which are not specifically attributable to particular components of the activities (joint costs). [Note to reader: The following sentence is encouraged but not required.] Joint costs for each kind of activity were \$50,000, \$150,000, and \$110,000 respectively. These joint costs were allocated as follows:

Fund raising	\$180,000
Program A	80,000
Program B	40,000
Management and general	10,000
Total	<u>\$310,000</u>

Alternative 2

Note X. Allocation of Joint Costs

In 19XX, the organization conducted activities that included appeals for contributions and incurred joint costs of \$310,000. These activities included direct mail campaigns, special events, and a telethon. Joint costs were allocated as follows:

	<u>Direct Mail</u>	<u>Special Events</u>	<u>Telethon</u>	<u>Total</u>
Fund raising	\$40,000	\$50,000	\$90,000	\$180,000
Program A	10,000	65,000	5,000	80,000
Program B		25,000	15,000	40,000
Management and general		10,000		10,000
Total	<u>\$50,000</u>	<u>\$150,000</u>	<u>\$110,000</u>	<u>\$310,000</u>

[Note to reader: Shading is used to highlight information that is neither required nor encouraged, but which is not prohibited. However, entities may prefer to disclose it. Disclosing the total joint costs for each kind of activity (\$50,000, \$150,000, and \$110,000) is encouraged but not required.]



## Appendix H

### Contrast of Guidance in This SOP With the Guidance in SOP 87-2<sup>14</sup>

#### This SOP

Applies to all entities that solicit contributions, including state and local governments.

Covers *all* costs of joint activities. (Costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, except for costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event [for example, a meal], should be charged to fund raising unless the criteria in the SOP are met.)

Criteria of purpose, audience, and content should all be met in order to charge costs of the activity to program or management and general.

#### SOP 87-2

Applied to entities that follow the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* or SOP 78-10. (SOP 87-2 was not applicable to entities that are within the scope of Governmental Accounting Standards Board Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*.)

Covers only joint costs of joint activities.

Unclear concerning whether all criteria should be met in order to charge costs of the activity to program or management and general.

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<sup>14</sup> In August 1996, the AICPA issued the Audit and Accounting Guide *Not-for-Profit Organizations*, which superseded Statement of Position (SOP) 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the guidance in SOP 87-2 is incorporated into paragraphs 13.36 to 13.45 of the Guide. Also, *Not-for-Profit Organizations* superseded the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* and SOP 78-10. *Not-for-Profit Organizations* applies to all nongovernmental not-for-profit organizations other than those required to follow the Audit and Accounting Guide *Health Care Organizations*. Therefore, incorporating the guidance in SOP 87-2 into *Not-for-Profit Organizations* broadened the scope of the guidance previously included in SOP 87-2 to all not-for-profit organizations other than those required to follow *Health Care Organizations*. The discussion in this SOP of SOP 87-2 refers to both SOP 87-2 and the guidance included in paragraphs 13.36 to 13.45 of *Not-for-Profit Organizations*, except that the guidance in *Not-for-Profit Organizations* applies to all not-for-profit organizations other than those required to follow *Health Care Organizations*.

*This SOP*

Neither prescribes nor prohibits any allocation methods. Includes a discussion to help users determine whether an allocation is reasonable, and provides some illustrations.

Requires note disclosures about the types of activities for which joint costs have been incurred, amounts allocated during the period, and amounts allocated to each functional expense or expenditure category.

*SOP 87-2*

Neither prescribes nor prohibits any allocation methods. No illustrations are provided.

Requires less extensive note disclosures: total amount allocated during the period and amounts allocated to each functional expense category.

## Appendix I

### Effects on Other Guidance

**I.1.** For nongovernmental organizations, this Statement of Position (SOP) amends the AICPA Audit and Accounting Guide *Health Care Organizations* and paragraphs 13.36 to 13.45 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.

**I.2.** Also, this SOP amends the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* to clarify that costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund-raising. In particular, paragraphs 13.22, 13.24, and 13.25 of *Not-for-Profit Organizations* are amended as follows:

**13.22** Some organizations conduct joint activities\* that are special events, including special social and educational events (such as symposia, dinners, dances, and theater parties) in which the attendee receives a direct benefit (for example, a meal or theater ticket). FASB Statement No. 117 requires the reporting of the gross amounts of revenues and expenses from special events and other fund-raising activities that are ongoing major or central activities, but permits (but does not require) reporting net amounts if the receipts and related costs result from special events that are peripheral or incidental activities.

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\* See the sections of this Guide that provide guidance concerning accounting for the costs of joint activities.

**13.24** For example, assume that an organization has a special event that is an ongoing and major activity with a ticket price of \$100. Assume that the activity does not meet the audience criterion in SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, and, therefore, all costs of the activity, other than the direct donor benefits, should be reported as fund raising. The event includes a dinner that costs the organization \$25 and that has a fair value of \$30. (Chapter 5, "Contributions Received and Agency Transactions," of this Guide, discusses the appropriate reporting if the meal or other items of value are donated to the organization for resale.) In addition, the organization incurs other direct costs of the event in connection with promoting and conducting the event, including incremental direct costs incurred in transactions with independent third parties and the payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. Those other direct costs, which include (a) \$5 that otherwise might be considered management and general costs if they had been incurred in a different activity, and (b) fund-raising costs of \$10, are unrelated to the direct benefits to donors and, accordingly, should not be included as costs of benefits to donors. In addition, the organization has the following transactions, which are unrelated to the special event: unrestricted contributions of \$200, program expenses of \$60, management and general expenses of \$20, and fund-raising expenses of \$20.

**13.25** Some ways in which the organization could display the results of the special event as part of its statement of activities are illustrated as follows:

Illustration 1

Changes in unrestricted net assets:		
Contributions		\$200
Special event revenue	100	
Less: Costs of direct benefits to donors	<u>(25)</u>	
Net revenues from special events		<u>75</u>
Contributions and net revenues from special events		275
Other expenses:		
Program		60
Management and general		20
Fund raising		<u>35</u>
Total other expenses		<u>115</u>
Increase in unrestricted net assets		<u>\$160</u>

Illustration 2

Changes in unrestricted net assets:		
Revenues:		
Contributions		\$200
Special event revenue		<u>100</u>
Total revenues		300
Expenses:		
Program		60
Costs of direct benefits to donors		25
Management and general		20
Fund raising		<u>35</u>
Total expenses		<u>140</u>
Increase in unrestricted net assets		<u>\$160</u>

Illustration 3

Changes in unrestricted net asset:		
Contributions		\$270
Dinner sales		30
Less: Costs of direct benefits to donors		<u>(25)</u>
Gross profit on special events		<u>5</u>
Contributions and net revenues from special events		275
Other expenses:		
Program		60
Management and general		20
Fund raising		<u>35</u>
Total other expenses		<u>115</u>
Increase in unrestricted net assets		<u>\$160</u>

**I.3.** For governmental entities that have applied the accounting and financial reporting principles in SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, or the AICPA Industry Audit Guide *Audits of Voluntary Health and Welfare Organizations* (modified by all applicable Financial Accounting Standards Board [FASB] pronouncements issued through November 30, 1989, and by most applicable Governmental Accounting Standards Board [GASB] pronouncements) in conformity with GASB

Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, this SOP amends the principles—based on SOP 78-10 and *Audits of Voluntary Health and Welfare Organizations*, as modified—that those entities apply. For governmental entities that have applied the accounting and financial reporting principles in the 1973 AICPA Industry Audit Guide *Audits of Colleges and Universities*, as amended by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, and as modified by applicable FASB pronouncements issued through November 30, 1989, and all applicable GASB pronouncements in conformity with GASB Statement No. 15, *Governmental College and University Accounting and Financial Reporting Models*, this SOP amends the principles—based on *Audits of Colleges and Universities*, as amended and modified—that those entities apply. For other governmental organizations, this SOP amends the Audit and Accounting Guide *Audits of State and Local Governmental Units*.

## Glossary

**Activities.** Activities are efforts to accomplish specific objectives. Some activities include producing and distributing materials. For example, if an entity undertakes a mass mailing that includes a letter and a pamphlet, producing and distributing the letter and pamphlet are part of the activity. Other activities may include no materials, such as an annual dinner or a radio commercial.

**Compensation or fees.** Reciprocal transfers of cash or other assets in exchange for services performed.

**Contributions.** Contributions are unconditional transfers of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

**Costs of joint activities.** Costs of joint activities are costs incurred for a joint activity. Costs of joint activities may include joint costs and costs other than joint costs. Costs other than joint costs are costs that are identifiable with a particular function, such as fund raising, program, management and general, and cost of sales. For example, some costs incurred for printing, paper, professional fees, and salaries to produce donor cards are not joint costs, although they may be incurred in connection with conducting joint activities.

**Fund-raising activities.** Fund-raising activities are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, governments, and others.

**Help accomplish the entity's mission.** Actions that help accomplish the entity's mission are actions that either benefit the recipient (such as by improving the recipient's physical, mental, emotional, or spiritual health and well-being) or benefit society (by addressing societal problems).

**Joint activity.** A joint activity is an activity that is part of the fund-raising function and has elements of one or more other functions, such as program, management and general, membership development, or any other functional category used by the entity.

**Joint costs.** Joint costs are the costs of conducting joint activities that are not identifiable with a particular component of the activity. For example, the cost of postage for a letter that includes both fund-raising and program components is a joint cost. Joint costs may include the costs of salaries, contract labor, consultants, professional fees, paper, printing, postage, event advertising, telephones, airtime, and facility rentals.

**Management and general activities.** Management and general activities are those that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. They

include oversight, business management, general recordkeeping, budgeting, financing, soliciting revenue from exchange transactions, such as government contracts and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. Disseminating information to inform the public of the organization's "stewardship" of contributed funds, announcements concerning appointments, and the annual report, among other activities, are management and general activities, as are soliciting funds other than contributions, including exchange transactions (whether program-related or not).

**Medium.** A medium is a means of mass communication, such as direct mail, direct response advertising, or television.

**Membership-development activities.** Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits or duties connected with membership, however, the substance of membership-development activities may, in fact, be fund-raising.

**Program activities.** Program activities are the activities that result in goods or services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs. For example, a large university may have programs for student instruction, research, and patient care, among others. Similarly, a health and welfare organization may have programs for health and family services, research, disaster relief, and public education, among others.

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## Section 10,740

### **Statement of Position 98-4 Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition**

This SOP has been amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*. See section 10,770 for the full text of these changes.

March 31, 1998

#### **NOTE**

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## **Summary**

This Statement of Position (SOP) defers for one year the application of the following passages in SOP 97-2 [section 10,700], which limit what is considered vendor-specific objective evidence (VSOE) of the fair value of the various elements in a multiple-element arrangement: (a) the second sentences of paragraphs 10, 37, 41, and 57 [section 10,700.10, .37, .41, and .57], (b) example 3 in "Multiple-Element Arrangements—Products" (appendix A [section 10,700.146]), and (c) example 3 in "Multiple-Element Arrangement—Products and Services" (appendix A [section 10,700.146]). All other provisions of SOP 97-2 [section 10,700] remain in effect.

This SOP applies to all multiple-element software arrangements, as defined in paragraph 9 of SOP 97-2 [section 10,700.09], and is effective as of March 31, 1998. If an enterprise had applied SOP 97-2 [section 10,700] in an earlier period for financial statements or information already issued prior to the promulgation of this SOP, amounts reported in those financial statements or as part of that information may be restated to reflect the deferral of the effective date of the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57] and the related examples.

## Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (a) a prospectus for a project to develop a document, (b) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (c) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

- a. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
- b. The proposal will result in an improvement in practice.
- c. The AICPA demonstrates the need for the proposal.
- d. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

## Introduction and Background

.01 On October 27, 1997, the AICPA Accounting Standards Executive Committee (AcSEC) issued Statement of Position (SOP) 97-2, *Software Revenue Recognition* [section 10,700].

.02 The first two sentences of paragraph 10 of SOP 97-2 [section 10,700.10] state:

If an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated within the contract for each element. Vendor-specific objective evidence of fair value is limited to the following:

- The price charged when the same element is sold separately
- For an element not yet being sold separately, the price established by management having the relevant authority; it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace

.03 This SOP defers for one year the application of the following passages in SOP 97-2 [section 10,700], which limit what is considered vendor-specific objective evidence (VSOE) of the fair value of the various elements in a multiple-element arrangement: (a) the second sentences of paragraphs 10, 37, 41, and 57 [section 10,700.10, .37, .41, and .57], (b) example 3 in "Multiple-Element Arrangements—Products" (appendix A [section 10,700.146]), and (c) example 3 in "Multiple-Element Arrangements—Products and Services" (appendix A [section 10,700.146]).

## Scope

.04 This SOP applies to all multiple-element software arrangements, as defined in paragraph 9 of SOP 97-2 [section 10,700.09]. Such multiple-element arrangements include all software arrangements that provide licenses for multiple software deliverables such as software products, upgrades/enhancements, postcontract customer support (PCS), or services.

## Conclusions

.05 The second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57], which limit what is considered VSOE [vendor-specific objective evidence] of the fair value of the various elements in a multiple-element arrangement, and the related examples noted in paragraph .03 of this SOP need not be applied to transactions entered into before fiscal years beginning after March 15, 1999. [Paragraph amended, effective December 15, 1998, by Statement of Position 98-9.]

.06 All other provisions of SOP 97-2 [section 10,700], including the remainder of paragraph 10 [section 10,700.10], should be applied as stated in SOP 97-2 [section 10,700]. Accordingly, this SOP does not alter the requirements that (a) any allocation of the fee in a multiple-element arrangement to the various elements should be based on the fair values of each element, (b) those fair values must be supported by VSOE, and (c) in instances where there is insufficient VSOE of the fair values of each element to allow for an allocation of revenue to each element, all revenue from the arrangement should be deferred pursuant to paragraph 12 [section 10,700.12] of that SOP.

## Effective Date and Transition

.07 This SOP is effective as of March 31, 1998. If an enterprise had applied SOP 97-2 [section 10,700] in an earlier period for financial statements or information already issued prior to the promulgation of this SOP, amounts reported in those financial statements or as part of that information may be restated to reflect the deferral of the effective date of the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57] and the related examples noted in paragraph .03 of this SOP.

**The provisions of this Statement need  
not be applied to immaterial items.**

## Basis for Conclusions

.08 Paragraph 10 of SOP 97-2 [section 10,700.10] establishes that the fee in a multiple-element arrangement should be allocated to the various elements based on VSOE of fair values. The second sentence of paragraph 10 [section 10,700.10] adds that evidence of VSOE of fair values is limited to the price charged when the same element is sold separately or is to be sold separately.

.09 In developing the “unbundling” guidance in SOP 97-2 [section 10,700], AcSEC emphasized the need for VSOE of each element’s fair value to properly recognize revenue upon delivery of each element. That principle remains unchanged.

.10 AcSEC concluded that the best evidence of the fair value of an element is the price charged for that element when it is sold separately. Some have argued, however, that conclusions with respect to the "best evidence" should not preclude revenue recognition when the fair value of an element can be determined by reference to other vendor-specific objective information.

.11 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, states the following in paragraphs 95 and 96.

Conservatism no longer requires deferring recognition of income beyond the time that adequate evidence of its existence becomes available or justifies recognizing losses before there is adequate evidence that they have been incurred.

The Board emphasizes that any attempt to understate results consistently is likely to raise questions about the reliability and the integrity of information about those results and will probably be self-defeating in the long run. That kind of reporting, however well-intentioned, is not consistent with the desirable characteristics described in this Statement. On the other hand, the Board also emphasizes that imprudent reporting, such as may be reflected, for example, in overly optimistic estimates of realization, is certainly no less inconsistent with those characteristics. Bias in estimating components of earnings, whether overly conservative or unconservative, usually influences the timing of earnings or losses rather than their aggregate amount. As a result, unjustified excesses in either direction may mislead one group of investors to the possible benefit or detriment of others.

.12 Subsequent to the issuance of SOP 97-2 [section 10,700], several examples of multiple-element arrangements were brought to AcSEC's attention in which the application of the limitations on VSOE of fair values in paragraph 10 of SOP 97-2 [section 10,700.10] would not allow "unbundling" and, as a result, may produce an unduly conservative pattern of revenue recognition. Those examples include the following.

- Software is sold only, or substantially always, in combination with PCS or other elements and there is VSOE of the fair value of the PCS or other elements and of the total arrangement. The restrictions in paragraph 10 of SOP 97-2 [section 10,700.10] led some to the conclusion that VSOE of fair value does not exist for the software element because that element is not "sold separately." Pursuant to paragraph 12 of SOP 97-2 [section 10,700.12], revenue for the entire fee, representing the value of both the software and PCS or other elements, would be recognized ratably over the period during which the obligations are discharged, even if the software product has been delivered.
- PCS or other elements are sold only, or substantially always, in combination with software in transactions for which there is VSOE of the fair value of the software and of the total arrangement. Paragraph 10 of SOP 97-2 [section 10,700.10] led some to the conclusion that VSOE of fair value does not exist for the PCS element in such circumstances, because that element is not "sold separately" (nor has a price been established in anticipation of separate introduction of PCS into the marketplace). Revenue for the entire fee would be recognized ratably over the period during which the PCS obligations are discharged, even if the software product has been delivered.

- Multi-year PCS is included in a multiple-element transaction in situations in which PCS renewals are sold only for periods of one year. Paragraph 10 of SOP 97-2 [section 10,700.10] could lead to the conclusion that VSOE does not exist for the multi-year PCS because PCS renewals are “sold separately” only for one-year periods. Pursuant to paragraph 12 of SOP 97-2 [section 10,700.12], revenue for the entire fee would be recognized ratably over the period during which the PCS obligations are discharged.

AcSEC considered the FASB guidance contained above in FASB Concepts Statement No. 2 and certain examples of transactions as presented above. AcSEC concluded that, although the best evidence of fair value of an element is the price charged for that element when it is sold separately, requiring deferral of recognition of revenue related to the delivered element when there is sufficient other VSOE of fair value to support the allocation of the fee to the various elements may be unduly conservative. Therefore, AcSEC concluded that the application of the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57] should be deferred for one year pending reconsideration by AcSEC.

.13 AcSEC notes that the requirement in the first sentence of paragraph 10 of SOP 97-2 [section 10,700.10] remains in effect during this deferral period, that is, revenues from a multiple-element arrangement should be allocated to each element on the basis of its fair value. This allocation principle is consistent with analogous provisions in other areas of accounting literature directed to multiple-element arrangements. Paragraph 99 of SOP 97-2 [section 10,700.99] cites the requirements of FASB Statement No. 45, *Accounting for Franchise Fee Revenue*, as one such example. Another example is the consensus on FASB's Emerging Issues Task Force (EITF) Issue 97-13, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*, which requires allocation of third-party consulting costs to different activities based on the relative fair values of the separate activities. A further requirement imposed by the first sentence of paragraph 10 of SOP 97-2 [section 10,700.10] is that the amounts determined to be fair value need to be supported by VSOE. The basis for such a conclusion is set forth in paragraph 100 of SOP 97-2 [section 10,700.100].

.14 There may be situations in which VSOE of the fair value of each element does not exist. Not all vendor-specific “evidence” is sufficiently objective and reliable to support a conclusion as to the fair value of an element. For example, amounts set forth for software products on a published price list may not represent customary sales prices. In the absence of representative selling prices, VSOE may not exist.

.15 It is AcSEC's intention to immediately begin a project to consider whether guidance is needed on any restrictions that should be placed on VSOE of fair value and, if so, what that guidance should be. Deferral of the second sentence of paragraph 10 of SOP 97-2 [section 10,700.10] will allow AcSEC sufficient time to reconsider its conclusions. Positions of AcSEC are determined through committee procedures, due process, and deliberation. Accordingly, this deferral should not be construed as a conclusion that AcSEC will amend SOP 97-2 [section 10,700]. AcSEC intends to complete its deliberations and, if determined appropriate, issue an SOP before the end of 1998.

**Effective Date**

.16 SOP 97-2 [section 10,700] was issued on October 27, 1997, and is effective for transactions in fiscal years beginning after December 15, 1997. This SOP is being issued before the end of the earliest three-month period for which SOP 97-2 [section 10,700] must be applied. Consequently, it is appropriate for this SOP to be effective upon issuance.

**Transition**

.17 Paragraph 92 of SOP 97-2 [section 10,700.92] prohibits retroactive application but encourages early application as of the beginning of a fiscal year or interim period for which financial statements or interim information have not been issued. AcSEC believes that permitting entities that may have adopted the SOP early to restate previously issued financial statements or information to reflect simultaneous adoption of SOP 97-2 [section 10,700] and this SOP will improve comparability among reporting entities. AcSEC believes that very few, if any, entities will be affected by the retroactive restatement provisions of this SOP.

## Appendix

### Response to Comments Received

**A.1.** On February 11, 1998, AcSEC issued an exposure draft of a proposed Statement of Position (SOP), *Deferral of the Effective Date of Certain Provisions of SOP 97-2, Software Revenue Recognition, for Certain Transactions*. The exposure draft proposed deferring the effective date of the provisions of paragraph 10 of SOP 97-2 [section 10,700.10] with respect to what constitutes vendor-specific objective evidence (VSOE) of fair value of the software element in multiple-element arrangements in which—

- a. A software element is sold only in combination with postcontract customer support (PCS) or other service element(s) that qualify for separate accounting pursuant to SOP 97-2 [section 10,700], or both.
- b. There is VSOE of the fair values of each of the service elements determined pursuant to paragraphs 10, 57, and 65 of SOP 97-2 [section 10,700.10, .57, and .65].

**A.2.** None of the commentators on that exposure draft objected to deferral of the effective date of paragraph 10 of SOP 97-2 [section 10,700.10] with respect to multiple-element arrangements within the scope proposed in the exposure draft. A significant number of commentators were concerned, however, about the implications of restricting the scope to only certain multiple-element arrangements, and they urged AcSEC to broaden the scope to all multiple-element arrangements.

**A.3.** As a result of AcSEC's deliberations of the comment letters and examples of arrangements brought to AcSEC's attention, AcSEC—

- a. Concluded that, for arrangements for which there is sufficient VSOE of the fair value of each element, even if each element is not sold separately, the basis for deferral of revenue recognition with respect to those elements that otherwise satisfied the criteria for revenue recognition in SOP 97-2 [section 10,700] needs to be reconsidered. Accordingly, AcSEC expanded the deferral to all arrangements discussed in paragraph .04 of this SOP, not just those arrangements described in paragraph A.1. of this SOP.
- b. Affirmed the requirement in SOP 97-2 [section 10,700] that any allocation of the fee in a multiple-element arrangement to the various elements should be based on fair values of each element and that such fair values must be supported by VSOE, thus reinforcing the applicability of that requirement to all arrangements.

## **Accounting Standards Executive Committee (1997–1998)**

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[The next page is 20,525.]



## Section 10,750

### **Statement of Position 98-5 Reporting on the Costs of Start-Up Activities**

April 3, 1998

#### **NOTE**

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

#### **Summary**

This Statement of Position (SOP) provides guidance on the financial reporting of start-up costs and organization costs. It requires costs of start-up activities and organization costs to be expensed as incurred.

The SOP broadly defines start-up activities and provides examples to help entities determine what costs are and are not within the scope of this SOP.

This SOP applies to all nongovernmental entities and, except as stated in the last paragraph, is effective for financial statements for fiscal years beginning after December 15, 1998. Earlier application is encouraged in fiscal years for which annual financial statements previously have not been issued.

Except for certain entities noted in the last paragraph, initial application of this SOP should be reported as the cumulative effect of a change in accounting principle, as described in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*. When adopting this SOP, entities are *not* required to report the pro forma effects of retroactive application.

Entities that report substantially all investments at market value or fair value, issue and redeem shares, units, or ownership interests at net asset value, and have sold their shares, units, or ownership interests to independent third parties before the later of June 30, 1998, or the date that the SOP is issued should adopt the SOP prospectively.

## Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

## Introduction and Background

**.01** The Accounting Standards Executive Committee (AcSEC) had on its agenda a series of projects on reporting the costs of activities that are undertaken to create future economic benefits.

**.02** The first phase of AcSEC's series of projects resulted in its issuance of Statement of Position (SOP) 93-7, *Reporting on Advertising Costs* [section 10,590]. It was AcSEC's intention to use SOP 93-7 [section 10,590] as a guide in developing guidance for reporting costs of other kinds of activities undertaken to create future economic benefits. This SOP on start-up costs is the next phase.

**.03** A review of a number of public-company financial statement disclosures indicates that some entities capitalize start-up costs whereas others expense start-up costs as they are incurred. In addition, entities that capitalize start-up costs use diverse amortization periods. These diverse practices exist within and across industries. AcSEC believes this SOP will significantly reduce these diversities in financial reporting.

**.04** AcSEC issued an exposure draft of a proposed SOP, *Reporting on the Costs of Start-Up Activities*, on April 22, 1997. AcSEC received more than eighty comment letters in response to the exposure draft.

## Scope

.05 For purposes of this SOP, start-up activities are defined broadly as those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with a new class of customer<sup>1</sup> or beneficiary, initiating a new process in an existing facility, or commencing some new operation. Start-up activities include activities related to organizing a new entity (commonly referred to as organization costs). This SOP provides guidance on accounting for the costs of start-up activities.

.06 In practice, various terms are used to refer to start-up costs, such as *preopening costs*, *preoperating costs*, *organization costs* and *start-up costs*. For purposes of this SOP, these costs are referred to as start-up costs.

*Note: As noted in subsequent paragraphs, the accounting for certain costs incurred in conjunction with start-up activities are not covered by this SOP. An entity should not infer that costs outside the scope of this SOP should be capitalized. Such costs should not be capitalized unless they qualify for capitalization under other generally accepted accounting principles.*

.07 For purposes of this SOP, activities related to routine, ongoing efforts to refine, enrich, or otherwise improve upon the qualities of an existing product, service, process,<sup>2</sup> or facility are not start-up activities and are not within the scope of this SOP. In addition, activities related to a merger or acquisition and to ongoing customer acquisition<sup>3</sup> are not start-up activities.

.08 Certain costs that may be incurred in conjunction with start-up activities are not subject to the provisions of this SOP. Such costs should be accounted for in accordance with other existing authoritative accounting literature. For example, the following costs are outside the scope of this SOP:

- Costs of acquiring or constructing long-lived assets and getting them ready for their intended uses (However, the costs of using long-lived assets that are allocated to start-up activities [for example, depreciation of computers] are within the scope of this SOP.)
- Costs of acquiring or producing inventory
- Costs of acquiring intangible assets (However, the costs of using intangible assets that are allocated to start-up activities [for example, amortization of a purchased patent] are within the scope of this SOP.)
- Costs related to internally developed assets (for example, internal-use computer software costs) (However, the costs of using those assets that are allocated to start-up activities are within the scope of this SOP.)
- Costs that are within the scope of Financial Accounting Standards Board (FASB) Statement No. 2, *Accounting for Research and Develop-*

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<sup>1</sup> This SOP does not address the financial reporting of costs incurred related to ongoing customer acquisition, such as policy acquisition costs in Financial Accounting Standards Board (FASB) Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, and loan origination costs in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. The SOP addresses the more substantive one-time efforts to establish business with an entirely new class of customers (for example, a manufacturer who does all of its business with retailers attempts to sell merchandise directly to the public).

<sup>2</sup> Costs addressed in Emerging Issues Task Force Issue No. 97-13, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*, are outside the scope of this SOP.

<sup>3</sup> See footnote 1.

*ment Costs*, and FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*

- Costs of fund raising incurred by not-for-profit organizations
- Costs of raising capital
- Costs of advertising
- Costs incurred in connection with existing contracts as stated in paragraph 75d of SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* [section 10,330.75d]

.09 Illustrations 1 through 3 in the Appendix [paragraph .44] provide examples of costs that are and are not within the scope of this SOP.

.10 This SOP applies to all nongovernmental entities (including not-for-profit organizations) and it applies to development-stage entities as well as established operating entities.

.11 This SOP amends the following AICPA SOPs and Audit and Accounting Guides that address start-up costs:

- a. SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, paragraph 75a [section 10,330.75a]
- b. SOP 88-1, *Accounting for Developmental and Preoperating Costs, Purchases and Exchanges of Take-off and Landing Slots, and Airframe Modifications*, paragraphs 23 and 25 [section 10,430.23 and .25]
- c. Industry Audit Guide *Audits of Airlines*, paragraphs 3.115 and 3.117
- d. Audit and Accounting Guide *Audits of Casinos*, paragraph 2.06
- e. Audit and Accounting Guide *Construction Contractors*, paragraph 2.14a
- f. Audit and Accounting Guide *Audits of Federal Government Contractors*, paragraph 3.09
- g. Audit and Accounting Guide *Audits of Investment Companies*, paragraphs 5.14, 8.10, 8.16, 8.17, and appendix K

## Conclusions

### Accounting for Start-Up Costs

.12 Costs of start-up activities, including organization costs, should be expensed as incurred.

### Amendments to Other Guidance

.13 This SOP amends SOP 81-1 [section 10,330] by requiring precontract costs that are start-up costs to be expensed as incurred. The following sentence is added to the end of paragraph 75a [section 10,330.75a]:

Those costs should be expensed as they are incurred if they are within the scope of SOP 98-5, *Reporting on the Costs of Start-Up Activities*.

.14 This SOP amends SOP 88-1 [section 10,430] by requiring preoperating costs to be expensed as incurred rather than capitalized. Paragraph 23 [section 10,430.23] is amended as follows:

Preoperating costs related to the integration of new types of aircraft should be expensed as incurred.

In addition, paragraph 25 [section 10,430.25] is deleted.

.15 This SOP amends the Industry Audit Guide *Audits of Airlines* by requiring preoperating costs to be expensed as incurred rather than capitalized. Paragraph 3.115 is amended as follows:

Preoperating costs related to the integration of new types of aircraft should be expensed as incurred.

In addition, paragraph 3.117 is deleted.

.16 This SOP amends the Audit and Accounting Guide *Audits of Casinos* by requiring preopening costs to be expensed as incurred. Paragraph 2.06 is amended to include the following at the end of the first sentence:

Preopening costs, however, should be charged to expense as incurred.

.17 This SOP amends the Audit and Accounting Guide *Construction Contractors* by requiring precontract costs that are start-up costs to be expensed as incurred. The following sentence is added to the end of paragraph 2.14a:

Those costs should be expensed as they are incurred if they are within the scope of SOP 98-5, *Reporting on the Costs of Start-Up Activities*.

.18 Paragraph 3.09 of the Audit and Accounting Guide *Audits of Federal Government Contractors* refers to paragraph 75 of SOP 81-1 [section 10,330.75] as the applicable guidance for accounting for precontract costs. This SOP amends paragraph 3.09 of the Guide as follows:

Precontract costs should be accounted for in conformity with paragraph 75 of SOP 81-1, as amended by SOP 98-5, *Reporting on the Costs of Start-Up Activities*.

.19 This SOP amends the Audit and Accounting Guide *Audits of Investment Companies* by requiring organization costs to be expensed as they are incurred. The last two sentences of paragraph 8.10 are deleted and replaced by the following:

Organization costs should be expensed as they are incurred. Entities should adopt the transition provisions of paragraphs 22 and 23 of SOP 98-5, *Reporting on the Costs of Start-Up Activities*.

In addition, paragraphs 8.16 and 8.17 are deleted, and the following footnote is added after the words *deferred organization expense* in paragraph 5.14 and in the Statement of Assets and Liabilities in appendix K (SOP 93-4, *Foreign Currency Accounting and Financial Statement Presentation for Investment Companies* [section 10,570]).

Organization costs should be expensed as they are incurred. Entities should adopt the transition provisions of paragraphs 22 and 23 of SOP 98-5, *Reporting on the Costs of Start-Up Activities*.

.20 The following sentence is added to the accounting policies footnote for organization costs in the illustrative financial statements in paragraph 9.10 of the Audit and Accounting Guide *Guide for Prospective Financial Information*:

(Note: SOP 98-5, *Reporting on the Costs of Start-Up Activities*, requires that organization costs be expensed as they are incurred.)

## Effective Date and Transition

.21 Except for certain entities noted in paragraph .23, this SOP is effective for financial statements for fiscal years beginning after December 15, 1998.

Earlier application is encouraged in fiscal years for which annual financial statements have not been issued. Restatement of previously issued financial statements is not permitted.

.22 Except for certain entities noted in paragraph .23, initial application of this SOP should be reported as the cumulative effect of a change in accounting principle, as described in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*. When adopting this SOP, entities are *not* required to report the pro forma effects of retroactive application. Entities are required to disclose the effect of adopting this SOP on income before extraordinary items and on net income (and on the related per share amounts) in the period of the change.

.23 Entities that meet all of the following conditions should not report the effect of initial application of this SOP as a cumulative effect of a change in accounting principle: (a) the entities' specialized accounting practices include accounting for substantially all investments at market value or fair value; (b) the entities' shares, units, or ownership interests are issued and redeemed at net asset value; and (c) the entities' shares, units, or ownership interests are sold to independent third parties (for example, parties other than founders, sponsors, and investment advisors) before the later of June 30, 1998, or the date that the SOP is issued. Capitalized costs incurred by these entities prior to initial application of this SOP should not be adjusted to the amounts that would have been expensed as incurred had this SOP been in effect when those costs were incurred. These entities should apply the SOP prospectively for all costs of start-up activities and organization costs incurred at the later of June 30, 1998, or the date that the SOP is issued. For these entities, costs previously deferred that continue to be reported as assets should continue to be amortized over the remaining life of the original amortization period used by the entity, or a shorter period if the expected period of benefit is reduced. The unamortized balance of deferred start-up costs or organization costs and the remaining amortization period should be disclosed.

.24 Except for those entities noted in paragraph .23, initial application of this SOP should be as of the beginning of the fiscal year in which the SOP is first adopted.

**The provisions of this Statement need  
not be applied to immaterial items.**

## Basis for Conclusions

### Scope

.25 AcSEC based its broad definition of start-up activities on the definition used in the 1973 FASB Discussion Memorandum (DM), *Accounting for Research and Development Costs*. That DM defines start-up costs as "those unusual one-time costs incurred in putting a new plant into operation, opening a new sales outlet, initiating a new process in an existing plant, or otherwise commencing some new operation."

.26 Some respondents to the exposure draft indicated that the definition of start-up activities is imprecise and leads to confusion about what differentiates start-up costs from certain other costs, such as costs incurred to get a long-lived asset ready for its intended use.

.27 AcSEC believes it is not possible to develop a detailed, all-inclusive definition of start-up activities and start-up costs. AcSEC believes the broad definition of start-up activities together with the identification of certain costs that are not start-up costs and the examples provided in the Appendix [paragraph .44] help the reader understand the kinds of activities and costs that may be involved in a start-up situation. Regardless, AcSEC believes that costs previously capitalized as either start-up costs or organization costs should now be expensed as they are incurred.

.28 AcSEC understands that entities may engage in start-up activities to generate revenue or increase efficiencies; AcSEC believes that it is unnecessary to distinguish between the objectives for undertaking start-up activities for purposes of this SOP.

.29 AcSEC recognizes that some entities use the terms *start-up*, *preopening*, *preoperating*, and *organization* interchangeably and that these terms are used inconsistently in practice. AcSEC believes that it is unnecessary to define the terms individually for purposes of this SOP.

.30 AcSEC also recognizes that some entities differentiate between preopening/preoperating costs and start-up costs as follows:

- a. Preopening/preoperating costs are incurred before the commencement of operations or production.
- b. Start-up costs are incurred after operations have begun, but before normal productive capacity is reached.

AcSEC believes that this distinction is not made consistently in practice. AcSEC also believes that the guidance in this SOP should be followed regardless of the terms used to describe the activities included in the scope.

.31 AcSEC decided that it was not necessary to develop boundaries for when the start-up period begins and ends. The definition of start-up activities is based on the nature of the activities and not the time period in which they occur. AcSEC believes that costs previously capitalized by entities as start-up costs will be expensed as incurred as start-up costs or some other costs, such as general and administrative.

.32 It is not uncommon for start-up activities to occur simultaneously with other activities, such as the acquisition or development of assets. Paragraph .08 provides examples of costs excluded from the scope of this SOP. AcSEC did not attempt to provide an all-inclusive detailed list of such costs because entities have different accounting policies for the kinds of costs capitalized under existing generally accepted accounting principles (for example, property, plant, and equipment). AcSEC believes entities are best capable of identifying those costs.

.33 This SOP applies to start-up activities of development stage entities as well as established operating entities, as those terms are discussed in FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*. Paragraph 10 of FASB Statement No. 7 states, "Generally accepted accounting principles that apply to established operating enterprises shall govern the recognition of revenue by a development stage enterprise and shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred." This SOP sets forth the generally accepted accounting principles for costs of start-up activities and thus applies to both kinds of entities.

.34 A majority of respondents to the exposure draft did not address issues related to organization costs. The majority of those who did address these issues believes that organization costs should not be included in the scope of the SOP. One reason proposed to exclude organization costs from the scope of this SOP was to avoid unnecessary bookkeeping resulting from book/tax differences. AcSEC concluded that organization costs are similar to start-up costs and that it could not justify excluding organization costs from the scope of the SOP. Further, if organization costs were excluded from the scope of the SOP, AcSEC believes that it would have needed to define organization costs to help entities distinguish between start-up and organization costs. AcSEC's definition of organization costs would have been narrower than that contained in the Internal Revenue Code. Therefore, AcSEC concluded that temporary tax differences would result for some entities whether AcSEC included or excluded organization costs from the scope of the document.

### Accounting for Start-Up Costs

.35 About half of the respondents to the exposure draft believe that start-up costs should be reported as assets. AcSEC considered requiring capitalization and amortization of the costs of start-up activities, including organization costs. AcSEC believes that entities incur costs related to start-up and organization activities with an expectation that there will be future benefits. However, AcSEC believes that this is also often the case with other costs, such as costs related to research and development activities.

.36 Paragraph 86 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, states, "Consumption of economic benefits during a period may be recognized either directly or by relating it to revenues recognized during the period: . . . ." Paragraph 148 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, states, "Other costs are also recognized as expenses in the period in which they are incurred because the period to which they otherwise relate is indeterminable or not worth the effort to determine."

.37 Some AcSEC members believe that start-up costs may meet the definition of an asset. However, they note that some items that meet the definition of an asset are not recognized as assets because of uncertainty. Paragraph 175 of FASB Concepts Statement No. 6 states, "... business enterprises engage in research and development activities, advertise, develop markets, open new branches or divisions, and the like, and spend significant funds to do so. The uncertainty is not about the intent to increase future economic benefits but about whether and, if so, to what extent they succeeded in doing so. Certain expenditures for research and development, advertising, training, start-up and preoperating activities, development stage enterprises, relocation or rearrangement, and goodwill are examples of the kinds of items for which assessments of future economic benefits may be especially uncertain."

.38 Paragraph 24 of APB Opinion 17 states, "Costs of developing, maintaining, or restoring intangible assets which are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole—such as goodwill—should be deducted from income when incurred." Start-up costs as defined in this SOP meet all three conditions: they are not specifically identifiable, have indeterminate lives, and are inherent in a continuing business and related to an enterprise as a whole.

.39 AcSEC decided that the SOP should not amend paragraph 75d of SOP 81-1 [section 10,330.75d]. AcSEC believes that start-up costs incurred in con-



nection with existing contracts are contract costs related to a specific source of revenue that should be subject to the accounting prescribed in SOP 81-1 [section 10,330]. Further, AcSEC decided that start-up costs incurred in connection with existing contracts *and* in anticipation of follow-on or future contracts for the same goods and services should also be accounted for as contract costs within the existing contract because those costs are expected to be recovered. AcSEC also believes that it is impracticable to bifurcate incremental learning curve or start-up costs that may be incurred under existing contracts in anticipation of follow-on or future contracts.

## Disclosure and Transition

.40 AcSEC considered requiring entities to disclose start-up costs incurred in an accounting period and total start-up costs expected to be incurred over the life of a project. AcSEC decided that, for many entities, the costs of recordkeeping to identify separately start-up costs incurred in an accounting period likely would outweigh the related benefits of disclosing those costs to users of financial statements. AcSEC also believes that it cannot provide an all-inclusive definition of start-up costs, which would ensure comparability between entities. In addition, AcSEC believes that, if an entity discloses total start-up costs expected to be incurred, it is likely to do so outside the financial statements (for example, in Management's Discussion and Analysis for a public company).

.41 Some entities currently report certain costs, such as depreciation incurred in conjunction with start-up activities, as start-up costs. Other entities currently report those costs under captions such as "depreciation." This SOP does not require entities to report those costs as start-up costs.

.42 AcSEC decided that entities that report substantially all investments at market value or fair value, issue and redeem shares, units, or ownership interests at net asset value, and have sold their shares, units, or ownership interests to independent third parties before the later of June 30, 1998, or the date that the SOP is issued should adopt the SOP prospectively. Examples of such entities include open-end mutual funds, regardless of their load features, because open-end mutual funds issue and redeem shares at net asset value (however, closed-end funds would not be examples because those funds may trade at a premium or discount in relation to net asset value). Before operations begin, these entities often incur start-up or organization costs. The expectation is that all shareholders will bear the costs as amortization gradually decreases asset value. Alternatively, the sponsors could pay the start-up or organization costs and get reimbursed through fees charged to the entity that would be borne by the shareholders. AcSEC believes that existing shareholders would experience negative economic consequences if previously capitalized costs were required to be expensed immediately, thereby causing an immediate decrease in net asset value per share. AcSEC believes that it has made a practical decision to ensure that the adoption of the SOP does not cause economic harm to existing shareholders in entities that report substantially all investments at market value or fair value and issue and redeem shares, units, or ownership interests at net asset value.

## Other Authoritative Literature

.43 AcSEC considered the following other authoritative literature in its deliberations of financial reporting of start-up costs. However, the guidance in

the following literature is *not* affected by the provisions of this SOP: (a) FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, and the related AICPA Audit and Accounting Guide *Audits of Entities With Oil and Gas Producing Activities*; (b) FASB Statement No. 34, *Capitalization of Interest Cost*; (c) FASB Statement No. 50, *Financial Reporting in the Record and Music Industry*; (d) FASB Statement No. 51, *Financial Reporting by Cable Television Companies*; (e) FASB Statement No. 53, *Financial Reporting by Producers and Distributors of Motion Picture Films*; (f) FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*; (g) FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*; and (h) FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

## Appendix

### Illustrations

*The Illustrations provide examples that should not be interpreted to be all-inclusive. Accounting for certain costs incurred in conjunction with start-up activities are not covered by this SOP. An entity should not infer that costs outside the scope of this SOP should be capitalized. Such costs should not be capitalized unless they qualify for capitalization under other generally accepted accounting principles.*

#### Illustration 1

Scenario—A major U.S. beverage company (the Company) begins construction of a new plant in China. This represents the Company's initial entry into the Chinese market. As part of the overall strategy, the Company plans to introduce into China, on a locally produced basis, the Company's major U.S. beverage brands. Following are some of the costs that might be incurred in conjunction with start-up activities that are subject to the provisions of this SOP:

- Travel costs, employee salary-related costs, and consulting costs related to feasibility studies, accounting, legal, tax, and governmental affairs
- Training of local employees related to production, maintenance, computer systems, engineering, finance, and operations
- Recruiting, organization, and training related to establishing a distribution network
- Nonrecurring operating losses
- Depreciation, if any, of new computer data terminals and other communication devices

The following costs incurred in conjunction with start-up activities are outside the scope of this SOP (as noted in paragraphs .07 and .08):

- Costs of long-lived asset additions, such as the new plant, production equipment, and packaging lines
- Internal-use computer software systems development costs
- Costs that are capitalizable as inventory
- Deferred financing costs

**Illustration 2**

**Scenario**—A retail chain is constructing and opening two new stores. One will open in a territory in which the entity already has three stores operating. The other will open in a territory new to the entity. (Costs related to both openings are treated the same for purposes of this SOP.) All of the stores provide the same products and services. Following are some of the costs that might be incurred in conjunction with start-up activities that are subject to the provisions of this SOP:

- Salary-related expenses for new employees
- Salary-related expenses for the management store opening team
- Training costs and meals for newly hired employees
- Hotel charges, meals, and transportation for the opening team
- Security, property taxes, insurance, and utilities costs incurred after construction is completed
- Depreciation, if any, of new computer data terminals and other communication devices
- Nonrecurring operating losses

The following costs incurred in conjunction with start-up activities are outside the scope of this SOP (as noted in paragraphs .07 and .08):

- Store advertising costs
- Coupon giveaways
- Costs of uniforms
- Costs of furniture and cash registers
- Costs to obtain licenses, if any
- Security, property taxes, insurance, and utilities costs related to construction activities
- Deferred financing costs

**Illustration 3**

**Scenario**—A not-for-profit organization that has provided meals to the homeless is opening a shelter to house the homeless. The organization will rent the facility. This will be the organization's first shelter and it will conduct a fund-raising campaign to raise money to start up the shelter. The organization will lease space for the shelter and will incur capital expenditures for leasehold improvements and furniture. The organization expects that it will require three months to set up the space for the shelter. The organization will hire a security firm to secure the premises during the three-month period in which the shelter is built. Following are some of the costs that might be incurred in conjunction with start-up activities that are subject to the provisions of this SOP:

- Employee salary-related costs related to needs and feasibility studies
- Staff recruiting and training
- Rent, security, insurance, and utilities
- Consultant fees for developing policies and procedures for operating the shelter
- Amortization and depreciation, if any, of leasehold improvements and furniture
- Costs of social workers

The following costs incurred in conjunction with start-up activities are outside the scope of this SOP (as noted in paragraphs .07 and .08):

- Costs of fund-raising
- Costs of leasehold improvements and furniture
- Architect fees for the leasehold improvements
- Advertising costs to publicize the shelter

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The task force and staff gratefully acknowledge the contributions made to the development of this Statement of Position by Kevin G. Varty.

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[The next page is 20,545.]

**Section 10,760****Statement of Position 98-7  
Deposit Accounting: Accounting for  
Insurance and Reinsurance Contracts That  
Do Not Transfer Insurance Risk**

October 19, 1998

**NOTE**

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the area of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

**Summary**

This Statement of Position (SOP) provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. It applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long-duration life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to in this SOP as deposit accounting. The SOP does not address when deposit accounting should be applied.

This SOP specifies the following.

- Insurance and reinsurance contracts for which the deposit method is appropriate should be classified as one of the following, which are those that—
  - Transfer only significant timing risk.
  - Transfer only significant underwriting risk.
  - Transfer neither significant timing nor underwriting risk.
  - Have an indeterminate risk.

- At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract.
- Insurance and reinsurance contracts that transfer neither significant timing nor underwriting risk, and insurance and reinsurance contracts that transfer only significant timing risk, should be accounted for using the interest method. Changes in estimates of the timing or amounts of recoveries should be accounted for by recalculating the effective yield. The asset or liability should then be adjusted to the amount that would have existed had the new effective yield been applied since the inception of the contract. The revenue and expense recorded for such contracts shall be included in interest income or interest expense.
- Insurance or reinsurance contracts that transfer only significant underwriting risk should be accounted for by measuring the deposit based on the unexpired portion of the coverage provided until losses are incurred that will be reimbursed under the contracts. Once a loss is incurred that will be reimbursed under this kind of contract, then the deposit should be measured by the present value of the expected future cash flows arising from the contract, plus the remaining unexpired portion of the coverage provided. Changes in the recorded amount of the deposit, other than the unexpired portion of the coverage provided, should be included in the income statement of the insured as an offset against the loss recorded by the insured that will be reimbursed under the contract and in an insurer's income statement as an incurred loss. The reduction in the deposit related to the unexpired portion of the coverage provided should be recorded by the insured and the insurer who are insurance enterprises as an adjustment to incurred losses. If the insured is an enterprise other than an insurance enterprise, then the reduction in the deposit related to the unexpired portion of the coverage provided should be recorded as an expense.
- For insurance and reinsurance contracts with indeterminate risk, the guidance in SOP 92-5, *Accounting for Foreign Property and Liability Reinsurance* [section 10,520] as to the open-year method, should be followed. The open-year method should not, however, be used to defer losses that otherwise would be recognized pursuant to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. Under the open-year method, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate and allocate premiums. The open-year method requires that these effects be aggregated in the balance sheet. When sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of the other three categories as an insurance or reinsurance contract that transfers neither significant timing nor underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly.



This SOP is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Restatement of previously issued annual financial statements is not permitted. Initial application of this SOP is as of the beginning of an entity's fiscal year (that is, if the SOP were adopted before the effective date and during an interim period, all prior interim periods are required to be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle, in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*.

## Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

## Introduction

.01 "Insurance provides indemnification against loss or liability from specified events and circumstances that may occur or be discovered during a specified period. In exchange for a payment from the policyholder (a premium), an insurance enterprise agrees to pay the policyholder if specified events occur or are discovered. Similarly, the insurance enterprise may obtain indemnification against claims associated with contracts it has written by entering into a reinsurance contract with another enterprise."<sup>1</sup> Insurance and reinsurance contracts may be structured in various ways. The premium paid by the policyholder may represent a payment for the transfer of **insurance risk** or it may represent a deposit.<sup>2</sup>

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<sup>1</sup> The source is paragraph 1 of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*.

<sup>2</sup> Terms defined in the Glossary [paragraph .39] are set in boldface the first time they appear in this SOP.

.02 Paragraph 44 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, states the following, in part.

To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or ceding company.

.03 FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, established certain conditions for determining whether a reinsurance contract indemnifies against loss or liability relating to insurance risk. Although existing accounting literature does not provide similar criteria to evaluate whether an insurance contract indemnifies against loss or liability, generally accepted accounting principles (GAAP) require a determination of whether insurance risk has been transferred (as discussed in paragraph .02 above). This SOP neither addresses *when* deposit accounting should be applied nor provides criteria to make this determination. Such guidance is provided on a case-by-case basis in the applicable pronouncements.

.04 As stated above, FASB Statement Nos. 5 and 113 and Emerging Issues Task Force (EITF) Issue Nos. 93-14, *Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises*, and 93-6, *Accounting for Multiple-Year Retrospectively Rated Reinsurance Contracts by Ceding and Assuming Enterprises*, each require that the deposit method of accounting be applied when parties enter into insurance or reinsurance contracts that do not transfer insurance risk. Nevertheless, the existing accounting pronouncements do not describe what is meant by deposit accounting in those circumstances or how it should be applied.

.05 The consensus decisions in FASB EITF Issue Nos. 93-14 and 93-6 provide further guidance on when deposit accounting should be applied to reinsurance and insurance contracts.

## Applicability and Scope

.06 This SOP provides guidance on how to apply the deposit method of accounting when it is required for insurance and reinsurance contracts that do not transfer insurance risk. These contracts may be prospective or retroactive in nature. This SOP applies to all entities that have entered into the following kinds of insurance and reinsurance contracts:

- a. Short-duration insurance and reinsurance contracts that do not transfer insurance risk as described in paragraph 44 of FASB Statement No. 5 and, for reinsurance contracts, as described in paragraphs 8 through 11 and 18(a) of FASB Statement No. 113 and EITF Issue No. 93-6.
- b. Multiple-year insurance and reinsurance contracts that do not transfer insurance risk or for which insurance risk transfer is not determinable. (EITF Issue Nos. 93-14 and 93-6 prescribe the deposit method of accounting for multiple-year retrospectively rated insurance and reinsurance contracts, respectively, that do not transfer insurance risk.)

However, FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and FASB Statement No. 113 explicitly provide that long-duration life and health insurance contracts that do not indemnify against mortality or morbidity risk should be accounted for as investment contracts as defined and described in FASB Statement No. 97. Therefore, such contracts are not covered by this SOP.

.07 This SOP does not address or change existing requirements as to when deposit accounting should be applied. Appendix A [paragraph .37], "Illustrations of Application of Conclusions," herein, provides examples that illustrate the application of certain provisions of this SOP. The illustrations are intended as examples only; it should not be construed that any aspect of the illustrations establishes or changes requirements as to when deposit accounting should be applied. The conclusions in this SOP apply to both the insured and the insurer in an insurance contract. The conclusions in this SOP also apply to the **ceding** and **assuming entity** in a reinsurance contract.

## Kinds of Contracts

.08 The transfer of insurance risk requires transferring both **timing risk** and **underwriting risk**. Therefore, four possible categories for deposit arrangements have been identified as follows.

- a. *An insurance or reinsurance contract that transfers only significant timing risk.* For an insurance or reinsurance contract to be considered to have transferred significant timing risk, the timing of the loss reimbursement under the contract must be based on the timing of the loss event.<sup>3</sup> An insurance or reinsurance contract that transfers only significant timing risk limits the amount of underwriting risk to which the insurer or reinsurer is subject and is commonly entered into by the insured or ceding entity to provide liquidity. These limitations may result in an insufficient transfer of insurance risk. For example, insurance and reinsurance contracts that provide for **experience adjustments** may indicate that a sufficient amount of underwriting risk has not been transferred. The recovery of the amount of the initial deposit for a contract that transfers only significant timing risk is not substantially dependent on future loss experience of the insured.
- b. *An insurance or reinsurance contract that transfers only significant underwriting risk.* For an insurance or reinsurance contract to be considered to have transferred significant underwriting risk, the probability of a significant variation in the amount of payments under the insurance or reinsurance contract must be more than remote. Such variation must also result from variation in the insured's losses, and it must be at least reasonably possible that the insurer will realize a significant loss from the transaction. An insurance or reinsurance contract that transfers only significant underwriting risk may be entered into to lessen the overall economic risks

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<sup>3</sup> With respect to insurance contracts, the timing of the loss reimbursement under the contract would be based on the timing of the payment with respect to the loss event. For reinsurance contracts, the timing of the loss reimbursement under the contract would be based on the timing of payment by the insured (reinsured) of the underlying loss, as well as when recovery is expected from the reinsurer.

associated with the contract and permit a greater amount of coverage than would otherwise be obtainable for a comparable premium. Features in insurance or reinsurance contracts that transfer only significant underwriting risk limit the uncertainties about the timing of the receipt and payment of cash flow, thus, limiting the amount of timing risk assumed by the insurer. A delayed reimbursement of losses by the insurer is a possible indication that timing risk has not been transferred.<sup>4</sup> Unlike insurance and reinsurance contracts that transfer only significant timing risk, the recovery of the amount of the initial deposit for an insurance or reinsurance contract that transfers only significant underwriting risk is substantially dependent on the future loss experience of the insured. Depending on such experience, the initial deposit may be recovered or the recovery may be significantly more or less than the original deposit.

- c. *An insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk.* Insurance and reinsurance contracts that transfer neither significant timing nor significant underwriting risk are expected to be rare.
- d. *An insurance or reinsurance contract with an indeterminate risk.* These insurance and reinsurance contracts have uncertain terms, or there is insufficient information to reasonably estimate and allocate premiums in proportion to the protection provided. For example, certain insurance and reinsurance contracts allow the insured to obtain some degree of coverage for multiple years without exposing the insurer to a defined level of insurance risk each year. Uncertainties surrounding these insurance and reinsurance contracts are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5 [section 10,520].

For short-duration reinsurance contracts, FASB Statement No. 113 requires that two conditions be met in order to account for that contract as reinsurance. The first condition is that the contract must transfer significant insurance risk to the reinsurer. The second condition is that the contract must subject the reinsurer to the reasonable possibility of realizing a significant loss from the transaction, unless substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. If a short-duration reinsurance contract does not meet the second condition but transfers significant insurance risk, then the accounting for contracts that transfer only significant underwriting risk should be followed (see paragraphs .13 through .15 in this SOP).

## Conclusions

### Initial Measurement

**.09** At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting

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<sup>4</sup> FASB Statement No. 113, paragraph 9, states, in part, "A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Contractual provisions that delay timely reimbursement to the ceding enterprise would prevent this condition from being met."

and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees should be based on the terms of the contract. Deposit assets and liabilities should be reported on a gross basis, unless the right of offset exists as defined in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*. The accounting by the insured and insurer are symmetrical, except as noted in paragraph .15 of this SOP.

## **Subsequent Measurement**

### ***Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk and Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Underwriting Risk***

.10 For insurance and reinsurance contracts that transfer only significant timing risk or that transfer neither significant timing nor significant underwriting risk, the amount of the deposit asset or liability should be adjusted at subsequent reporting dates by calculating the effective yield on the deposit to reflect actual payments to date and expected future payments (as discussed in paragraph .11 below), with a corresponding credit or charge to interest income or expense. This approach is consistent with the interest method described in Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

.11 The calculation of the effective yield should use the estimated amount and timing of cash flows. Consistent with paragraph 19 of FASB Statement No. 91, if a change in the actual or estimated timing or amount of cash flows occurs, the effective yield should be recalculated to reflect the revised actual or estimated cash flows. The deposit should be adjusted to the amount that would have existed at the balance-sheet date had the new effective yield been applied since the inception of the insurance or reinsurance contract. Changes in the carrying amount of the deposit should be reported as interest income or interest expense.

.12 Significant changes in the expected amounts of aggregate cash flows are expected to occur infrequently because of the nature of these kinds of contracts. Should a significant change occur in the total amount of actual or estimated cash flows, the enterprise should determine whether the change indicates that the contract does include significant underwriting risk and therefore should be converted to the accounting for contracts that transfer only significant underwriting risk. (See paragraphs .13 through .15 for the accounting guidance for insurance and reinsurance contracts that transfer only significant underwriting risk.) In addition, a contract that transfers only significant timing risk, which subsequently is determined also to transfer significant underwriting risk, cannot be accounted for under insurance or reinsurance accounting when the revised determination is made.

### ***Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk***

.13 Until such time as a loss is incurred that will be reimbursed under an insurance or reinsurance contract that transfers only significant underwriting

risk, the deposit should be measured based on the unexpired portion of the coverage provided. Once a loss is incurred that will be reimbursed under such a contract, then the deposit should be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the coverage provided.

.14 Changes in the recorded amount of the deposit, other than the unexpired portion of the coverage provided, arising from an insurance or reinsurance contract that transfers only significant underwriting risk should be recorded in an insured's income statement as an offset against the loss recorded by the insured that will be reimbursed under the insurance or reinsurance contract and in an insurer's income statement as an incurred loss. Insurance enterprises should record the reduction in the deposit related to the unexpired portion of the coverage provided as an adjustment to incurred losses. Insurance enterprises should disclose the amounts related to those deposit contracts that are reported in incurred losses in their statement of earnings. (See paragraph .19.) If the insured is an enterprise other than an insurance enterprise, the reduction in the deposit related to the unexpired portion of the coverage provided should be recorded as an expense.

.15 For the insured or ceding enterprise, the discount rate used to determine the deposit asset should be the current rate on United States government obligations with similar cash-flow characteristics, adjusted for default risk. Consideration of the default risk, if any, should be based on the assessment of the creditworthiness of the insurer. For the insurer or assuming enterprise, the discount rate used to determine the deposit liability should be the current rate on United States government obligations with similar cash-flow characteristics. These rates should be established at the date of each loss incurred and used for the remaining life of the contract and should not be changed. If numerous losses occur, the use of average rates is permitted because establishing individual rates might require detailed recordkeeping and computations that could be burdensome and unnecessary to produce reasonable approximations of the results.

### ***Insurance and Reinsurance Contracts With Indeterminate Risk***

.16 Uncertainties surrounding insurance and reinsurance contracts with indeterminate risk are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5 [section 10,520]. As a result, the guidance in SOP 92-5 [section 10,520], regarding the open-year method, should be followed. The open-year method should not, however, be used to defer losses that otherwise would be recognized pursuant to FASB Statement No. 5.

.17 Under the open-year method, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate and allocate premiums. The open-year method requires that these effects be aggregated in the balance sheet. If sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of the three categories as an insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly. The change in deposit assets or liabilities that result if sufficient information becomes available is treated as a change in accounting estimate in accordance with APB Opinion 20, *Accounting Changes*.

## Disclosures

.18 Entities should disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.

.19 Insurance enterprises should disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:

- a. The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred losses
- b. Any adjustment of amounts initially recognized for expected recoveries (The individual components of the adjustment (meaning, interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries) should be disclosed separately.)
- c. The amortization expense attributable to the expiration of coverage provided under the contract

## Effective Date and Transition

.20 This SOP is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Previously issued annual financial statements should not be restated. The initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period, all prior interim periods should be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle (in accordance with the provisions of APB Opinion 20).

**The provisions of this Statement need  
not be applied to immaterial items.**

## Basis for Conclusions

.21 Because of questions raised about the application of the deposit method of accounting to insurance and reinsurance contracts that do not indemnify against loss or liability and the scarcity of guidance concerning the accounting for such contracts, AcSEC believes that guidance is needed for all entities that enter into insurance and reinsurance contracts that are to be accounted for as deposits under FASB Statement Nos. 5, 60, and 113 and EITF Issue Nos. 93-6 and 93-14. Long-duration life and health insurance and reinsurance contracts that do not indemnify against mortality and morbidity risk are not covered under this SOP because FASB Statement Nos. 97 and 113 provide sufficient guidance on accounting for these kinds of insurance and reinsurance contracts.

.22 Paragraph 44 of FASB Statement No. 5 states the following.

To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid

less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or ceding company. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding company is a deposit, it shall be accounted for as such.<sup>5</sup>

That guidance also is incorporated in paragraph 18(a) of FASB Statement No. 113.

**.23** The consensus in EITF Issue No. 93-6 states, the following, in part.

The Task Force reached a consensus that in order to be accounted for as reinsurance, a contract that reinsures risk arising from short-duration insurance contracts must meet all of the following conditions: (1) the contract must qualify as a short-duration contract under paragraph 7(a) of Statement 60, (2) the contract must not contain features that prevent the risk transfer criteria in paragraphs 8 through 13 of Statement 113 from being reasonably applied (and those criteria must be met), and (3) the ultimate premium expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraph 14(a) and (b) of Statement 60 and paragraph 21 of Statement 113. If any of these conditions are not met, a deposit method of accounting should be applied by the ceding and assuming enterprises.

The consensus in EITF No. 93-14 states, the following, in part.

The Task Force reached a consensus that in order to be accounted for as insurance, an insurance contract must indemnify the insured as required by paragraph 44 of Statement 5. For those contracts that do not provide indemnification, the premium paid, less the amount of the premium to be retained by the insurer, should be accounted for as a deposit by the insured.

## Initial Measurement

**.24** This SOP states that, at inception, insurance and reinsurance contracts accounted for under deposit accounting should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. The provisions of paragraph 44 of FASB Statement No. 5 and paragraph 18a of FASB Statement No. 113 state that "for those contracts that do not provide indemnification, the premium paid, less the amount of the premium to be retained by the insurer, should be accounted for as a deposit by the insured." AcSEC believes that it may be difficult, if not impossible, to reasonably determine the amount of the premium to be retained by the insurer when initially measuring the deposit unless it is explicitly identified in the contract because the implicit rate of interest in the contract reflects a combination of considerations including prevailing market rates, uncertainty regarding amounts and timing of cash flows, as well as ranges of possible margins that may be retained by the insurer. The accounting provided in this SOP is similar to accounting for prepaid insurance.

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<sup>5</sup> FASB Statement No. 113 amended FASB Statement No. 5 to include the following footnote at the end of paragraph 44: "Paragraphs 8 to 13 of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, identify conditions that are required for a reinsurance contract to indemnify the ceding enterprise against loss or liability and to be accounted for as reinsurance. Any transaction between enterprises to which FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, applies must meet those conditions to be accounted for as reinsurance."



### **Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk and Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Significant Underwriting Risk**

.25 AcSEC concluded that the revenue and expense associated with insurance and reinsurance contracts that transfer only significant timing risk, and with insurance and reinsurance contracts that transfer neither significant timing nor significant underwriting risk are attributable primarily to the time value of money. Accordingly, AcSEC concluded that the interest method described in FASB Statement No. 91 is the appropriate model to apply to these kinds of insurance and reinsurance contracts. AcSEC also concluded that changes in actual or estimates of timing and, where applicable, the amount of cash flows under such insurance and reinsurance contracts should be accounted for consistent with paragraph 19 of FASB Statement No. 91 by recalculating the effective yield for the entire contract.

### **Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk**

.26 This SOP requires that deposits under insurance and reinsurance contracts that transfer only significant underwriting risk be measured based on the unexpired portion of the coverage provided until such time as a loss is incurred that will be reimbursed under the contract. Once a loss is incurred that will be reimbursed under the insurance or reinsurance contract that transfers only significant underwriting risk, the deposit is to be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the original deposit for the coverage provided.

.27 AcSEC considered a variety of discount rates and concluded that the deposit should be measured by the present value of expected future cash flows discounted at the current-risk-free rate available in the market, adjusted for default risk associated with the insurer's creditworthiness in the case of a deposit asset. AcSEC also discussed whether this rate should continue to be used in subsequent periods (often referred to as the *lock-in concept*) or whether the rate should change throughout the remaining life of the contract. AcSEC concluded that the rate should be established at the date of each loss incurred and used until the expected cash flows associated with the loss are collected. AcSEC believes that changes that occur are only changes in the estimate of cash flows and, therefore, the rate should not change. In those circumstances in which there is more than one loss, there will be different rates for each of the loss occurrences. If numerous losses occur, establishing these rates might require detailed recordkeeping and computations that could be burdensome as well as unnecessary to produce reasonable approximations of the results. Therefore, the use of average rates is permitted.

.28 For insurance and reinsurance contracts that transfer insurance risk (meaning contracts that transfer both underwriting and timing risk), the purchaser (who is in a comparable position to the insured or ceding entity) pays a fixed or determinable amount and receives a right to an uncertain future return. Estimated recoveries under such contracts generally are recorded at undiscounted amounts. For insurance and reinsurance contracts that transfer only significant underwriting risk, the deposit is measured by the present value of the expected future cash flows. AcSEC believes that this difference in

measurement—between insurance and reinsurance contracts that transfer insurance risk and those that transfer only significant underwriting risk—appropriately reflects the dissimilarities in these contracts, principally the failure of contracts that transfer only significant underwriting risk to match the timing of the recoveries to the timing of the payments of the loss.

.29 When an asset or liability is measured by discounting expected future cash flows, the present value of such asset or liability will increase from one reporting period to the next as a result of the passage of time (assuming that the actual or expected timing and amount of cash flows remain constant). Nevertheless, the present value of a deposit under an insurance or reinsurance contract that transfers only significant underwriting risk may change from one reporting period to the next as a result of not only the passage of time but also the changes in actual or estimated timing and amount of cash flows.

.30 AcSEC considered whether the change in the present value of the cash flows should be recognized entirely as interest related, entirely as underwriting related (offsetting the recorded loss under the insurance or reinsurance contract), or partly as interest related and partly underwriting related. AcSEC concluded that the entire change should be recognized in the income statement as an offset to the loss recorded by the insured that will be reimbursed under the insurance or reinsurance contract that transfers only significant underwriting risk. With regard to insurance enterprises and because of the significance of amounts recorded as incurred losses by these enterprises, AcSEC believes that disclosure of the components of the deposit that are recorded in incurred losses is appropriate. AcSEC noted that, if the *amount* of expected future cash flows under the deposit contract changes, the reporting entity will report both a change in the deposit and a corresponding change related to the underlying loss accrual; AcSEC concluded that both of those changes should be recognized in a similar manner. Additionally, because this kind of contract transfers significant underwriting risk, AcSEC considered it inappropriate to recognize the entire change in the present value of the cash flows as interest related. AcSEC also concluded that the costs of accounting separately for the interest-related component of the change in the present value of the cash flows outweighed the benefits of such separate accounting. AcSEC noted the following areas in which the interest-related component of a change in the present value of an asset or liability is recognized as an operating item rather than as interest related:

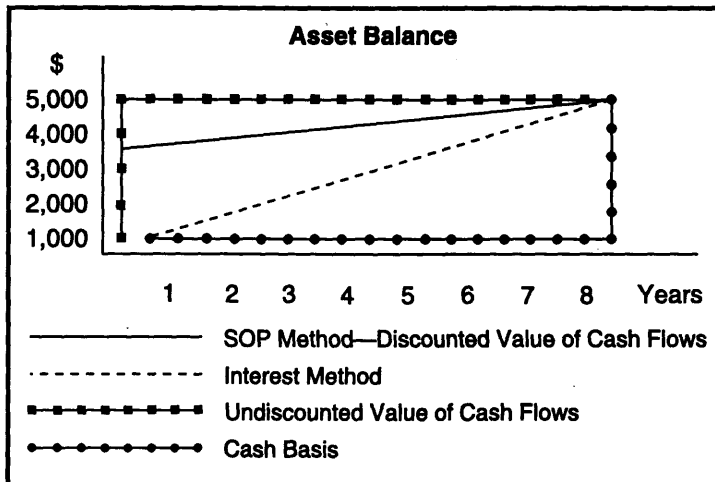
- a. Accounting for long-duration insurance liabilities and changes in cash surrender value of life insurance contracts
- b. Accounting for pension and other post-retirement benefit expenses
- c. Accounting generally used when insurance claim liabilities are measured on a discounted basis
- d. Accounting for a change in the present value of an impaired loan

.31 AcSEC considered a variety of possible ways to apply deposit accounting to insurance and reinsurance contracts that transfer only significant underwriting risk. The following graph, which is based on the example in Appendix A [paragraph .37], "Illustrations of Application of Conclusions," paragraphs A.6 through A.9, illustrates the effects of four alternative methods of accounting for insurance and reinsurance contracts that transfer only significant underwriting risk that were considered by AcSEC. In this example, the insured or ceding entity pays an initial premium of \$1,000 and expects to re-

cover \$5,000 at the end of Year 8 based on an actual loss incurred by the insured. A delayed reimbursement clause mitigates timing risk.<sup>6</sup>

.32 AcSEC eliminated from consideration the cash basis and the undiscounted value of cash flows methods because they fail to properly reflect the time value of money, the receivable or payable under the contract, or both.

.33 AcSEC concluded that the interest method fails to recognize that the \$5,000 incurred loss is a discrete event that has been recorded under the contract in Year 1 giving rise to the ultimate recovery of \$5,000 in Year 8.



### Insurance and Reinsurance Contracts With Indeterminate Risk

.34 In insurance and reinsurance contracts with indeterminate risk, there are uncertain terms, or there is insufficient information to reasonably estimate and allocate premiums in proportion to the protection provided. Paragraph 15 of SOP 92-5 [section 10,520.15] provides that, in circumstances in which a foreign ceding entity cannot provide the information required by the assuming entity to estimate both the ultimate premiums and the appropriate periods of recognition, the open-year method should be used.

.35 AcSEC concluded that uncertainties surrounding these insurance and reinsurance contracts are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5 [section 10,520]. As a result, the guidance in SOP 92-5 [section 10,520] as to the open-year method should be followed.

.36 If sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of three categories as an insurance or reinsurance contract that transfers neither significant timing nor underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly. FASB Statement No. 113 provides that the determination of whether a contract transfers risk should be evaluated at the inception of the contract. There are no provisions in FASB Statement No. 113 that provide for subsequent reevaluation of

<sup>6</sup> The table only presents the recovery under the contract and does not depict the underlying loss associated with the contract.

a contract. Therefore, AcSEC concluded that when sufficient information becomes available to reasonably estimate and allocate premiums, the accounting for an insurance or reinsurance contract, with indeterminate risk at its inception, should be reclassified as an insurance or reinsurance contract that does one of the following:

1. Transfers neither significant timing nor significant underwriting risk
2. Transfers only significant timing risk
3. Transfers only significant underwriting risk

As appropriate, the reclassified contract should be accounted for accordingly using deposit accounting as described in this SOP.

## Appendix A

### Illustrations of Application of Conclusions

**A.1.** The following examples illustrate the application of the conclusions in this SOP. The illustrations are intended as examples only; it should not be construed that any aspect of the illustrations establishes or changes requirements as to when deposit accounting should be applied. Rather, the examples illustrate how deposit accounting is to be applied when it is determined that it should be applied under other accounting literature. These examples illustrate the accounting by the insured. The accounting by the insurer would be symmetrical, except as noted in paragraph .15 of this SOP.

### Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Significant Underwriting Risk

**A.2.** This example illustrates the accounting by the insured for an insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk. The facts are as shown in the following table.

Premium	\$1,000
Coverage period	1 year
Expected recoveries	\$250 at the end of each year for five years
Implicit interest rate	8 percent <sup>(*)</sup>

<sup>(\*)</sup> Present value of \$250 per year for five years at 8 percent = \$1,000.

**A.3.** At contract inception, the insured records a \$1,000 asset. Changes in the amount or timing of cash flows are not anticipated. As they are received, cash recoveries reduce the carrying amount of the deposit, and the carrying amount of the deposit is increased at each reporting date by the amount of the interest earned during the period. The example assumes that the enterprise is reporting related financial information as of the end of each year, as shown in the following table.

<u>Description</u>	<u>8-Percent Interest Income</u>	<u>Cash Recoveries</u>	<u>Deposit Balance</u>
Initial payment			\$1,000
Year 1	\$ 80		1,080
End of Year 1		\$ (250)	830
Year 2	66		896
End of Year 2		(250)	646
Year 3	52		698
End of Year 3		(250)	448
Year 4	36		484
End of Year 4		(250)	234
Year 5	16		250
End of Year 5		(250)	0
Totals	<u>\$250</u>	<u>\$(1,250)</u>	<u>\$ 0</u>

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk

A.4. This example illustrates the accounting by the insured for an insurance or reinsurance contract that transfers only significant timing risk. The facts are as shown in the following table.

Premium	\$1,000
Coverage period	1 year
Initial expected recoveries	\$225 per year (at end of year) for five years
Initial implicit rate	4 percent <sup>(*)</sup>

(\*) Present value of \$225 per year for five years at 4 percent = \$1,000.

This implicit rate often will be less than the current risk-free rate because of the uncertainties as to the timing of cash flows in the insurance or reinsurance contract.

A.5. At contract inception, the insured records a \$1,000 asset. Though the total amount (\$1,125) is likely to be paid, changes in estimates of the timing of cash flows are expected. At each subsequent reporting date, the amount of the deposit would be increased by the amount of interest earned during the period, calculated using the estimated future cash flows to determine the then-current implicit discount rate (this is consistent with the retrospective approach in applying the interest method). At the end of Year 2, the timing of anticipated recoveries under the insurance or reinsurance contract is revised. A reevaluation of the implicit interest rate produces a rate of 3.63 percent and an asset of \$640 at the end of the year. Given the change in the expected timing of cash flows at the end of Year 2, the carrying amount of the asset would be calculated as shown in the following table.

<u>Description</u>	<u>Interest Income</u>	<u>Cash Recoveries</u>	<u>Deposit Balance</u>
Initial payment			\$1,000
Year 1 (4 percent) <sup>(*)</sup>	\$ 40		1,040
End of Year 1		\$ (225)	815
Year 2 (4 percent)	33		848
End of Year 2		(200)	648
Yield adjustment	(8)		640
Year 3 (3.63 percent)	23		663
End of Year 3		(175)	488
Year 4 (3.63 percent)	18		506
End of Year 4		(175)	331
Year 5 (3.63 percent)	12		343
End of Year 5		(175)	168
Year 6 (3.63 percent)	7		175
End of Year 6		(175)	0
Totals	<u>\$125</u>	<u>\$(1,125)</u>	<u>\$ 0</u>

(\*) Implicit rate at the inception of the insurance or reinsurance contract.

## Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk

**A.6.** This example illustrates the accounting by the insured for an insurance or reinsurance contract that transfers only significant underwriting risk. The facts are as shown in the following table.

Initial Premium	\$1,000
Coverage period	1 year
Expected recoveries	Could aggregate up to \$10,000 with none paid prior to Year 8 regardless of when the insured incurs or pays a loss

**A.7.** A delayed reimbursement clause, which provides that the full amount will be paid to the insured or ceding entity at the end of Year 8, mitigates timing risk. A \$5,000 loss is incurred at the end of Year 1 and is expected to be recovered at the end of Year 8. The risk-free rate of interest in Year 1 for the period from the loss to the expected payment date, adjusted for default risk, is 6 percent. (For the insurer, the risk-free rate would be used but it would not be adjusted for default risk.) At the end of Year 3, the estimated loss is increased from \$5,000 to \$6,000.

**A.8.** At contract inception, the insured records a \$1,000 asset. The \$1,000 amount is amortized over the coverage period of one year. If the \$5,000 loss is incurred, the insured increases the amount of the asset by the present value of the \$5,000. (Note that the insured has recorded the entire \$5,000 loss from the underlying event in the same period.) At each subsequent reporting date, the portion of the carrying amount of the asset attributable to the incurred loss would be recalculated by discounting the estimated future cash flows.

**A.9.** The carrying amount of the asset would be calculated as shown in the following table.

<i>Description</i>	<i>Amortization</i>	<i>Offset to Recorded Losses</i>	<i>Cash Recoveries at End of Year</i>	<i>Deposit Balance</i>
Initial payment				\$1,000
Amortization	\$1,000			0
Year 1		\$3,325 <sup>(*)</sup>		3,325 <sup>(†)</sup>
Year 2		200		3,525
Year 3		211		3,736
<b>Adjustment</b>		<b>747</b>		<b>4,483<sup>(‡)</sup></b>
Year 4		270		4,753
Year 5		284		5,037
Year 6		303		5,340
Year 7		320		5,660
Year 8		340	\$6,000	0
Totals	<u>\$1,000</u>	<u>\$6,000</u>	<u>\$6,000</u>	<u>\$ 0</u>

<sup>(\*)</sup> The loss occurred on the last day of the year.

<sup>(†)</sup> The present value of \$5,000 received after seven years discounted at 6 percent. At the end of Year 1, there is no remaining deposit applicable to the unexpired portion of the coverage because it is a one-year contract.

<sup>(‡)</sup> The present value of \$6,000 received after five years discounted at 6 percent.

### Conversion From a Contract That Transfers Neither Significant Timing Risk Nor Significant Underwriting Risk or a Contract That Transfers Only Significant Timing Risk to a Contract That Transfers Significant Underwriting Risk

A.10. The following illustration builds on the examples in paragraphs A.4 and A.5. It uses the same assumptions and facts as that example for the first two years; however, at the end of Year 3, the estimated recovery is increased from \$1,125 to \$1,950 (with the remaining recovery to be \$450 per year for the remaining three years). For purposes of this example, assume the magnitude of the change in the estimated recovery is such that a determination should be reached that the contract does include significant underwriting risk. The risk-free rate of interest at Year 1 is 6 percent adjusted for default risk. In addition, this rate would be utilized when appropriate for the life of the contract.

<i>Description</i>	<i>Interest Income</i>	<i>Offset to Recorded Losses</i>	<i>Cash Recoveries at End of Year</i>	<i>Deposit Balance</i>
Initial payment				\$1,000
Year 1				
(4 percent)	\$40		\$ (225)	815
Year 2				
(4 percent)	25 <sup>(*)</sup>		(200)	640
Year 3				
(3.63 percent)	23		(175)	488
Adjustment		\$715 <sup>(†)</sup>		1,203 <sup>(‡)</sup>
Year 4				
(6 percent)		72	(450)	825
Year 5				
(6 percent)		50	(450)	425
Year 6				
(6 percent)		25	(450)	0
Totals	<u>\$88</u>	<u>\$862</u>	<u>\$(1,950)</u>	<u>\$ 0</u>

(\*) The interest income adjustment at 4 percent of \$33 less the yield adjustment of \$8 equals \$25.

(†) At the end of Year 3, there is a change in the estimated recovery to \$1,950. The payment of the remaining losses will occur over three years, in Years 4, 5, and 6.

(‡) The present value of \$450 per year for three years discounted at 6 percent (the risk-free rate at the time of the loss adjusted for default risk).



## Appendix B

### Discussion of Comments Received on the Exposure Draft

**B.1.** An exposure draft of a proposed Statement of Position, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, was issued for public comment on June 30, 1997, and distributed to a variety of interested parties to encourage comment by those who would be affected by the proposal. Twenty-three comment letters were received in response on the exposure draft. The most significant and pervasive comments received were in the following areas:

- a. Scope
- b. Kinds of contracts
- c. Risk transfer criteria for direct insurance contracts
- d. Recognition of fees to be retained by the insurer or reinsurer
- e. Discount rate
- f. Accounting for contracts that transfer only significant underwriting risk

#### Scope

**B.2.** The guidance regarding scope in the exposure draft caused some confusion. Several respondents requested clarification about the kinds of insurance contracts that would be covered by the SOP. AcSEC clarified the guidance to explain that the SOP applies to contracts that do not transfer insurance risk, except for those contracts which Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards Nos. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* and 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, provide explicit guidance.

#### Kinds of Contracts

**B.3.** Several comment letters expressed concern about the complexity of the various contract types. AcSEC continues to believe that the various deposit categories are appropriate and adequately capture the majority of potential kinds of contracts.

**B.4.** For short-duration reinsurance contracts, FASB Statement No. 113 requires that two conditions be met in order to account for that contract as reinsurance. The first condition is that the contract must transfer significant insurance risk to the reinsurer. The SOP provides guidance on accounting for contracts that fail to transfer one or both of these risks, which must be transferred for a contract to be considered to have transferred significant insurance risk. FASB Statement No. 113 also provides a second condition that

must be met for a contract to receive reinsurance accounting. The second condition is that the contract must subject the reinsurer to the reasonable possibility of realizing a significant loss from the transaction, unless substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. The exposure draft did not specifically identify this situation. The SOP has been changed to state that for short-duration reinsurance contracts that do not meet the second condition, but that do transfer significant insurance risk, the accounting for these reinsurance contracts should be the same as the accounting for contracts that transfer only significant underwriting risk. AcSEC believes that for short-duration reinsurance contracts to satisfy the requirements of paragraph 9a of FASB Statement No. 113, there is an expectation that there is variability in the amount and timing of expected cash flows. Therefore, the accounting for contracts that transfer only significant underwriting risk would be appropriate.

### **Risk Transfer Criteria for Direct Insurance Contracts**

**B.5.** Several comment letters expressed concern that the risk transfer criteria from FASB Statement No. 113 were being applied to direct insurance contracts. Paragraph 44 of FASB Statement No. 5, *Accounting for Contingencies*, and FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, do not specifically state risk transfer criteria in the same manner as does FASB Statement No. 113. The SOP's objective is to address how to account for contracts that do not transfer insurance risk and consequently must be accounted for as deposit accounting. The SOP is not intended to provide a method to determine whether risk transfer exists.

### **Recognition of Fees to Be Retained by the Insurer or Reinsurer**

**B.6.** Several comments were received on the initial measurement of the deposit asset or liability relating to the recognition of fees to be retained by the insurer or reinsurer. AcSEC continues to believe that such fees should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, based upon the terms and conditions of the contract. AcSEC believes that a reasonable determination of premiums or fees is ordinarily not possible at the inception of the contract. Each contract should be evaluated based on its relevant terms and conditions.

### **Discount Rate**

**B.7.** The use of a risk-free interest rate locked in at the loss event was addressed in several comment letters. Several respondents believe that this method is inconsistent with other accounting literature and believe the rate does not fully recognize the current market value of the deposit. AcSEC believes that the method chosen is consistent with other recent literature issued. The SOP has been changed to explicitly document that AcSEC believes that changes that occur are only changes in the estimate of expected cash flows resulting from the previous loss event and, therefore, the rate should not change. It is not AcSEC's intention to measure the deposit amount on a fair-value basis.

### **Accounting for Contracts That Transfer Only Significant Underwriting Risk**

**B.8.** The accounting in the SOP prescribes that recoveries for contracts that transfer only significant underwriting risk to be recognized through un-

derwriting income. Some respondents believe that the accounting is inconsistent with FASB Statement No. 113. Other respondents believe that these kinds of contracts should receive reinsurance accounting under FASB Statement No. 113 when a recovery under the contract occurs. Some changes in the balance of the amount recoverable are related to underwriting activities and it is, therefore, reasonable to include that activity in the underwriting account. AcSEC believes that bifurcation or a financial approach that would allocate underwriting and interest components would be preferable; however, current insurance company GAAP does not permit that approach. Therefore, AcSEC continues to believe that the accounting described in the SOP is appropriate.

## Glossary

**Assuming entity (or enterprise).** The party that receives a reinsurance premium in a reinsurance transaction. The assuming enterprise (or reinsurer) accepts an obligation to reimburse a ceding enterprise under the terms of the reinsurance contract.

**Ceding entity (or enterprise).** The party that pays a reinsurance premium in a reinsurance transaction. The ceding enterprise receives the right to reimbursement from the assuming enterprise under the terms of the reinsurance contract.

**Experience adjustment.** A provision in an insurance or reinsurance contract that modifies the premium, coverage, commission, or a combination of the three, in whole or in part, based on experience under the contract.

**Insurance risk.** The risk arising from uncertainties about both underwriting risk and timing risk. Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured.

**Timing risk.** The risk arising from uncertainties about the timing of the receipt and payments of the net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

**Underwriting risk.** The risk arising from uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

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The AICPA gratefully acknowledges the contributions made to the development of this Statement of Position by George O'Shaughnessy and Thomas Genrich.

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[The next page is 20,575.]



## Section 10,770

# **Statement of Position 98-9 Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions**

December 22, 1998

### NOTE

Statements of Position on accounting issues present the conclusions of at least two thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

## Summary

This Statement of Position (SOP) amends paragraphs 11 and 12 of SOP 97-2, *Software Revenue Recognition* [section 10,700.11 and .12], to require recognition of revenue using the "residual method" when (1) there is vendor-specific objective evidence of the fair values of *all* undelivered elements in a multiple-element arrangement that is not accounted for using long-term contract accounting, (2) vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement, and (3) all revenue-recognition criteria in SOP 97-2 [section 10,700] other than the requirement for vendor-specific objective evidence of the fair value of each delivered element of the arrangement are satisfied. Under the residual method, the arrangement fee is recognized as follows: (1) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and subsequently recognized in accordance with the relevant sections of SOP 97-2 [section 10,700] and (2) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

Effective December 15, 1998, this SOP amends SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition* [section 10,740], to extend the deferral of the application of certain passages of SOP 97-2 [section 10,700] provided by SOP 98-4 [section 10,740] through fiscal years beginning on or before March 15, 1999.

All other provisions of this SOP are effective for transactions entered into in fiscal years beginning after March 15, 1999. Earlier adoption is permitted as of the beginning of fiscal years or interim periods for which financial statements or information has not been issued. Retroactive application of the provisions of this SOP is prohibited.

## Foreword

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

## Introduction and Background

.01 On October 27, 1997, the AICPA Accounting Standards Executive Committee (AcSEC) issued Statement of Position (SOP) 97-2, *Software Revenue Recognition* [section 10,700].

.02 Paragraph 10 of SOP 97-2 [section 10,700.10] states that, if an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value. Vendor-specific objective evidence of fair value is limited to the following:

- a. The price charged when the same element is sold separately
- b. For an element not yet being sold separately, the price established by management having the relevant authority (it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace)



**.03** Paragraph 12 of SOP 97-2 [section 10,700.12] requires deferral of all revenue from multiple-element arrangements that are not accounted for using long-term contract accounting if sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement.

**.04** This SOP amends that guidance to require recognition of revenue in accordance with the “residual” method in the limited circumstances described in paragraph .05 of this SOP.

## Scope

**.05** This SOP applies only to multiple-element arrangements in which (a) a software element or other delivered element is sold *only* in combination with one or more other elements that qualify for separate accounting pursuant to SOP 97-2 [section 10,700], (b) vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements, and (c) there is vendor-specific objective evidence of the fair value of each of the undelivered elements determined pursuant to paragraphs 10, 37, 57, and 66 of SOP 97-2 [section 10,700.10, .37, .57, and .66].

## Conclusions

**.06** The following changes are made to SOP 97-2 [section 10,700].

- a. The following sentence is added to the end of paragraph 11 of SOP 97-2 [section 10,700.11].

Moreover, to the extent that a discount exists, the residual method described in paragraph 12 [of SOP 97-2] attributes that discount entirely to the delivered elements.

- b. The following is added to the end of paragraph 12 of SOP 97-2 [section 10,700.12].
  - There may be instances in which there is vendor-specific objective evidence of the fair values of *all* undelivered elements in an arrangement but vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement. In such instances, the fee should be recognized using the residual method, provided that (a) all other applicable revenue recognition criteria in this SOP [SOP 97-2] are met and (b) the fair value of all of the undelivered elements is less than the arrangement fee. Under the residual method, the arrangement fee is recognized as follows: (a) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and (b) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.
- c. The following example is added to appendix A of SOP 97-2 [section 10,700.146], following “Multiple Element Arrangements—Products and Services—Example 3.”

### **Multiple Element Arrangements—Products and Services—Example 4**

#### **Facts**

A vendor sells software product A for \$950. The license arrangement for product A always includes one year of “free” PCS. The annual renewal price of PCS is \$150.

#### **Revenue Recognition**

Assuming that, apart from the lack of vendor-specific objective evidence of the fair value of the delivered software element, all applicable revenue recognition criteria in this SOP [SOP 97-2] are met, revenue in the amount of \$150 should be deferred and recognized in income over the one-year PCS service period. Revenue of \$800 should be allocated to the software element and recognized upon delivery of the software.

#### **Discussion**

Vendor-specific objective evidence of the fair value of the software does not exist because the software is never sold separately. Consequently, sufficient vendor-specific objective evidence of fair value does not exist for the allocation of revenue to the various elements based on their relative fair values. Paragraph 12 of this SOP [SOP 97-2] states, however, that the residual method should be used when there is vendor-specific objective evidence of the fair values of *all* undelivered elements; all other applicable revenue recognition criteria in this SOP [SOP 97-2] are met; and the fair value of all of the undelivered elements is less than the total arrangement fee.

If there had been vendor-specific objective evidence of the fair value of the delivered software but not of the undelivered PCS, the entire arrangement fee would be deferred and recognized ratably over the contractual PCS period in accordance with paragraphs 12 and 58 [of SOP 97-2].

**.07** Paragraph 5 of SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2*, Software Revenue Recognition [section 10,740.05], is replaced with the following.

The second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2, which limit what is considered VSOE [vendor-specific objective evidence] of the fair value of the various elements in a multiple-element arrangement, and the related examples noted in paragraph 3 of this SOP [SOP 98-4] need not be applied to transactions entered into before fiscal years beginning after March 15, 1999.

**.08** All provisions of SOP 97-2 [section 10,700] for software transactions outside the scope of this SOP and all other provisions of SOP 97-2 [section 10,700] for transactions within the scope of this SOP should be applied as stated in SOP 97-2 [section 10,700].

### **Effective Date and Transition**

**.09** The provisions of this SOP that extend the deferral of the application of certain passages of SOP 97-2 [section 10,700] are effective December 15, 1998. All other provisions of this SOP are effective for transactions entered into in fiscal years beginning after March 15, 1999. Earlier adoption is permitted as of the beginning of fiscal years or interim periods for which financial statements or information has not been issued. Retroactive application of the provisions of this SOP is prohibited.

**The provisions of this Statement need  
not be applied to immaterial items.**

## Background Information and Basis for Conclusions

.10 SOP 97-2, *Software Revenue Recognition* [section 10,700], was issued on October 27, 1997 and became effective for transactions entered into in fiscal years beginning after December 15, 1997, with earlier application encouraged.

.11 Paragraph 10 of SOP 97-2 [section 10,700.10] provides that, if a software arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value. Paragraph 12 of SOP 97-2 [section 10,700.12] provides that, if sufficient vendor-specific objective evidence of fair value does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement should be deferred.

.12 Paragraph 10 of SOP 97-2 [section 10,700.10] establishes only two conditions that constitute vendor-specific objective evidence of fair value. Neither of those conditions allows for the determination of the fair value of an element of a multiple-element arrangement that is never sold separately. A consequence of not having separate sales of one or more elements under SOP 97-2 [section 10,700], as issued, is that all revenue from such an arrangement would be deferred in accordance with paragraph 12 of SOP 97-2 [section 10,700.12].

.13 In developing the “unbundling” guidance in SOP 97-2 [section 10,700], AcSEC deliberated the need for verifiable fair values of each of the elements. AcSEC did not support permitting allocation of the sales price of the package of elements to the individual elements using differential measurement, in which an amount to allocate to an element for which there is no separate vendor-specific objective evidence of fair value is inferred by reference to the fair values of elements for which there is vendor-specific objective evidence of fair value and the fair value of the total arrangement.<sup>1</sup> AcSEC was concerned that, under differential measurement, any difference between the fair values of the individual elements when sold separately and the fair value of the elements when sold as a package (that is, a discount) would be allocated entirely to undelivered elements, possibly resulting in a significant overstatement of reported revenue in the period in which the software is delivered.

.14 In arriving at its conclusion in SOP 97-2 [section 10,700], AcSEC did not deliberate situations in which software or other delivered elements would *always* be sold with one or more services or other undelivered elements that qualify for separate accounting. In such situations, there could be vendor-specific objective evidence of the fair value of the undelivered elements when sold separately (for example, by reference to renewal PCS or to the price for user training that is sold separately). Application of the conclusions in paragraph 10 of SOP 97-2 [section 10,700.10], however, would have resulted in a determination that there was not vendor-specific objective evidence of the fair value of the delivered element (for example, software). The provisions in paragraph 12 of SOP 97-2 [section 10,700.12] would have required the initial deferral of all revenue from such arrangements.

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<sup>1</sup> Differential measurement encompasses the residual method described in this SOP.

.15 Subsequent to the issuance of SOP 97-2 [section 10,700], some AcSEC members came to believe that it is inappropriate to defer all revenue from the arrangement in such situations, because the use of the residual method would result in allocation of any discount entirely to the delivered element. Thus, there would be no potential for overstatement of revenue at the time of initial delivery of the software element. Indeed, it had been argued that recognizing no revenue from the delivered software element in such circumstances would inappropriately understate reported income.

.16 AcSEC considered this matter in light of paragraphs 95 and 96 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*. Those paragraphs state the following.

Conservatism no longer requires deferring recognition of income beyond the time that adequate evidence of its existence becomes available or justifies recognizing losses before there is adequate evidence that they have been incurred.

The Board emphasizes that any attempt to understate results consistently is likely to raise questions about the reliability and the integrity of information about those results and will probably be self-defeating in the long run. That kind of reporting, however well-intentioned, is not consistent with the desirable characteristics described in this Statement. On the other hand, the Board also emphasizes that imprudent reporting, such as may be reflected, for example, in overly optimistic estimates of realization, is certainly no less inconsistent with those characteristics. Bias in estimating components of earnings, whether overly conservative or unconservative, usually influences the timing of earnings or losses rather than their aggregate amount. As a result, unjustified excesses in either direction may mislead one group of investors to the possible benefit or detriment of others.

.17 On February 11, 1998, AcSEC issued an exposure draft of a proposed SOP, *Deferral of the Effective Date of Certain Provisions of SOP 97-2, Software Revenue Recognition, for Certain Transactions*. The exposure draft proposed deferring the effective date of the provisions of paragraph 10 of SOP 97-2 [section 10,700.10] with respect to what constitutes vendor-specific objective evidence of fair value of the software element in multiple-element arrangements in which—

- a. A software element is sold only in combination with PCS or other service elements that qualify for separate accounting pursuant to SOP 97-2 [section 10,700], or both.
- b. There is vendor-specific objective evidence of the fair value of each of the service elements determined pursuant to paragraphs 10, 57, and 65 of SOP 97-2 [section 10,700.10, .57, and .65].

.18 None of the commentators on that exposure draft objected to deferral of the effective date of paragraph 10 of SOP 97-2 [section 10,700.10] with respect to multiple-element arrangements within the scope proposed in the exposure draft. A significant number of commentators were concerned, however, about the implications of restricting the scope to only certain multiple-element arrangements, and they urged AcSEC to broaden the scope to all multiple-element arrangements.

.19 As a result of AcSEC's deliberations of the comment letters on the February 11, 1998, exposure draft and examples of arrangements brought to AcSEC's attention, AcSEC —

- a. Concluded that, for arrangements for which there is sufficient vendor-specific objective evidence of the fair value of each element, even if each element is not sold separately, the basis for deferral of revenue recognition with respect to those elements that otherwise satisfied the criteria for revenue recognition in SOP 97-2 [section 10,700] needed to be reconsidered. Accordingly, AcSEC expanded the deferral to encompass all multiple-element software arrangements.
- b. Affirmed the requirement in SOP 97-2 [section 10,700] that any allocation of the fee in a multiple-element arrangement to the various elements should be based on fair values of each element and that such fair values must be supported by vendor-specific objective evidence, thus reinforcing the applicability of that requirement to all arrangements.

These conclusions were set forth in SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2*, Software Revenue Recognition [section 10,740].

.20 On July 31, 1998, AcSEC issued an exposure draft of an SOP, *Modification of the Limitations on Evidence of Fair Value in Software Arrangements* (A proposed amendment to SOP 97-2, Software Revenue Recognition). That exposure draft proposed rescinding the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57]. Further, the exposure draft proposed that vendor-specific objective evidence of the fair value of any one element of an arrangement could be inferred by reference to vendor-specific objective evidence of the fair value of the remaining elements in the arrangement and vendor-specific objective evidence of the fair value of the total arrangement. An example in the exposure draft suggested that such vendor-specific objective evidence of the fair value of the total arrangement, which could differ from the arrangement fee, might be provided by sufficiently consistent pricing for the total arrangement in sales to other customers.

.21 Under AcSEC's July 31, 1998, proposal, any difference between the fair value of the total arrangement and the arrangement fee (the discount) for the particular transaction would be allocated to each element in the arrangement based on each element's fair value without regard to the discount, in accordance with paragraph 11 of SOP 97-2 [section 10,700.11].

.22 AcSEC received twenty comment letters on the exposure draft. Although none of the commentators opposed modification of the evidentiary requirements of the second sentence of paragraph 10 of SOP 97-2 [section 10,700.10], approximately half of the commentators requested further guidance on some aspect of what would constitute vendor-specific objective evidence of fair value and on some aspect of what might constitute "consistent pricing." Five respondents requested reconsideration of the acceptability of methods, perhaps in addition to the exposure draft method, that would permit recognition of a "minimum" amount of revenue when vendor-specific objective evidence of fair value does not exist for each element in an arrangement or for the total arrangement.

.23 The Software Revenue Recognition Working Group, which had been advising AcSEC during this process continued to support the position in the exposure draft. However, AcSEC was troubled by the significant number of comment letters requesting more guidance on the terms "consistent pricing" and "vendor-specific objective evidence." In addition, certain comment letters explained that determining vendor-specific objective evidence of fair value of total arrangements is difficult because, in many cases, each sale represents an

independent negotiation. AcSEC believes that, because of the wide variety of facts and circumstances that influence individual transactions, not all of which can be anticipated, it cannot further define the term consistent pricing without making arbitrary decisions and drafting a multitude of rules. AcSEC believes that promulgating such specificity and arbitrary rules would be unwise. AcSEC was further troubled by the concept that there could be a fair value for a multiple-element arrangement that differs from the price paid for the total arrangement, which is negotiated between independent parties.

.24 AcSEC concluded, based on the information obtained during AcSEC's due process, that the approach proposed in the July 31, 1998, exposure draft was not operational for multiple-element software arrangements. This conclusion, combined with concerns about the potential for a disproportionate allocation of any discount on an arrangement to undelivered elements (possibly resulting in an overstatement of revenue reported in the period of initial delivery of the software), caused AcSEC to conclude that it should retain the limitations on evidence of fair value in SOP 97-2 [section 10,700]. AcSEC did agree, however, to provide for the use of the residual method in circumstances where there is vendor-specific objective evidence of the fair value of all the undelivered elements in an arrangement but there is not vendor-specific objective evidence of the fair value of one or more delivered elements.

.25 AcSEC notes that the residual method is not an acceptable alternative to allocation based on relative fair values when there is vendor-specific objective evidence of the fair value of each element in a multiple-element arrangement. AcSEC acknowledges that the residual method represents an exception to the revenue-recognition model in SOP 97-2 [section 10,700] that the arrangement fee should be allocated on the basis of relative fair values. AcSEC believes, however, that, in the particular circumstances discussed in this SOP, recognition of some revenue for a delivered element is more appropriate than deferral of all revenue.

## Effective Date and Transition

.26 AcSEC initially agreed that this SOP should be effective for transactions entered into in fiscal years beginning after December 15, 1998, the date on which the deferral of certain passages of SOP 97-2 [section 10,700] that is provided by SOP 98-4 [section 10,740] would have expired. However, several subsequent letters from the software industry stated that some software companies would have difficulty implementing this SOP (and the provisions of SOP 97-2 [section 10,700] that had been deferred for one year by SOP 98-4 [section 10,740]) by that date. In response, AcSEC agreed to change the effective date of this SOP to make it apply to transactions entered into in fiscal years beginning after March 15, 1999. Moreover, in order to avoid the need for two accounting changes, AcSEC agreed to amend SOP 98-4 [section 10,740] to extend the deferral period through fiscal years beginning on or before March 15, 1999. AcSEC believes that this additional three-month period is sufficient to permit companies to implement both this SOP and the passages of SOP 97-2 [section 10,700] that had been deferred by SOP 98-4 [section 10,740].

.27 The transition provisions of both SOP 97-2 [section 10,700] and SOP 98-4 [section 10,740] are transaction based. It is, therefore, appropriate for this SOP to be applied on a prospective basis to transactions entered into in fiscal years beginning after March 15, 1999.

.28 The guidance that was deferred by SOP 98-4 [section 10,740] was to have been applied prospectively. As this SOP reinstates the guidance in SOP 97-2 [section 10,700] while adding one narrow exception, it is appropriate for this SOP to provide also for prospective application.

.29 Some entities may have adopted SOP 97-2 [section 10,700] before its December 15, 1997, effective date and, upon the issuance of SOP 98-4 [section 10,740], may have chosen not to restate their financial statements to reflect the deferral of the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57], as was permitted. Any differences in reported revenue pursuant to SOP 97-2 [section 10,700] from the revenue that would have been reported under SOP 97-2 [section 10,700] as amended by this SOP will reverse as the revenue recognition criteria are met for the undelivered elements of these arrangements. This is consistent with the transition methodology incorporated in SOP 97-2 [section 10,700]. AcSEC believes that it is therefore unnecessary to permit retroactive application of this SOP by any entities.

## Due Process

.30 The exposure draft that preceded this SOP proposed rescinding the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 [section 10,700.10, .37, .41, and .57]. Further, the exposure draft proposed that vendor-specific objective evidence of the fair value of any one element of an arrangement could be inferred by reference to vendor-specific objective evidence of the fair value of the remaining elements in the arrangement and vendor-specific objective evidence of the fair value of the total arrangement. An example in the exposure draft suggested that such vendor-specific objective evidence of the fair value of the total arrangement, which could differ from the arrangement fee, might be provided by sufficiently consistent pricing for the total arrangement in sales to other customers.

.31 The July 31, 1998, exposure draft did not propose the use of the residual method that is required by this SOP. However, the comment letters on the exposure draft clearly identified perceived weaknesses in the proposed approach. The comment letters also included recommendations to adopt the residual method in addition to the proposed approach that AcSEC ultimately rejected. Moreover, AcSEC received and considered comments on the scope of the February 11, 1998, exposure draft, which was similar to the scope of this SOP. AcSEC concluded that it could reach an informed decision based on the comments received on the two exposure drafts, without issuing a revised exposure draft for public comment.

**Accounting Standards Executive Committee  
(1998–1999)**

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# STATEMENTS OF POSITION AUDITING AND ATTESTATION

## Introduction

Auditing and Attestation Statements of Position are issued to achieve one or more of several objectives: to revise, clarify, or supplement guidance in previously issued Audit and Accounting Guides; to describe and provide implementation guidance for specific types of audit and attestation engagements; or to provide guidance on specialized areas in audit and attestation engagements. The auditing and attestation guidance in a Statement of Position has the same authority as auditing and attestation guidance in an Audit and Accounting Guide, and members should be aware that they may be asked to justify departures from such guidance if the quality of their work is questioned.

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## AUD Section 11,000

# STATEMENTS OF POSITION AUDITING AND ATTESTATION

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## Section 11,040

**Confirmation of Insurance Policies in Force**

August 1978

**NOTICE TO READERS**

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of those guides, AICPA committees may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA committee.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to those matters, members should be aware that they may be called on to justify departures from the recommendations of the committee.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the committee are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the committee believes would be in the public interest.

.01 In February 1975, the AICPA Special Committee on Equity Funding stated "... except for certain observations relating to confirmation of insurance in force and auditing related party transactions, generally accepted auditing standards are adequate and ... no changes are called for in the procedures commonly used by auditors." The AICPA industry audit guide, *Audits of Stock Life Insurance Companies* (paragraph 3.78), states: "It may also be appropriate to select in-force policies for confirmation directly with policyholders of premium amounts, date to which premiums are paid, policy loans, accumulated dividends, etc." The special committee recommended "that the Institute's auditing standards executive committee consider whether the Life Insurance Audit Guide requires clarification with regard to the confirmation of policies with policyholders."

.02 The special committee further stated:

Another auditing procedure, which heretofore has not been considered particularly useful, is verification of the authenticity of a selected number of policies included in the in-force inventory by direct confirmation with the policyholders. Such a procedure has not generally been considered necessary because it would be unusual for companies to overstate liabilities. Inflation of the inventory of life insurance in force by a company that follows statutory accounting would result in an overstatement of the liability for future policyholder benefits and a reduction in current earnings. However, when companies report on the basis of generally accepted accounting principles (GAAP) there could be motivation for overstating insurance in force because it could result in an addition to current earnings.

There could be an additional motivation for overstating insurance in force when reinsurance of policies has the effect of materially increasing current earnings, which can occur when a company reports on the basis of either GAAP or statutory accounting. Reinsurance of life insurance policies permits the elimination of the related liability for future policyholder benefits. Under certain circumstances, reinsurance may also result in increasing current earnings to the extent that the proceeds received from reinsurance exceed expenses incurred in connection with the sale and servicing of the reinsured policies.

.03 As stated above, the audit guide suggests confirmation of insurance policies in force directly with policyholders; however, the audit guide does not discuss circumstances when confirmation would be appropriate and, as a result, practice has varied. The purpose of this statement of position is to identify those circumstances in which the independent auditor ordinarily should confirm insurance policies in force. This statement of position is applicable to both stock and mutual life insurance companies.

.04 Satisfactory results of the comparison of insurance policies in force with premium collections along with other ordinary auditing procedures (see paragraphs 3.70 through 3.90, 6.08 through 6.14, and 9.02 through 9.07 of the audit guide) will normally provide the auditor with sufficient competent evidential matter as to the validity of those policies included in the inventory of insurance policies in force. However, the auditor ordinarily should confirm insurance policies in force with policyholders in the following circumstances:

- a. Proper maintenance of the inventory of insurance in force may be materially deficient due to an absence of segregation of duties or other controls.
- b. Trend analyses or ratios that measure insurance in force indicate erratic or unusual results that have not been satisfactorily explained.
- c. Additions to insurance in force cannot be related to the collection of premiums.
- d. Significant amounts of insurance in force result from related party transactions, and the related party's financial statements are not audited by the auditor.
- e. The company markets insurance products, such as those with immediate cash value features or with unusual commissions arrangements, that could motivate the agent to submit fictitious policies.
- f. Ceded reinsurance activities can materially increase earnings or investable funds.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

## Effective Date

.05 This statement of position provides for practices that may differ in certain respects from present acceptable practices. Accordingly, this statement of position will be effective for audits performed in accordance with generally accepted auditing standards for periods ending on or after December 31, 1978. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

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## Section 11,060

# Auditing Property and Liability Reinsurance

Supplements *Audits of Property and Liability Insurance Companies*

October 1982

### NOTICE TO READERS

This Statement of Position presents recommendations of the Reinsurance Auditing and Accounting Task Force of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards in auditing property and liability reinsurance. This Statement of Position supplements the audit and accounting guide *Audits of Property and Liability Insurance Companies*. It represents the considered opinion of the AICPA Reinsurance Auditing and Accounting Task Force on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

## Introduction

.01 Reinsurance is the assumption by one insurer of all or part of a risk originally undertaken by another insurer. Reinsurance is not transacted directly with the general public, but, instead, between insurance companies. In the United States there are basically three types of reinsurance entities: professional reinsurers, reinsurance departments of primary insurance companies, and various groups or syndicates of insurers referred to as reinsurance pools or associations.

- *Professional reinsurers*, while likely permitted by their charters and licenses to operate as primary insurance companies, engage almost exclusively in reinsurance.
- *Reinsurance departments* of primary insurance companies function as units of primary insurers and engage in the reinsurance business.
- *Reinsurance pools* (also referred to as associations or syndicates) may be organized to provide their members with reinsurance protection and management for certain specialized, high-risk coverage or with general access to the reinsurance market for traditional lines of business.

In addition, reinsurance intermediaries (including brokers, agents, managing general agents, and similar entities) facilitate the business of reinsurance by bringing together reinsurance purchasers and sellers. The functions of reinsurance entities may include underwriting, designing and negotiating the terms of reinsurance, placing reinsurance, accumulating and reporting transactions, distributing premiums, and collecting and settling claims.

.02 Major reasons for insurance companies to enter reinsurance contracts are to—

- a. Reduce their exposure on particular risks or classes of risks.
- b. Protect against accumulations of losses arising from catastrophes.

- c. Reduce their total liabilities to a level appropriate to their premium volumes and amounts of capital.
- d. Provide financial capacity to accept risks and policies involving amounts larger than could otherwise be accepted.
- e. Help stabilize operating results.
- f. Obtain assistance with new products and lines of insurance.

For similar reasons, reinsurers may at times reinsure their own risks with other insurance and reinsurance companies, a practice known as retrocession.

.03 Reinsurance may be transacted under broad, automatic contracts called "treaties," which are usually of long duration and which cover some portion of a particular class of business underwritten by the insurers. Reinsurance may also be transacted under "facultative" agreements, which cover specific individual risks and require the insurer and reinsurer to agree on terms and conditions of reinsuring each risk. Reinsurance may either be "pro rata," in which the reinsurer and the insurer share proportionately in the premiums and losses, or "excess," in which only the insurer's losses above a fixed point, known as the "retention," are reinsured. (For a description of the various types of reinsurance transactions, see the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*, chapter 6.) [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.04 In ceding all or part of a risk the "ceding company" does not discharge its primary liability to its insureds. The ceding company remains fully liable for the face amount of the policy issued. Through reinsurance, the ceding company reduces its maximum exposure in the event of loss by obtaining the right to reimbursement from the "assuming company" for the reinsured portion of the loss.

.05 The accounting entries for reinsurance ceded transactions are the opposite of the entries that arise from direct business. The amounts for reinsurance transactions are usually netted against the related accounts in financial statements. FASB Statement No. 60,\* *Accounting and Reporting by Insurance Enterprises*, describes in paragraph 38 the accounting for ceded reinsurance:

Amounts that are recoverable from reinsurers and that relate to paid claims and claim adjustment expenses shall be classified as assets, with an allowance for estimated uncollectible amounts. Estimated amounts recoverable from reinsurers that relate to the liabilities for unpaid claims and claim adjustment expenses shall be deducted from those liabilities. Ceded unearned premiums shall be netted with related unearned premiums. Receivables and payables from the same reinsurer, including amounts withheld, also shall be netted. Reinsurance premiums ceded and reinsurance recoveries on claims may be netted against related earned premiums and incurred claim costs in the income statement.<sup>1</sup>

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\* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38–40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

<sup>1</sup> FASB Statement No. 60,\* paragraph 60f also specifies the following disclosures regarding reinsurance: "The nature and significance of reinsurance transactions to the insurance enterprise's operations, including reinsurance premiums assumed and ceded, and estimated amounts that are recoverable from reinsurers and that reduce the liabilities for unpaid claims and claim adjustment expenses."

.06 The accounting entries for reinsurance assumed normally parallel those for direct insurance. However, the extent of the detail in the information provided to the assuming company by the ceding company or the reinsurance intermediary can vary significantly regarding—

- a. Timeliness of the information submitted.
- b. Detail of information relating to policies, claims, unearned premiums, and loss reserves.
- c. Annual statement line-of-business classification.
- d. Foreign currency translation information on business assumed from companies domiciled in foreign countries (“alien companies”).

Information on losses incurred but not reported (IBNR) and bulk reserves also may be provided by ceding companies under pro rata reinsurance arrangements. Generally no IBNR will be provided on nonproportional (excess) reinsurance arrangements. Based on the quality and comprehensiveness of the detail presented, the information provided may or may not be used by the assuming company.

.07 FASB Statement No. 60\* describes reporting in conformity with generally accepted accounting principles for “payments to insurance companies that may not involve transfer of risk.” Similar guidance is provided in FASB Statement No. 5, *Accounting for Contingencies*, paragraph 44. Paragraph 40 of FASB Statement No. 60 states—

To the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer shall be accounted for as a deposit by the ceding enterprise. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the ceding enterprise is a deposit, the amount paid shall be accounted for as such. A net credit resulting from the contract shall be reported as a liability by the ceding enterprise. A net charge resulting from the contract shall be reported as an asset by the reinsurer.

## Applicability and Scope

.08 This statement provides guidance on auditing property and liability reinsurance, including accident and health reinsurance. The following sections describe certain significant aspects of internal control structure policies and procedures regarding ceded reinsurance and assumed reinsurance and describe the related auditing procedures. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, states, “establishing and maintaining an internal control structure is an important management responsibility.” The concept of materiality is inherent in the work of the independent auditor, and the elements of materiality and relative risk underlie the application of generally accepted auditing standards. [Revised to reflect the

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\* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38—40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

conforming changes necessary due to the issuance of recent authoritative literature.]

## Ceded Reinsurance

### Internal Controls of the Ceding Company

.09 The ceding company should have those internal control structure policies and procedures that it considers necessary to (a) evaluate the financial responsibility and stability of the assuming company (whether the assuming company is domiciled in the United States or in a foreign country) and (b) provide reasonable assurance of the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company. The ceding company's control procedures to evaluate the financial responsibility and stability of the assuming company may include—

- a. Obtaining and analyzing recent financial information of the assuming company, such as—
  - Financial statements and, if audited, the independent auditor's report.
  - Financial reports filed with the Securities and Exchange Commission (U.S.), Department of Trade (U.K.), or similar authorities in other countries.
  - Financial statements filed with insurance regulatory authorities, with particular consideration of loss reserve development and the quality and liquidity of the company's invested assets.
- b. Obtaining and reviewing available sources of information relating to the assuming company, such as—
  - Insurance industry reporting and rating services.
  - Insurance department examination reports.
  - Loss reserve certifications filed with regulatory authorities.
  - Letters relating to the design and operation of internal control structure policies and procedures filed with regulatory authorities.
  - Insurance Regulatory Information System results filed with regulatory authorities.
- c. Inquiring about the assuming company's retrocessional practices and experience.
- d. Inquiring about the general business reputation of the assuming company and the background of its owners and management.
- e. Ascertaining whether the assuming company is authorized to transact reinsurance within the ceding company's state of domicile or whether letters of credit or other means of security are provided if the assuming company is not so authorized.
- f. Considering the need for and evaluating the adequacy of collateral from the assuming company on certain reinsurance contracts.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.10 The ceding company's control procedures relating to the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company are generally similar in nature to other control procedures for the recording of insurance transactions. Those control procedures are not addressed in this statement.

## Auditing Procedures

.11 In obtaining an understanding of the internal control structure, the ceding company's independent auditor should review the ceding company's procedures for determining the assuming company's ability to honor its commitments under the reinsurance contract. If the auditor intends to rely on the prescribed procedures, he should perform tests of the ceding company's procedures to obtain reasonable assurance that they are in use and operating as planned. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.12 The absence of adequate procedures by the ceding company to determine the assuming company's ability to honor its contractual commitments, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the ceding company's internal control structure.<sup>2</sup> If the auditor assesses control risk at the maximum level, whether because of a material weakness or other reasons, he should extend his procedures to evaluate the collectibility of amounts recorded in the financial statements as recoverable from the assuming company. The auditor's extended procedures may include certain of the procedures specified in paragraph .09, but they are not necessarily limited to those procedures. The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of the work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 58, paragraphs 40 through 48 and 70 through 72). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.13 To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the ceding company should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

- a. Read the reinsurance contract and related correspondence to—
  - Obtain an understanding of the business objective of the reinsurance contract, and

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<sup>2</sup> SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, states, "A material weakness in the internal control structure is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions." SAS No. 60 requires the auditor to communicate to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one, reportable conditions, including material weaknesses in the internal control structure that come to his or her attention during an audit. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

- Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60,<sup>\*</sup> paragraph 40 (see paragraph .07, above).
- b. Trace entries arising from selected reinsurance contracts to the appropriate records.
- c. Trace the selected transactions to supporting documents and test the related receivables and payables.
- d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

## Assumed Reinsurance

### Internal Controls of the Assuming Company

.14 A significant element of the assuming company's internal control structure related to assumed reinsurance is appropriate control procedures that the company considers necessary for assessing the accuracy and reliability of data received from the ceding company (whether the ceding company is domiciled in the United States or in a foreign country). Principal control procedures of the assuming company may include—

- a. Maintaining an underwriting file with information relating to the business reasons for entering the reinsurance contract and anticipated results of the contract. The underwriting file may include—
  - Historical loss ratios and combined ratios of the ceding company.
  - Anticipated loss ratios under the contract.
  - An indication of the frequency and content of reports from the ceding company.
  - Prior business experience with the ceding company.
  - The assuming company's experience on similar risks.
  - Information regarding pricing and ceding commissions.
- b. Monitoring the actual results reported by the ceding company and investigating the reasons for and the effects of significant deviations from anticipated results.
- c. Visiting the ceding company and reviewing and evaluating its underwriting, claims processing, loss reserving, and loss reserve development monitoring procedures.
- d. Obtaining from the ceding company a special-purpose report by their independent accountant regarding the ceding company's internal

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<sup>\*</sup> FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38—40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

accounting controls relating to ceded reinsurance (see SAS No. 30,\* *Reporting on Internal Accounting Control*, paragraphs 60–61).

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.15 Additional control procedures of the assuming company may include—

- a. Obtaining and analyzing recent financial information of the ceding company, such as—
  - Financial statements and, if audited, the independent auditor's report.
  - Financial reports filed with the Securities and Exchange Commission (U.S.), Department of Trade (U.K.), or similar authorities in other countries.
  - Financial statements filed with insurance regulatory authorities, with particular consideration of loss reserve development.
- b. Obtaining and reviewing available sources of information on the ceding company, such as—
  - Insurance industry reporting and rating services.
  - Insurance department examination reports.
  - Loss reserve certifications filed with regulatory authorities.
  - Letters relating to the design and operation of internal control structure policies and procedures filed with regulatory authorities.
  - Insurance Regulatory Information System results filed with regulatory authorities.
- c. Inquiring about the general business reputation of the ceding company and the background of its owners and management.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

## Auditing Procedures

.16 In obtaining an understanding of the internal control structure, the assuming company's independent auditor should review the assuming company's procedures for assessing the accuracy and reliability of data received from the ceding company. If the auditor intends to rely on the prescribed procedures, he should perform tests of the company's procedures to obtain reasonable assurance that they are in use and operating as planned. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.17 The absence of adequate procedures by the assuming company to obtain assurance regarding the accuracy and reliability of data received from

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\* On April 20, 1992, the AICPA's Auditing Standards Board issued an exposure draft of a proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*. The Statement would supersede SAS No. 30. A final statement is expected to be issued in 1993. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

the ceding company, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the assuming company's internal control structure.<sup>3</sup> If the auditor assesses control risk at the maximum level, whether because of a material weakness or other reasons, he should extend his procedures to obtain assurance regarding the accuracy and reliability of the data received from the ceding company. The auditor's extended procedures should ordinarily include, but would not necessarily be limited to, one or more of the following:

- a. Performing certain of the principal control procedures specified in paragraph .14
- b. Visiting the ceding company's independent auditor and reviewing his working papers (see SAS No. 1, section 543.12.)
- c. Performing auditing procedures at the ceding company or requesting the independent auditor of the ceding company to perform agreed-upon procedures
- d. Obtaining the report of the ceding company's independent auditor on policies and procedures (relating to ceded reinsurance) placed in operation and tests of operating effectiveness (see SAS No. 70, *Reports on the Processing of Transactions by Service Organizations.*)

The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of the work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 58, paragraphs 40 through 48 and 70 through 72). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.18 To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the assuming company should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

- a. Read the reinsurance contract and related correspondence to—
  - Obtain an understanding of the business objective of the reinsurance contract.
  - Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60,\* paragraph 40 (see paragraph .07, above).
- b. Trace entries arising from selected reinsurance contracts to the appropriate records.

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<sup>3</sup> See footnote 2.

\* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38–40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]



- c. Trace the selected transactions to supporting documents and test the related receivables and payables.
- d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

### **Pools, Associations, and Syndicates**

.19 Participation in reinsurance pools, associations, and syndicates is in some respects similar to reinsurance, and the guidance in paragraphs .14–.18 is generally applicable in the audit of an assuming company (participating company). Pools, associations, and syndicates often issue audited financial statements to participating companies, and the auditor of a participating company may use the report of the independent auditor of the pool, association, or syndicate in his audit. Guidance on the auditor's considerations in those circumstances is provided in SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

### **Reinsurance Intermediaries**

.20 Reinsurance may be transacted and serviced directly between the ceding and assuming companies or through reinsurance intermediaries (including brokers, agents, managing general agents, or similar entities). When a reinsurance intermediary is involved, the control procedures of the reinsurance intermediary are an integral part of the reinsurance transaction. The assuming and ceding companies should coordinate their control procedures with those of the reinsurance intermediary.

.21 A company may delegate to a reinsurance intermediary the performance of the procedures described in paragraphs .09 and in .14 and .15. The company, however, should have procedures to satisfy itself that the reinsurance intermediary is adequately performing those procedures. The guidance provided the independent auditor in paragraphs .11 and .12 and in .16 and .17 is applicable.

.22 In addition to the functions discussed in paragraphs .09 and in .14 and .15, a reinsurance intermediary may be authorized to collect, hold, disburse, and remit funds on behalf of the insurance company. The insurance company should have controls to provide reasonable assurance that the reinsurance intermediary is—

- a. Adequately performing those functions.
- b. Safeguarding the funds and, if required, appropriately segregating the funds.
- c. Settling accounts on a timely basis.

The insurance company may accomplish this by obtaining a special report from the independent auditor of the reinsurance intermediary or by visiting the reinsurance intermediary and reviewing its controls relating to those functions. The auditor of the insurance company should review the company's internal control procedures, and, if he intends to rely on them, he should test the operation of those control procedures. If the auditor decides not to rely on those controls, he should extend his procedures to obtain assurance that the objectives described in a–c above are met.

### **Effective Date**

.23 This statement of position provides for practices that may differ in certain respects from present practices. Accordingly, this statement of position

will be effective for audits performed in accordance with generally accepted auditing standards for periods ending on or after December 31, 1983. Earlier application is encouraged. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

## Reinsurance Auditing and Accounting Task Force

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## Insurance Companies Committee

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[The next page is 30,341.]



## Section 11,070

# Auditing Life Reinsurance

Supplements *Audits of Stock Life Insurance Companies*

November 1984

### NOTICE TO READERS

This statement of position presents the recommendations of the Reinsurance Auditing and Accounting Task Force of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards in auditing life reinsurance. This statement of position supplements the industry audit guide, *Audits of Stock Life Insurance Companies*. It represents the considered opinion of the Reinsurance Auditing and Accounting Task Force on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

## Applicability

.01 This statement provides guidance on auditing life reinsurance. Guidance on auditing property and liability reinsurance, including accident and health reinsurance, is provided in the statement of position entitled, *Auditing Property and Liability Reinsurance*, issued by the AICPA Auditing Standards Division in October 1982.

## Introduction

.02 When an insurance company issues life insurance policies, it undertakes a number of risks relating to the ultimate profitability of the policies, such as adverse experience regarding mortality or terminations, inadequate investment earnings, and unanticipated costs. Reinsurance is the assumption by one insurer (the assuming company) of all or part of the risks originally undertaken by another insurer (the ceding company).

.03 Each life insurance company determines its *retention limit*, which represents the maximum loss exposure acceptable to the company that could result from the death of any individual insured by the company. The retention limit will vary depending on the age of the insured at issuance of the policy, the type of insurance plan involved, and whether the insured is classified as a standard or substandard risk. If the policy exceeds the retention limit, the company will reinsure the excess portion of the risk. A company may also reinsure part or all of a policy within its retention limit if the company sees a need to limit its risk.

.04 Reinsurance also provides a means for the company to meet certain other objectives such as to avoid "surplus strain" resulting from the statutory accounting treatment of expenses and reserves, to reduce fluctuations in claim experience or to stabilize mortality cost, to provide additional capacity to accept business that would otherwise have to be declined, to protect solvency, to obtain underwriting assistance regarding risk classification, or to assist in financial and tax planning strategies.

.05 By ceding all or part of the risk, the ceding company does not discharge its primary obligations to its insureds. Therefore, the ceding company is concerned with the ability of the assuming company to honor its commitments under the reinsurance contract. The assuming company, on the other hand, is concerned with the accuracy and reliability of the information received from the ceding company regarding the risks it has assumed and, in some circumstances, the ability of the ceding company to honor commitments to the assuming company. Factors that are pertinent to the auditor's evaluation of reinsurance contracts include the types of reinsurance agreements and the consequent nature of the risks transferred, contractual safeguards in the reinsurance agreements, and internal control structure regarding reinsurance maintained by the ceding company or by the assuming company. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.06 Reinsurance may be transacted through—

- a. *Facultative agreements*, whereby each risk or portion of a risk is reinsured individually, the assuming company having the option to accept or reject it.
- b. *Automatic agreements*, whereby an agreed portion of business written is automatically reinsured, thus eliminating the need to submit each risk to the assuming company for acceptance or rejection.

.07 Life reinsurance contracts generally take one of three forms: yearly renewable term, coinsurance, or modified coinsurance.

- a. *Yearly renewable term (YRT)* reinsurance involves the purchase of reinsurance on the policyholder's life on a year-by-year basis. Typically the amount of reinsurance provided and the reinsurance premium charged for a particular contract will change from year to year on a scheduled basis. The reinsurance premium will depend on factors such as the age and sex of the insured, the duration of the policy, and the underwriting classification (standard or substandard risks). Yearly renewable term reinsurance generally transfers only the mortality risk to the assuming company.
- b. *Coinsurance* differs from yearly renewable term reinsurance in that the assuming company participates in substantially all aspects of the original policy and in that the contract generally covers a longer period of time. The assuming company will receive its share of the policy premiums and pay its share of the face amount of claims and cash values on terminations. The assuming company will establish its share of the statutory policy reserves, and the ceding company will reduce its reserves for the portion reinsured. If the policy is participating, the assuming company will generally reimburse the ceding company for its share of the policyholder dividend. The assuming company also generally reimburses the ceding company for its commission outlay and usually pays an additional amount toward the ceding company's expenses. The assuming company ordinarily participates in the risks regarding investment, mortality, terminations, and other risks of the policy.
- c. *Modified coinsurance* differs from coinsurance only in that the reserves and the assets supporting the reserves remain with the ceding company. In addition to the transactions required by coinsurance, a "reserve adjustment" payment between the assuming and ceding

companies is made each year. The assuming company will be paid interest on the assets supporting the reserves according to a specified formula, which may involve a fixed rate or may be related to the interest earnings of the ceding company. Depending on the formula, the investment risk may be borne by the ceding company or the assuming company, or it may be shared. As with coinsurance, the assuming company ordinarily participates in the mortality, termination, and other risks.

.08 Life insurance companies may also purchase *nonproportional reinsurance* on all or part of their insurance. One form of nonproportional reinsurance is stop-loss, under which the assuming company agrees to reimburse the ceding company for aggregate losses that exceed a specified amount. Another form is catastrophe reinsurance, under which the assuming company agrees to reimburse the ceding company for losses in excess of a specified amount that result from a single accident.

.09 Reinsurance agreements often provide for participation by the ceding company in the profits generated under the reinsurance. The reinsurance agreement will specify the method of computing the profit and the formula for sharing it.

.10 Typically, reinsurance agreements are individually negotiated and tailored to the needs and objectives of the ceding and assuming companies. The foregoing descriptions of life reinsurance agreements are not exhaustive, and variations from the described approaches are common.

## Generally Accepted Accounting Principles

.11 The accounting entries for reinsurance ceded transactions are the opposite of the entries that arise from direct business. With certain exceptions, the amounts for reinsurance transactions are netted against the related accounts in financial statements. The accounting entries for reinsurance assumed normally parallel those for direct insurance.<sup>1</sup>

.12 FASB Statement No. 60\* describes reporting in conformity with generally accepted accounting principles for "payments to insurance companies that may not involve transfer of risk." Similar guidance is provided in FASB Statement No. 5, *Accounting for Contingencies*, paragraph 44. Paragraph 40 of FASB Statement No. 60\* states—

To the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer shall be accounted for as a deposit by the ceding enterprise. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the ceding enterprise is a deposit, the amount paid shall be accounted for as such. A net credit resulting from the contract shall be reported as a liability by the ceding enterprise. A net charge resulting from the contract shall be reported as an asset by the reinsurer.

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<sup>1</sup> FASB Statement No. 60\*, *Accounting and Reporting by Insurance Enterprises*, specifies certain accounting and disclosure requirements for reinsurance.

\* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38 through 40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

## Scope

.13 The following sections describe certain significant aspects of internal control structure regarding ceded reinsurance and assumed reinsurance and describe the related auditing procedures. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, states “establishing and maintaining an internal controlling structure is an important management responsibility.” The concept of reasonable assurance is inherent in management’s determination of the nature and extent of internal control structure, and the elements of audit risk and materiality underlie the application of generally accepted auditing standards by the independent auditor. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

## Ceded Reinsurance

### Internal Control Structure of the Ceding Company

.14 The ceding company should have those internal control structure policies and procedures that it considers necessary to (a) evaluate the financial responsibility and stability of the assuming company (whether the assuming company is domiciled in the United States or in a foreign country) and (b) provide reasonable assurance of the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company. The ceding company’s control procedures to evaluate the financial responsibility and stability of the assuming company may vary, depending on the type of contracts (such as yearly renewable term and coinsurance) and other factors, and may include<sup>2</sup>

- a. Obtaining and analyzing recent financial information of the assuming company, such as—
  - Financial statements and, if the statements are audited, the independent auditor’s report.
  - Financial reports filed with the Securities and Exchange Commission (United States), Department of Trade (United Kingdom), or similar authorities in other countries.
  - Financial statements, including the actuary’s opinion, filed with insurance regulatory authorities, with particular consideration of the quality and liquidity of the company’s invested assets.
- b. Obtaining and reviewing available sources of information relating to the assuming company, such as—
  - Insurance industry reporting and rating services.
  - Insurance department examination reports.
  - Letters relating to the design and operation of internal control structure policies and procedures filed with regulatory authorities.
  - Insurance Regulatory Information System results filed with regulatory authorities.

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<sup>2</sup> The absence of one or more specific control procedures does not necessarily indicate a weakness in the internal control structure. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]



- c. Inquiring about the assuming company's retrocessional practices and experience.
- d. Inquiring about the general business reputation of the assuming company and the background of its owners and management.
- e. Ascertaining whether the assuming company is authorized to transact reinsurance within the ceding company's state of domicile or whether letters of credit or other means of security are provided if the assuming company is not so authorized.
- f. Considering the need for and evaluating the adequacy of collateral from the assuming company on certain reinsurance contracts.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.15 The ceding company's control procedures relating to the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company are generally similar in nature to other control procedures for the recording of insurance transactions. Those control procedures are not addressed in this statement.

## Auditing Procedures

.16 The independent auditor's consideration of the ceding company's internal control structure ordinarily should include a review of the ceding company's procedures for determining the assuming company's ability to honor its commitments under the reinsurance contract. If the auditor intends to rely on the prescribed procedures, he should perform tests of the ceding company's procedures to obtain reasonable assurance that they are in use and operating as planned. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.17 The absence of adequate procedures by the ceding company to determine the assuming company's ability to honor its contractual commitments, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the ceding company's internal control structure.<sup>3</sup> If the auditor assesses control risk at the maximum level, whether because of a material weakness or other reasons, he should extend his procedures to evaluate the collectibility of amounts recorded in the financial statements as receivables or reductions of liabilities that are recoverable from the assuming company. The auditor's extended procedures may include certain of the procedures specified in paragraph .14, but they are not necessarily limited to those procedures. The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the account-

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<sup>3</sup> SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, states, "A material weakness in the internal control structure is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions." SAS No. 60 requires the auditor to communicate to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one, reportable conditions, including material weaknesses in the internal control structure that come to his or her attention during an audit. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

ing records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 58, *Reports on Audited Financial Statements*, paragraphs 38 through 66, and 70 through 72). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.18 Reinsurance of life insurance permits the elimination of the reinsured portion of the related liability for future policy benefits from the ceding company's financial statements. Under certain circumstances, reinsurance may also result in increasing current earnings or investable funds to the extent that the proceeds received from the assuming company exceed expenses incurred in connection with the sale and servicing of the reinsured policies. The auditor of the ceding company ordinarily should confirm insurance policies in force with policyholders when ceded reinsurance activities can materially increase current earnings or investable funds. (See the statement of position entitled *Confirmation of Insurance Policies in Force*, issued by the AICPA Auditing Standards Division, August 1978.)

.19 To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the ceding company ordinarily should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

- a. Read the reinsurance contract and related correspondence to—
  - Obtain an understanding of the business objective of the reinsurance contract.
  - Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60,\* paragraph 40 (see paragraph .12 above).
- b. Trace entries arising from selected reinsurance contracts to the appropriate records.
- c. Trace the selected transactions to supporting documents and test related receivables and payables.
- d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

## Assumed Reinsurance

### Internal Control Structure of the Assuming Company

.20 A significant element of the assuming company's internal control structure related to assumed reinsurance is appropriate control procedures that the company considers necessary for assessing the accuracy and reliability of data received from the ceding company (whether the ceding company is domiciled in the United States or in a foreign country). The appropriate control

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\* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38 through 40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

procedures may vary depending on the type of contracts (such as yearly renewable term and coinsurance) and other factors. Principal control procedures of the assuming company may include<sup>4</sup>—

- a. Maintaining information relating to the business reasons for entering the reinsurance contract and anticipated results of the contract, such as—
  - Actuarial studies of the business assumed.
  - Anticipated profitability.
  - Anticipated termination rates.
  - Prior business experience with the ceding company.
  - The assuming company's experience on similar business.
  - Information regarding pricing and ceding commissions.
  - An indication of the frequency and content of reports from the ceding company.
- b. Monitoring the actual results reported by the ceding company and investigating the reasons for and the effects of significant deviations from anticipated results.
- c. Visiting the ceding company and reviewing and evaluating its sales, underwriting, benefits processing, and actuarial policies and procedures.
- d. Obtaining from the ceding company a special-purpose report by their independent accountant regarding the ceding company's internal accounting controls relating to ceded reinsurance (see SAS No. 30,<sup>\*</sup> *Reporting on Internal Accounting Control*, paragraphs 60 and 61). If the ceding company's independent auditor confirmed life insurance policies in force (see paragraph .18), the assuming company might also consider obtaining a special report from the ceding company's independent auditor regarding the results of those confirmation procedures.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.21 Additional control procedures of the assuming company may include—

- a. Obtaining and analyzing recent financial information of the ceding company, such as—
  - Financial statements and, if audited, the independent auditor's report.
  - Financial reports filed with the Securities and Exchange Commission (United States), Department of Trade (United Kingdom), or similar authorities in other countries.

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<sup>4</sup> See footnote 2.

<sup>\*</sup> On April 20, 1992, the AICPA's Auditing Standards Board issued an exposure draft of a proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*. The Statement would supersede SAS No. 30. A final Statement is expected to be issued in 1993. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

- Financial statements, including the actuary's opinion, filed with regulatory authorities.
- b. Obtaining and reviewing available sources of information on the ceding company, such as—
  - Insurance industry reporting and rating services.
  - Insurance department examination reports.
  - Letters relating to the adequacy of internal control structure filed with regulatory authorities.
  - Insurance Regulatory Information System results filed with regulatory authorities.
- c. Inquiring about the general business reputation of the ceding company and the background of its owners and management.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

## Auditing Procedures

.22 The independent auditor's consideration of the assuming company's internal control structure ordinarily should include a review of the assuming company's procedures for assessing the accuracy and reliability of data received from the ceding company. If the auditor intends to rely on the prescribed procedures, he should perform tests of the company's procedures to obtain reasonable assurance that they are in use and operating as planned. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.23 The absence of adequate procedures by the assuming company to obtain assurance regarding the accuracy and reliability of data received from the ceding company, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the assuming company's internal control structure.<sup>5</sup> If the auditor assesses control risk at the maximum level, whether because of a material weakness or other reasons, he should extend his procedures to obtain assurance regarding the accuracy and reliability of the data received from the ceding company. The auditor's extended procedures should ordinarily include, but would not necessarily be limited to, one or more of the following:

- a. Performing procedures such as certain of the procedures specified in paragraph .20
- b. Visiting the ceding company's independent auditor and reviewing his working papers (see SAS No. 1, section 543.12, *Part of Audit Performed by Other Independent Auditors*)
- c. Performing auditing procedures at the ceding company or requesting the independent auditor of the ceding company to perform agreed-upon procedures
- d. Obtaining the report of the ceding company's independent auditor on policies and procedures (related to ceded reinsurance) placed in operation and tests of operating effectiveness (see SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*)

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<sup>5</sup> See footnote 3.

The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of the work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 58, paragraphs 40 through 48 and 70 through 72). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

**.24** To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the assuming company ordinarily should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

- a. Read the reinsurance contract and related correspondence to—
  - Obtain an understanding of the business objective of the reinsurance contract.
  - Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60,\* paragraph 40 (see paragraph .12 above).
- b. Trace entries arising from selected reinsurance contracts to the appropriate records.
- c. Trace selected transactions to supporting documents and test the related receivables and payables.
- d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

## Effective Date

**.25** This statement of position provides for practices that may differ in certain respects from present practices. Accordingly, this statement of position will be effective for audits performed in accordance with generally accepted auditing standards for periods ending on or after December 31, 1985. Earlier application is encouraged. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

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\* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38 through 40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

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DAN M. GUY  
*Vice President, Auditing*  
BRIAN ZELL  
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## Section 11,100

# Statement of Position 89-2 Reports on Audited Financial Statements of Investment Companies

January 1989

### NOTE

This statement of position presents the recommendations of the AICPA Investment Companies Committee regarding the application of generally accepted auditing standards to reports on audited financial statements of investment companies. It represents the considered opinion of the committee on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

## Introduction

.01 In 1987, the Audit and Accounting Guide, *Audits of Investment Companies*, was issued. Chapter 9 of that guide illustrates reports on audited financial statements. In April 1988, the AICPA's Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements*, which changes the auditor's standard report on financial statements. This statement of position amends *Audits of Investment Companies* in response to the changes required by SAS No. 58; it replaces paragraphs 9.03 through 9.09 of the guide with new paragraphs 9.03 through 9.09<sup>\*</sup>.

9.03. The following form of auditor's report may be used to express an unqualified opinion on the financial statements:

### Independent Auditor's Report

To the Shareholders and  
Board of Directors  
XYZ Investment Companies

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of portfolio investments, as of December 31, 19X4, and the related statements of operations and cash flows<sup>1</sup> for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

\* Paragraph 9.08 of the Guide was deleted and subsequent paragraphs were renumbered in October 1996 to reflect the new guidance set forth in SAS No. 79, *Amendment to Statement on Auditing Standards No. 58, Reports on Audited Financial Statements*. [Footnote added, June 1997.]

<sup>1</sup> FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Held for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows<sup>2</sup> for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA  
January 21, 19X5

9.04 The reference to “and brokers” in the fourth sentence of the scope paragraph is not normally required if the investment company’s financial statements do not show an amount payable for securities purchased. Also, if securities were “verified by examination,” the report should be modified to state that.

9.05 The accountant’s report for a fund referred to as a “series fund” needs to be modified because of the uniqueness of the financial statements that have evolved to present its financial position, results of operations, and cash flows. The financial position, results of operations, and cash flows of the portfolios or other entities constituting the series are frequently presented in separate columns. The financial statements of the series may also be presented as if the series were a separate entity. In both cases, the scope of the audit should be sufficient to enable the auditor to report on the individual financial statements of the various entities constituting the series fund.

9.06 The following illustration is for a multicolumnar presentation of the portfolios constituting the series:

Independent Auditor’s Report

To the Shareholders and  
Board of Directors  
XYZ Series Investment Company:

We have audited the accompanying statement of assets and liabilities, including the schedules of investments, of XYZ Series Investment Company (comprising, respectively, the Foreign, Domestic Common Stock, Long-Term Bond, and Convertible Preferred Portfolios) as of December 31, 19X4, and the related statements of operations and cash flows<sup>3</sup> for the year then ended, the statements of changes in net assets for each of the two years in the period then ended,

<sup>2</sup> See footnote 1.

<sup>3</sup> See footnote 1.



and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

*[Same second paragraph as in the report illustrated in paragraph 9.03.]*

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of each of the respective portfolios constituting the XYZ Series Investment Company as of December 31, 19X4, the results of their operations and their cash flows<sup>4</sup> for the year then ended, the changes in their net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA  
January 21, 19X5

9.07 The following illustration is for a presentation of one of the portfolios or entities constituting the series:

Independent Auditor's Report

To the Shareholders and  
Board of Directors  
XYZ Series Investment Company:

We have audited the accompanying statement of assets and liabilities, including the schedule of portfolio investments, of the Convertible Preferred Portfolio (one of the portfolios constituting the XYZ Series Investment Company) as of December 31, 19X4, and the related statements of operations and cash flows<sup>5</sup> for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

*[Same second paragraph as in the report illustrated in paragraph 9.03.]*

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of the Convertible Preferred Portfolio of the XYZ Series Investment Company as of December 31, 19X4, and the results of its operations and cash flows<sup>6</sup> for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA  
January 21, 19X5

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<sup>4</sup> See footnote 1.

<sup>5</sup> See footnote 1.

<sup>6</sup> See footnote 1.

The auditor's reports illustrated in this paragraph and in paragraph 9.06 are not intended to be all-encompassing or necessarily illustrative of all situations that may be encountered in practice.

9.08\* The auditor's report should include an explanatory paragraph when the financial statements contain securities whose values were estimated by the Board of Directors in the absence of readily ascertainable market values, and the range of possible values of those securities is significant. That report, as illustrated below, should be used only if the auditor concludes that, after examining the underlying documentation supporting the board's good-faith estimate of value, the valuation principles are acceptable, are being consistently applied, are reasonably supported by the documentation, and the range of possible values is significant. If the range of possible values is not significant, a report such as that illustrated in paragraph 9.03 may be issued.

#### Independent Auditor's Report

To the Shareholders and  
Board of Directors  
XYZ Investment Company:

*[Same first, second, and third paragraphs as in the report illustrated in paragraph 9.03.]*

As explained in Note 2, the financial statements include securities valued at \$\_\_\_\_\_ (\_\_\_\_\_ % of net assets), whose values have been estimated by the Board of Directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of value of such securities and have inspected underlying documentation, and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

Independent Auditor

Anytown, USA  
January 21, 19X5

9.09 If the auditor concludes that the valuation procedures are inadequate or unreasonable, or that the underlying documentation does not support the valuation, the auditor should express a qualified opinion as follows:

#### Independent Auditor's Report

To the Shareholders and  
Board of Directors  
XYZ Investment Company:

*[Same first and second paragraphs as in the report illustrated in paragraph 9.03.]*

As explained in Note 2, the financial statements include securities valued at \$\_\_\_\_\_ (\_\_\_\_\_ % of net assets), whose values have been estimated by the Board of Directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of value of such securities and have inspected underlying documentation. In our opinion, those procedures are not reasonable, and the documen-

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\* Paragraph 9.08 of the Guide was deleted and subsequent paragraphs were renumbered in October 1996 to reflect the new guidance set forth in SAS No. 79, *Amendment to Statement on Auditing Standards No. 58, Reports on Audited Financial Statements*. [Footnote added, June 1997.]

tation is not appropriate to determine the value of the securities in conformity with generally accepted accounting principles. The effect on the financial statements of not applying adequate valuation procedures is not readily determinable.

In our opinion, except for the effects on the financial statements and selected per share data and ratios of the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows<sup>7</sup> for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA  
January 21, 19X5

## Effective Date

.02 This statement is effective at the time of its issuance.

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<sup>7</sup> See footnote 1.

**Investment Companies Committee  
(1988-1989)**

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*Audit and Accounting Guides*  
DIONNE D. MCNAMEE, *Technical*  
*Manager Accounting Standards*

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## Section 11,110

### **Statement of Position 89-3 Questions Concerning Accountants' Services on Prospective Financial Statements**

April 1989

#### **NOTE**

This statement of position presents the recommendations of the Forecasts and Projections Audit Issues Task Force regarding accountants' services on prospective financial statements. It represents the considered opinion of the task force on the best practice for such engagements and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

### **Reporting on Financial Forecasts That Include a Projected Sale of an Entity's Real Estate Investment**

#### **Question:**

.01 The AICPA *Guide for Prospective Financial Information* ("the Guide") states that "short-term financial forecasts may not be meaningful in (a) industries with a lengthy operating cycle or (b) situations where long-term results are necessary to evaluate the investment consequences involved. It may not be practical in all situations to present financial forecasts for enough future periods to demonstrate the long-term results. In those circumstances, the presentation should include a description of the potential effects of such results. For example, if a real estate entity's forecast does not extend to the period in which the entity's investment is expected to be liquidated, the disclosures would include a discussion of the effects of a liquidation at the end of the forecast period. Exhibit 9.08 of the Guide illustrates such a disclosure."<sup>1</sup> The information in exhibit 9.08 is presented in a note to a financial forecast. How should the practitioner report on a financial forecast that includes a hypothetical sale of an entity's real estate investment at the end of the forecast period?

#### **Answer:**

.02 The hypothetical sale of an entity's real estate, presented to demonstrate the potential effects of long-term results, may appear in the notes to the financial forecast or in a separate statement presented as part of the financial forecast. Such presentations should be appropriately labeled and accompanied by applicable disclosures, including significant assumptions and an indication of the purpose of the presentation.

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<sup>1</sup> See paragraph 8.34 of the Guide.

.03 When the effects of a hypothetical sale of an entity's real estate are included in a note to the financial forecast, the disclosure is part of the financial forecast and it is covered by the accountant's standard report. If the hypothetical sale is presented as a projection in a separate statement, the accountant's report should be modified to report specifically on the statement. Examples of appropriate forms of reports follow:

#### *Examination*

We have examined the accompanying forecasted balance sheet of XYZ Company as of December 31, 19X8, and the related forecasted statements of income, retained earnings, and cash flows for the year then ending (the forecast), and the accompanying statement of the effect on limited partners of the projected sale of property at December 31, 19X8 (the projection). Our examination was made in accordance with standards for an examination of prospective financial statements established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the statements.

The accompanying projection was prepared by management to provide potential investors with information to analyze the effect of a hypothetical sale of the properties as of December 31, 19X8, and should not be considered a presentation of expected future results.

In our opinion, the accompanying forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecast. Also, in our opinion, the accompanying projection is presented in conformity with guidelines for presentation of a projection established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's projection, assuming the hypothetical sale of properties on the date and for the sales prices indicated. However, because events and circumstances frequently do not occur as expected, there will usually be differences between the forecasted and actual results, and even if the properties are sold on the date and for the prices indicated, there will usually be differences between the projected and actual results, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

#### *Compilation*

We have compiled the accompanying forecasted balance sheet of XYZ Company as of December 31, 19X8, and the related forecasted statements of income, retained earnings, and cash flows for the year then ending (the forecast), and the accompanying statement of the effect on limited partners of the projected sale of property at December 31, 19X8 (the projection). Our compilation was made in accordance with standards established by the American Institute of Certified Public Accountants.

The accompanying projection was prepared by management to provide potential investors with information to analyze the effect of a hypothetical sale of the properties as of December 31, 19X8, and should not be considered a presentation of expected future results.

A compilation is limited to presenting, in the form of a forecast or projection, information that is the representation of management, and does not include evaluation of the support for the assumptions underlying the forecast or projection. We have not examined the forecast or projection and, accordingly, do not express an opinion or any other form of assurance on the accompanying

statements or assumptions. Furthermore, because events and circumstances frequently do not occur as expected, there will usually be differences between the forecasted and actual results, and even if the properties are sold on the date and for the prices indicated, there will usually be differences between the projected and actual results, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.04 In rare cases, management may forecast the sale of its investment in real estate during the forecast period. In such circumstances, the sale would not be hypothetical and should be included in the financial forecast with other operating results and significant changes in financial position. Furthermore, the sale would be covered by the accountant's standard report.<sup>2</sup>

## Sales Prices Assumed When a Financial Forecast Includes a Projected Sale of an Entity's Real Estate Investment

### Question:

.05 Paragraph 8.34 of the Guide indicates that short-term forecasts may not be meaningful in certain situations and that it may not be practical in those situations to present financial forecasts for enough future periods to demonstrate the long-term results of investment decisions. In those circumstances, the presentation should include a description of the potential effect of such results. For example, the Guide indicates that if a real estate entity's forecast does not extend to the period in which the entity's investment is expected to be liquidated, the forecast would include a discussion of the effects of a liquidation at the end of the forecast period, as shown in exhibit 9.08 of the Guide.<sup>3</sup>

.06 When disclosing the effects of a hypothetical liquidation (sale) of the entity's real estate investment at the end of the forecast period, what are appropriate assumptions for the sales price?

### Answer:

.07 The Guide states (paragraph 7.01P) that although the responsible party need not have a reasonably objective basis for the hypothetical assumptions used in a projection, those assumptions should be consistent with the purpose of the projection. The purpose of disclosing the effects of a hypothetical sale of an entity's real estate investment at the end of the forecast period is to provide users with meaningful information about the long-term results of their investment decisions.

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<sup>2</sup> In such rare circumstances, the accountant should treat the sale the same as any other significant assumption. For example, when examining the forecast, the accountant should consider whether the assumptions related to the sale are appropriate and suitably supported (for example, with respect to the timing of the sale and sales price). The accountant should also consider whether the assumptions should be identified by the responsible party as being particularly sensitive. Paragraph 8.25 of the Guide discusses the identification and disclosure of particularly sensitive assumptions.

<sup>3</sup> This disclosure can be presented as a footnote to a financial forecast or as a separate schedule (see "Reporting on Financial Forecasts That Include a Projected Sale of an Entity's Real Estate Investment" [paragraphs .01-.04]).

.08 Typically, the sales price is based on a specified capitalization rate of forecasted cash flows. To be consistent with the purpose of disclosing the hypothetical sale of the entity's real estate investment, the capitalization rate assumed should be consistent with the assumptions used in the forecast as well as with the entity's and the industry's experience. If the capitalization rate assumed is not consistent with the entity's or the industry's experience, the responsible party should consider whether the resulting projected sales price is appropriate, since it may result in a presentation that is inconsistent with the objective of providing users with meaningful information about the long-term results of their investment decisions.<sup>4</sup>

.09 Other sales prices may also be consistent with the purpose of the projection. For example, when significant nonrecourse debt is involved, the sales price assumed is often the existing mortgage balance or the existing mortgage balance plus original capital contributions.<sup>5</sup> Such assumed sales prices provide meaningful information that helps investors analyze their investment risk.

## Reporting on Information Accompanying a Financial Forecast in an Accountant-Submitted Document

### Question:

.10 An entity may request that additional details or explanations of items in a financial forecast (for example, details of sales or forecasted product line information) be included in an accountant-submitted document that contains a financial forecast and the accountant's report thereon. An entity may also request that certain nonaccounting information or other information not directly related to the basic forecast be included in such a document. The accompanying information is presented outside the financial forecast and is not considered necessary for the presentation of the forecast to be in conformity with guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants. How should the accountant report on accompanying information presented outside the financial forecast in an accountant-submitted document when he or she has not been engaged to examine the information separately?

### Answer:

.11 An accountant's report on information accompanying a financial forecast in an accountant-submitted document has the same objective as an accountant's report on the financial forecast: to describe clearly the character of the accountant's work and the degree of responsibility taken. When an accountant has examined a financial forecast included in an accountant-submitted document, the accountant's report on the accompanying information would ordinarily include the following:

- A statement that the examination has been made for the purpose of forming an opinion on whether (1) the financial forecast is presented

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<sup>4</sup> Paragraph 8.22 states that "the basis or rationale for the assumptions should preferably be disclosed to assist the user of the financial forecast (projection) to understand the forecast (projection) and make an informed judgment about it."

<sup>5</sup> Paragraph 8.23P of the Guide states that "The responsible party should identify which assumptions in the projection are hypothetical."



in conformity with AICPA guidelines for the presentation of a forecast and (2) the underlying assumptions provide a reasonable basis for the forecast.

- Identification of the accompanying information.
- A statement that the accompanying information is presented for purposes of additional analysis and is not a required part of the financial forecast.
- An opinion on whether the accompanying information is fairly stated in all material respects in relation to the financial forecast taken as a whole or a disclaimer of opinion, depending on whether the information has been subjected to procedures applied in the examination of the financial forecast. The accountant may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder.<sup>6</sup>
- A caveat that the prospective results may not be achieved.

.12 Following are examples of reports that may be issued.<sup>7</sup>

*Accompanying information has been subjected to procedures applied in the examination*

Our examination of the financial forecast presented in the preceding section of this document was made for the purpose of forming an opinion on whether the financial forecast is presented in conformity with AICPA guidelines for the presentation of a forecast and whether the underlying assumptions provide a reasonable basis for the forecast. The [identify accompanying information] is presented for purposes of additional analysis and is not a required part of the financial forecast. Such information has been subjected to procedures applied in the examination of the financial forecast and, in our opinion, is fairly stated in all material respects in relation to the financial forecast taken as a whole. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

*Accompanying information has not been subjected to procedures applied in the examination*

Our examination of the financial forecast presented in the preceding section of this document was made for the purpose of forming an opinion on whether the financial forecast is presented in conformity with AICPA guidelines for the presentation of a forecast and whether the underlying assumptions provide a reasonable basis for the forecast. The [identify accompanying information] is presented for purposes of additional analysis and is not a required part of the financial forecast. Such information has not been subjected to procedures applied in the examination of the financial forecast and, accordingly, we express no opinion or any other form of assurance on it. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may

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<sup>6</sup> If the accountant concludes, on the basis of known facts, that any accompanying information is materially misstated in relation to the financial forecast taken as a whole, he or she should discuss the matter with the responsible party and propose appropriate revision of the accompanying information or related disclosures. If the responsible party will not agree to revision of the accompanying information, the accountant should either modify the report on the accompanying information and describe his or her reservations regarding the information or refuse to include the information in the document.

<sup>7</sup> The report may be added to the report on the financial forecast or may be presented with the information accompanying the financial forecast.

be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.13 If accompanying information is included in an accountant-submitted document that includes a financial forecast and the accountant's compilation report thereon, the accountant's compilation report should also cover the other data. For example, the following paragraph may be added to the accountant's standard compilation report on a financial forecast if the accountant compiled the accompanying information.

We also compiled [*identify accompanying information*] and, accordingly, do not express an opinion or any other form of assurance on such information.

## Financial Projections Included in General-Use Documents

### Question:

.14 The Guide indicates that, if a client expects to include a financial projection (as defined in paragraph 3.05 of the Guide) in a general-use document, an accountant should not submit the projection to the client or provide the client with any type of report thereon unless the projection is used to supplement a financial forecast for a period covered by the forecast.<sup>8</sup> What is an accountant's responsibility for a projection (not used to supplement a financial forecast for the period covered by the forecast) included in a client-prepared general-use document when historical financial statements and the accountant's report thereon are included in the same document?

### Answer:

.15 If an accountant consents to the use of his or her report on historical financial statements in a client-prepared general-use document that contains a financial projection for a period not covered by the forecast, such projection should be accompanied by an indication by the responsible party or the accountant that the accountant provides no assurance on the financial projection.<sup>9, 10</sup> If the accountant has audited the historical financial statements, he or she should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*. Although the accountant should consider informing the responsible party that the presentation of a financial projection for a period not covered by the forecast in a general-use document is not in conformity with the Guide, the use of such a projection in a general-use document is not presumed to be a material misstatement of fact.

### Question:

.16 What is the accountant's responsibility for a financial projection (not used to supplement a financial forecast for the period covered by the forecast) included in a client-prepared general-use document when a financial forecast and the accountant's report thereon are included in the same document?

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<sup>8</sup> Paragraph 10.12P of the Guide states that "an accountant . . . should not submit or report on or consent to the use of his name in conjunction with a financial projection that he believes will be distributed to those who are unable to negotiate directly with the responsible party . . ." Also, see paragraph 4.05 of the Guide.

<sup>9</sup> See paragraph 10.20 of the Guide.

<sup>10</sup> In documents filed with the Securities and Exchange Commission (SEC), the responsible party should make this statement. In addition, the presentation of the financial projection should be labeled "supplemental and unaudited."

**Answer:**

.17 If an accountant consents to the use of his or her report on a financial forecast in a client-prepared general-use document that contains a financial projection for a period not covered by the forecast, such projection should be accompanied by an indication by the responsible party or the accountant that the accountant provides no assurance on the financial projection.<sup>11</sup> In addition, the accountant should refer to the guidance in paragraphs 10.24–10.30 of the Guide and consider informing the responsible party that the presentation of a projection for a period not covered by the forecast in a general-use document is not in conformity with the Guide.

**Support for Tax Assumptions****Question:**

.18 Sometimes, one of the most sensitive assumptions underlying a financial forecast relates to the income tax treatment of prospective transactions. To obtain a reasonably objective basis for such tax assumptions, the responsible party may obtain a “tax opinion” from another practitioner, such as the entity’s tax counsel or another accountant. What responsibility does an accountant examining a financial forecast have in considering whether the tax opinion provides suitable support for tax assumptions underlying the financial forecast?

**Answer:**

.19 Technical training and experience, as well as knowledge of the client and its industry, enable the accountant to be knowledgeable about income tax matters and competent in assessing their presentation in prospective financial statements. Therefore, when carrying out procedures to determine whether another practitioner’s tax opinion provides suitable support for tax assumptions, the accountant is viewed as being one who is knowledgeable in income tax matters related to the entity’s forecast.<sup>12</sup>

.20 In determining whether another practitioner’s tax opinion provides suitable support for tax assumptions<sup>13</sup> underlying a financial forecast, the accountant should<sup>14</sup>—

- a. Obtain a copy of the tax opinion expected to be issued.
- b. Apply the following procedures from SAS No. 73, *Using the Work of a Specialist*:
  - Evaluate the professional qualifications of the other practitioner including consideration of his or her (a) professional certification, license, or other recognition of professional competence, (b)

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<sup>11</sup> See footnote 10.

<sup>12</sup> The tax opinion provided by the other practitioner may address matters of a legal nature not directly related to amounts included in the forecast—for example, matters related to the legal form of the entity. Accountants are not expected to have the technical training and experience necessary to form an opinion on legal matters.

<sup>13</sup> Paragraph 15.21 of the Guide states that “the accountant should evaluate whether assumptions have been developed for all key factors upon which the entity’s financial results appear to depend.” When evaluating a tax opinion, the accountant should take into account whether all material tax issues have been considered.

<sup>14</sup> See paragraph 15.32 of the Guide. Also, if an accountant is relying on the opinion of another practitioner in connection with a tax shelter offering, reference should be made to Internal Revenue Service regulations regarding tax shelter opinions (see appendix D to the Guide).

reputation and standing in the view of peers or others, and (c) experience in the type of work under consideration.

- Obtain an understanding of the nature of the work to be performed by the other practitioner including the (a) objectives and scope of the practitioner's work, (b) the relationship of the other practitioner to the responsible party, (c) methods or assumptions used by the other practitioner, (d) the appropriateness of using the other practitioner's work for the intended purpose, and (e) the form and content of the other practitioner's findings that will enable the practitioner to make an evaluation described in SAS No. 73, paragraph 12.
- Make appropriate tests of data provided to the other practitioner.
- Evaluate whether the other practitioner's findings support the related representations in the prospective financial statements. In doing this, the accountant should read the tax opinion and consider whether (a) the facts used in the tax opinion are consistent with the information obtained during the examination of the forecast, (b) the assumptions and arguments used in the tax opinion are reasonable,<sup>15</sup>— and (c) the assumptions, facts, and arguments used in the tax opinion support the conclusions reached.

## Periods Covered by an Accountant's Report on Prospective Financial Statements

### Question:

.21 The Guide includes an example of an accountant's examination report on a financial forecast "for the annual periods ending December 31, 19X2 through 19X6."<sup>16</sup> The examination report states that the forecast was examined and concludes that (a) the forecast is presented in conformity with the presentation guidelines established by the American Institute of Certified Public Accountants, and (b) the underlying assumptions provide a reasonable basis for management's forecast. Does the accountant's examination report on a financial forecast apply to the forecast taken as a whole or to each of the discrete periods presented in the forecast?

### Answer:

.22 The accountant's report on a financial forecast should correspond to the form of the forecast. Accordingly, if the forecast is presented in a columnar format in which each column represents a specific period, the accountant's report on the forecast applies to each period presented in the forecast. Conversely, an accountant's report would pertain to the entire period covered by the forecast (taken as a whole) if the presentation included a single column labeled "for the five years ending December 31, 19X6."

.23 When an accountant examines a financial forecast that presents individual discrete periods, he or she should evaluate the support for the underlying assumptions used in the preparation of the forecast for each period presented.<sup>17</sup>

<sup>15</sup> See footnote 12.

<sup>16</sup> See the illustrative report for a financial feasibility study in paragraph 17.27 of the Guide.

<sup>17</sup> Paragraph 15.05 of the Guide states: "Materiality is a concept that is judged in light of the expected range of reasonableness of the information, and therefore users should not expect prospective information . . . to be as precise as historical information."

## Forecasts and Projections Audit Issues Task Force (1988)

KENNETH J. DIRKES, *Chairman*  
RICHARD DIETER  
GEORGE J. DUVA  
ROBERT W. BERLINER  
ERNEST L. TEN EYCK  
RICHARD M. STEINBERG  
DON PALLAIS  
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DAN M. GUY  
*Vice President, Auditing*  
MIMI BLANCO-BEST  
*Technical Manager*  
*Auditing Standards*

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[The next page is 30,461.]



## Section 11,140

# **Statement of Position 89-7 Report on the Internal Control Structure in Audits of Investment Companies**

December, 1989

### **NOTE**

This statement of position presents the recommendations of the AICPA Investment Companies Committee regarding the application of generally accepted auditing standards to reports on the internal control structure in audits of investment companies. It represents the considered opinion of the committee on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

## **Introduction**

[.01-.02] [Paragraphs deleted to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

## **Report on Internal Control Required by the SEC**

.03 The following is an illustration of the independent auditor's report on a management investment company's internal control structure based on the results of procedures performed in obtaining an understanding of the internal control structure and assessing control risk. These procedures should include the review, study, and evaluation of the accounting system, internal accounting controls, and procedures for safeguarding securities required by the instructions to Form N-SAR.

Board of Directors  
XYZ Investment Company

In planning and performing our audit of the financial statements of XYZ Investment Company for the year ended December 31, 19X1, we considered its internal control structure, including procedures for safeguarding securities, in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and to comply with the requirements of Form N-SAR, not to provide assurance on the internal control structure.

The management of XYZ Investment Company is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility,

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\* Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, revises the definition and description of internal control and makes conforming changes to relevant terminology. This SOP will be amended to conform to SAS No. 78 in a future edition of *Technical Practice Aids*.

estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. Two of the objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that it may become inadequate because of changes in conditions or that the effectiveness of the design and operation may deteriorate.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure, including procedures for safeguarding securities, that we consider to be material weaknesses as defined above as of December 31, 19X1.\*

This report is intended solely for the information and use of management and the Securities and Exchange Commission.

Accounting Firm

New York, New York  
February 15, 19X2

## Effective Date

.04 This statement is effective for audits of financial statements for periods beginning on or after January 1, 1989, with early application permissible.

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\* If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fourth paragraph of the report should be modified as follows:

However, we noted the following matters involving the (control environment, accounting system, control procedures, or procedures for safeguarding securities) and its (their) operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the financial statements of XYZ Investment Company for the year ended December 31, 19X1, and this report does not affect our report thereon dated February 15, 19X2. [A description of the material weaknesses that have come to the auditor's attention would follow. Also, Sub-item 77B of the instructions to Form N-SAR says "(d) disclosure of a material weakness should include an indication of any corrective action taken or proposed."]



**Investment Companies Committee  
(1988-1989)**

JERRY A. DAVIS, *Chairman*  
STEVEN E. BULLER  
M. CHRISTOPHER CANAVAN, JR.  
NICHOLAS P. CONSTANTAKIS  
ROBERT F. GUNIA  
PAUL A. KELLER  
JAMES F. MAHONEY  
RICHARD P. MEYEROWICH  
PAUL R. NEVIERA  
DAVID M. TAYLOR  
FREDERICK M. WERBLOW

JONATHAN F. ZESCHIN

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DAN M. GUY,  
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PATRICK L. MCNAMEE,  
*Director*  
*Audit and Accounting Guides*  
DIONNE D. MCNAMEE,  
*Technical Manager*  
*Accounting Standards*

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[The next page is 30,471.]



## Section 11,150

### ***Statement of Position 90-1 Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations***

January, 1990

#### **NOTE**

This statement of position presents the recommendations of the Forecasts and Projections Task Force regarding accountants' services on prospective financial statements for internal use only and partial presentations. It represents the considered opinion of the task force on the best practice for such engagements and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

#### **Part I**

### **Guidance on the Accountant's Services and Reports on Prospective Financial Statements for Internal Use Only<sup>1</sup>**

.01 An accountant may be engaged to provide services on financial forecasts that are restricted to internal use in a variety of circumstances. For example, he or she may assemble a financial forecast in connection with an evaluation of the tax consequences of future actions or in connection with advice and assistance to a client evaluating whether to buy or lease an asset. When the forecast is to be restricted to internal use,<sup>1</sup> an accountant may perform a compilation, examination, or application of agreed-upon procedures in accordance with AICPA standards<sup>2</sup> or any of a spectrum of "other services" on it. The accountant need not report on such other services unless requested

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<sup>\*</sup> Note: Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. Italicized paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term *forecast*.

<sup>1</sup> In deciding whether a potential use is *internal use*, the accountant should consider the degree of consistency of interest between the responsible party and the user regarding the forecast. If their interests are substantially consistent (for example, both the responsible party and the user are employees of the entity about which the forecast is made), the use would be deemed internal use. On the other hand, where the interest of the responsible party and the user are potentially inconsistent (for example, the responsible party is a nonowner manager and the user is an absentee owner), the use would not be deemed internal use. In some cases, this determination will require the exercise of considerable professional judgment.

<sup>2</sup> See chapters 12, 13, and 14 of the Guide for guidance on compilations, chapters 15, 16, and 17 of the Guide for examinations, and chapters 19, 20, and 21 of the Guide for application of agreed-upon procedures.

to by the client.<sup>3</sup> This section also suggests procedural and reporting guidance that an accountant might use in providing such other services on a financial forecast for internal use only.

.02 In satisfying himself or herself that the forecast will be restricted to internal use, the accountant may rely on either the written or oral representation of the responsible party, unless information comes to his or her attention that contradicts the responsible party's representation. If the accountant is not satisfied that the financial forecast will be restricted to internal use only, he or she should follow the guidance in paragraph 10.02 of the Guide.

## Procedures

.03 The accountant's procedures should be consistent with the nature of the engagement. Other chapters of the Guide provide useful guidance on the type of procedures an accountant would apply when the nature of the engagement is similar to either a compilation, examination, or application of agreed-upon procedures.

.04 When an accountant provides other services on a financial forecast for internal use, he or she should establish an understanding with the client, preferably in writing, regarding the services to be performed and should specify in this understanding that the financial forecast and the report, if any, are not to be distributed to outside users.

## Reporting

.05 The Statement on Standards for Accountants' Services on Prospective Financial Information, *Financial Forecasts and Projections*, does not require the accountant to report on other services performed on a financial forecast for internal use only. Accordingly, an accountant can submit a computer-generated or manually prepared financial forecast to a client without reporting on it when the forecast is for internal use only.

.06 If an accountant decides to issue a report and he or she purports to have compiled, examined, or applied agreed-upon procedures to a financial forecast for internal use only in conformity with AICPA standards, the accountant should follow the reporting guidance in other sections of the Guide.<sup>4</sup> If the accountant decides to issue a report on other services performed with respect to a financial forecast for internal use only, the report's form and content are flexible. However, the accountant should not report on financial forecasts that exclude a summary of significant assumptions.<sup>5</sup> The report preferably would—

- a. Be addressed to the responsible party.
- b. Identify the statements being reported on.
- c. Describe the character of the work performed and the degree of responsibility taken<sup>6</sup> with respect to the financial forecast.
- d. Include a caveat that the prospective results may not be achieved.

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<sup>3</sup> However, see paragraph .09.

<sup>4</sup> See chapters 14, 17, and 21 of the Guide for guidance on reporting on a compilation, examination, or application of agreed-upon procedures, respectively.

<sup>5</sup> See paragraph 9.05 of the Guide for guidance on presentation formats for disclosure of significant assumptions.

<sup>6</sup> The accountant's assurance on the financial forecast should not be similar to that given for an examination unless he or she complies with the procedures for an examination as described in chapter 15 of the Guide.

e. Indicate the restrictions as to the distribution of the financial forecast and report.

f. Be dated as of the date of the completion of his or her procedures.

**.06P** *In addition to the elements listed above, the accountant's report on a financial projection for internal use only preferably would include a description of the limitations on the usefulness of the presentation.*

**.07** In addition to the above, the accountant's report would, where applicable, preferably—

- a. Indicate if the accountant is not independent with respect to an entity on whose financial forecast he or she is providing services. An accountant should not provide any assurance on a financial forecast of an entity with respect to which he or she is not independent.
- b. Describe omitted disclosures that come to his or her attention (for example, the omission of the summary of significant accounting policies discussed in paragraph 8.06 of the Guide), or simply state that there are omissions of disclosures required under the guidelines for presentation of a financial forecast. For example, when a financial forecast is included in a personal financial plan, the description may be worded as follows:

This financial forecast was prepared solely to help you develop your personal financial plan. Accordingly, it does not include all disclosures required by the guidelines established by the American Institute of Certified Public Accountants for the presentation of a financial forecast.

**.08** The following is an example report, for cases in which the accountant chooses to issue a report, when he or she has assembled a financial forecast for which distribution is limited to internal use:

We have assembled, from information provided by management, the accompanying forecasted balance sheet and the related forecasted statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 19XX, and for the year then ending.

(This financial forecast omits the summary of significant accounting policies.)<sup>7</sup> We have not compiled or examined the financial forecast and express no assurance of any kind on it. Further, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. In accordance with the terms of our engagement, this report and the accompanying forecast are restricted to internal use and may not be shown to any third party for any purpose.

**.08P** *The following is an example report, for cases in which the accountant chooses to issue a report, when an accountant has assembled a financial projection for which distribution is limited to internal use:*

We have assembled, from information provided by management, the accompanying projected balance sheet and the related projected statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 19XX, and for the year then ending. (This financial projection omits the summary of significant accounting policies.)<sup>8</sup> The accompanying projection and this report were prepared for [state special purpose, for example, "presentation to the Board of Directors of XYZ Company for its consideration as to whether to add

<sup>7</sup> This sentence would be included, if applicable.

<sup>8</sup> This sentence would be included, if applicable.

a third operating shift"] and should not be used for any other purpose. We have not compiled or examined the financial projection and express no assurance of any kind on it. Further, even if [state hypothetical assumption, for example, "the third operating shift is added"] there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. In accordance with the terms of our engagement, this report and the accompanying projection are restricted to internal use and may not be shown to any third party for any purpose.

.09 When a financial forecast for internal use only is included with an accountant's written communication (for example, with a transmittal letter or report), a caveat that the prospective results may not be achieved and a statement that the financial forecast is for internal use only should be communicated in writing. Such caveat and statement should be included in the communication on or in the prospective financial statements.

## Part II

# Partial Presentations of Prospective Financial Information

## Introduction

.10 Much of the guidance in the AICPA's *Guide for Prospective Financial Statements* (the "Guide") can be applied to partial presentations of prospective financial information. This section—

- Describes how that guidance applies to the unique aspects of partial presentations.
- Discusses the accountant's responsibility for partial presentations when he or she is engaged to issue or does issue a written communication that expresses a conclusion about the reliability of a written partial presentation that is the responsibility of another party (see paragraph .25).

.11 A partial presentation is a presentation of prospective financial information that excludes one or more of the items required for prospective financial statements as described in paragraph 8.06 of the Guide.<sup>9</sup> A partial presentation may include either forecasted or projected information and may either be extracted from a presentation of prospective financial statements or may be prepared to meet a specific need.<sup>10</sup> Examples of partial presentations include—

- Sales forecasts.
- Presentations of forecasted or projected capital expenditure programs.

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\* *Note:* Because forecasted and projected information is similar in many respects, separate guidance for projected information is provided only to the extent that it differs from that for forecasted information. Italicized paragraphs show how the guidance presented for forecasted information should be modified for projected information. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasted and projected information even though it uses only the term *forecasted*.

<sup>9</sup> Paragraph 8.06 of the Guide indicates that a financial forecast may take the form of complete basic financial statements or may be limited to the following items (where such items would be presented for historical financial statements for the period):

- a. Sales or gross revenues
- b. Gross profit or cost of sales
- c. Unusual or infrequently occurring items
- d. Provision for income taxes
- e. Discontinued operations or extraordinary items
- f. Income from continuing operations
- g. Net income
- h. Primary and fully diluted earnings per share
- i. Significant changes in financial position

When the financial forecast takes the form of basic financial statements, the requirement to disclose significant changes in financial position in *i* above is accomplished by presenting a statement of cash flows and its related note disclosures in accordance with FASB Statement No. 95, *Statement of Cash Flows*.

If the omitted applicable item is derivable from the information presented, the presentation would not be deemed to be a partial presentation. Paragraph 8.08 of the Guide states that a summary of significant assumptions and accounting policies and an appropriate introduction should always accompany the forecast.

<sup>10</sup> Partial presentations do not include estimates in historical financial statements and related notes required by generally accepted accounting principles or an other comprehensive basis of accounting. Guidance on auditing accounting estimates is contained in SAS No 57, *Auditing Accounting Estimates*.

- Projections of financing needs.
- Other presentations of specified elements, accounts, or items of prospective financial statements (for example, projected production costs) that might be part of the development of a full presentation of prospective financial statements.
- Forecasts that present operating income but not net income.
- Forecasts or projections of taxable income that do not show significant changes in financial position.
- Presentations that provide enough information to be translated into elements, accounts, or items of a financial forecast or projection. Examples include a forecast of sales units and unit selling prices and a forecast of occupancy percentage, number of rooms, and average room rates for a hotel. In contrast, if the prospective information only presents units expected to be sold but excludes unit selling prices, it would not be considered a partial presentation.

## Uses of Partial Presentations

.12 Partial presentations may be appropriate in many “limited use” circumstances.<sup>11</sup> For example, a responsible party may prepare a partial presentation to analyze whether to lease or buy a piece of equipment or to evaluate the income tax implications of a given election, since it may only be necessary to assess the impact on one aspect of financial results rather than on the financial statements taken as a whole. However partial presentations are not ordinarily appropriate for general use. Accordingly, a partial presentation ordinarily should not be distributed to third parties who will not be negotiating directly with the responsible party (for example, in an offering document for an entity’s debt or equity interests). In this context, *negotiating directly* is defined as a third-party user’s ability to ask questions of and negotiate the terms or structure of a transaction directly with the responsible party.

.13 The responsible party should consider whether a presentation omitting one or more items required for prospective financial statements will adequately present the information given its special purpose. Unless there is agreement between the responsible party and potential users specifying the content of the partial presentation, a partial presentation is inappropriate if it is incomplete for what it purports to present. Examples of partial presentations that might be inappropriate include a statement of forecasted receipts and disbursements that does not include certain existing commitments of the entity or a forecast of net income that does not include disclosure of changes in financial position, when such disclosures would indicate the need for additional capital to sustain operations. A presentation of prospective sales, however, is an example of a presentation that would be appropriate in circumstances where its intended use is to negotiate the terms of a royalty agreement based on sales.

## Preparation and Presentation of Partial Presentations

.14 Partial presentations omit one or more of the minimum items required in paragraph 8.06 of the Guide for prospective financial statements.<sup>12</sup> The

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<sup>11</sup> See paragraphs 3.13 and 4.04 of the Guide.

<sup>12</sup> As used here, prospective financial statements include complete basic financial statements or the minimum items described in paragraph 8.06 of the Guide (see footnote 1).



guidance below describes matters to be considered in the preparation and presentation of partial presentations.

**.15 Key Factors.** If the responsible party prepares a partial presentation without preparing prospective financial statements, the responsible party should consider key factors affecting elements, accounts, or items of prospective financial statements that are interrelated with those presented. In a sales forecast, for example, a key factor to be considered is whether productive capacity is sufficient to support forecasted sales. When the prospective information included in the partial presentation is extracted from the prospective financial statements, the effects of interrelationships among elements of the prospective financial statements should have been previously determined.

**.16 Titles.** Titles of partial presentations should be descriptive of the presentation and state whether the presentation is of forecasted or projected information. In addition, titles should disclose the limited nature of the presentation and should not state that it is a "financial forecast" or a "financial projection." Examples of appropriate titles are "forecast of production capacity" and "projected operating income assuming a new plant facility."

**.17 Accounting Principles and Policies.** Significant accounting policies relevant to the information presented and its intended purpose should be disclosed.

**.18** Occasionally, a different basis of accounting is used for preparing a partial presentation than that expected to be used in preparing the historical financial statements covering the same period as the partial presentation. In such circumstances, the presentation should disclose the basis of accounting to be used to prepare the historical financial statements covering the prospective period. Differences resulting from the use of the different basis to prepare the partial presentation should be described but need not be quantified.

**.19 Materiality.** The concept of materiality should be related to the partial presentation taken as a whole.

**.20 Assumptions.** Assumptions that are significant to a partial presentation include those assumptions having a reasonable possibility of a variation that may significantly affect the prospective results. Such assumptions may be either directly or indirectly related to the presentation. The selling price of a product, for example, is an assumption that could directly affect a sales forecast, whereas a company's productive capacity is an example of an assumption that could indirectly affect the sales forecast. Frequently, the more indirectly related an assumption is to the partial presentation, the greater the potential variation would have to be to have a material impact on the prospective results presented.

**.21** In some situations, the disclosure of assumptions deemed to be significant to the partial presentation of prospective financial information would be virtually the same as those disclosures that would be necessary if a full presentation of prospective financial statements were to be made. For example, in a partial presentation of forecasted operating results, it is likely that most assumptions that would be significant with respect to a full presentation would also be significant with respect to the presentation of forecasted operating results. Thus, those assumptions should be disclosed.

**.22** In other, more limited partial presentations of prospective financial information, however, there may be few assumptions having a reasonable pos-

sibility of a variation that would significantly affect the presentation. In a presentation of forecasted sales, for example, it would only be necessary to disclose those assumptions relating directly to the sales forecast, such as future demand and pricing, unless other assumptions—such as marketing and advertising programs, productive capacity and production costs, financial stability or working capital sufficiency—have a reasonable possibility of a variation significant enough to have a material impact on the sales forecast.

**.23** The introduction preceding the summary of assumptions for a partial presentation should include a description of the purpose of the presentation and any limitations on the usefulness of the presentation.

**.24** The following is an example of the introduction for a partial presentation of forecasted sales:

*This sales forecast presents, to the best of management's<sup>13</sup> knowledge and belief, expected sales during the forecast period. Accordingly, the sales forecast reflects its judgment as of (date), the date of this forecast, of the expected conditions and its expected course of action. The sales forecast is for use in negotiating the Company's lease override provisions and should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the sales forecast. There will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.*

**.24P** *The following is an example of the introduction preceding the summary of assumptions for a schedule of projected production at a maximum productive capacity:*

*This projection of production by product line presents, to the best of management's<sup>14</sup> knowledge and belief, the Company's expected production for the period if management chooses to operate its plant at maximum capacity. Accordingly, the projection of production by product line reflects its judgment as of (date), the date of this projection, of the expected conditions and its expected course of action if the plant were operated at maximum capacity. The projected statement is designed to provide information to the Company's board of directors concerning the maximum production that might be achieved and related costs if current capacity were expanded through the addition of a third production shift. Accordingly, this projected statement should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the projected statement; however, management has not decided to operate the plant at maximum capacity. Even if the plant were operated at maximum capacity, there will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.*

## Accountant's Involvement With Partial Presentations

**.25** An accountant who is engaged to issue or does issue a written communication<sup>15</sup> that expresses a conclusion about the reliability<sup>16</sup> of a written par-

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<sup>13</sup> If the responsible party is other than management, this reference should be to the party who assumes responsibility for the assumptions.

<sup>14</sup> See footnote 5.

<sup>15</sup> An accountant should not report on a partial presentation that excludes disclosure of the summary of significant assumptions or, for a projection, excludes identification of the hypothetical assumptions.

<sup>16</sup> Reliability, as it applies to a partial presentation, does not relate to the achievability of the prospective results.

tial presentation<sup>17</sup> that is the responsibility of another party should examine or apply agreed-upon procedures to the presentation.<sup>18</sup> An accountant may also be engaged to compile a partial presentation. When an accountant compiles, examines, or applies agreed-upon procedures to a partial presentation, he or she should perform the engagement in accordance with the guidance in paragraphs .29 and .30.<sup>19</sup>

.26 This section does not provide standards or procedures for engagements involving partial presentations used solely in connection with litigation services, although it provides helpful guidance for many aspects of such engagements and may be referred to as useful guidance in such engagements. *Litigation services* are engagements involving pending or potential formal legal or regulatory proceedings before a "trier of fact" in connection with the resolution of a dispute between two or more parties, for example, in circumstances where an accountant acts as an expert witness. This exception is provided because, among other things, the accountant's work in such proceedings is ordinarily subject to detailed analysis and challenge by each party to the dispute.<sup>20</sup>

.27 The accountant should consider whether it is appropriate to report on a partial presentation.<sup>21</sup>

.28 Occasionally, an accountant may be engaged to prepare a financial analysis of a potential project where the engagement includes obtaining the information, making appropriate assumptions, and assembling the presentation. In such circumstances, the accountant is theasserter and the analysis is not, and should not be characterized as, forecasted or projected information as defined in paragraph .11. Such analysis would not be appropriate for general use.<sup>22</sup>

## Compilation and Examination Procedures

.29 The procedures for compilations and examinations of prospective financial statements are generally applicable to partial presentations.<sup>23</sup> However, the accountant's procedures may be affected by the nature of the information presented. As described in paragraph .15, many elements of prospective financial statements are interrelated. The accountant should give appropriate consideration to whether key factors affecting elements, accounts, or items that are interrelated with those in the partial presentation he or she has been engaged to examine or compile have been considered, including key factors that may not necessarily be obvious from the partial presentation (for

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<sup>17</sup> This statement covers only a partial presentation presented in written form by the party responsible for it. Consistent with the attestation standards, oral assertions about prospective results are not addressed by this statement.

<sup>18</sup> Examples of professional standards that may involve partial presentations not covered by this section are included in paragraph 2 of the Statements on Standards for Attestation Engagements (AICPA, *Professional Standards*, vol. 1, AT sec. 100). In addition, paragraphs 76–81 of that section contain guidance that an accountant should follow when he or she provides an attest service as part of an MAS engagement.

<sup>19</sup> If the accountant provides services on a partial presentation restricted to internal use only, he or she may apply the guidance in paragraphs .01–.09 of Part I of this section.

<sup>20</sup> See paragraph 10.03 of the Guide.

<sup>21</sup> See paragraphs .12 and .13.

<sup>22</sup> If the responsible party reviews and adopts the assumptions and presentation, the presentation might be a partial presentation. See paragraphs .11 and .12 for the definition and uses of partial presentations.

<sup>23</sup> See chapters 12 and 15 of the Guide.

example, productive capacity relative to a sales forecast), and whether all significant assumptions have been disclosed. The accountant may find it necessary for the scope of his or her examination or compilation of some partial presentations to be similar to that for his or her examination or compilation of a presentation of prospective financial statements. For example, the scope of an accountant's procedures when he or she examines forecasted results of operations would likely be similar to those for his or her examination of prospective financial statements since the accountant would likely need to consider the interrelationships of all accounts in the examination of results of operations.

### **Applying Agreed-Upon Procedures to Partial Presentations**

.30 An accountant may accept an engagement to apply agreed-upon procedures to a partial presentation provided (a) the specified users involved have participated in establishing the nature and scope of the engagement and take responsibility for the adequacy of the procedures to be performed, (b) distribution of the report is to be restricted to the specified users involved, and (c) the partial presentation includes a summary of significant assumptions. The guidance in chapter 19 of the Guide is generally applicable to such engagements.

### **Standard Accountant's Compilation, Examination, and Agreed-Upon Procedures Reports**

.31 The accountant's standard report on a partial presentation should include—

- An identification of the partial presentation reported on.
- A caveat that the forecasted results may not be achieved.
- A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.
- A description of any limitations on the usefulness of the presentation.
- For a compilation
  - A statement that the accountant has compiled the partial presentation in accordance with guidelines established by the American Institute of Certified Public Accountants.
  - A statement that a compilation is limited in scope and does not enable the accountant to express an opinion or any other form of assurance on the partial presentation of the assumptions.
- For an examination
  - A statement that the examination of the partial presentation was made in accordance with AICPA standards and a brief description of the nature of such an examination.
  - For forecasted information, the accountant's opinion that the partial presentation is presented in conformity with AICPA presentation guidelines and that the underlying assumptions provide a reasonable basis for the forecast.
  - *For projected information, the accountant's opinion that the partial presentation is presented in conformity with AICPA presenta-*

*tion guidelines and that the underlying assumptions provide a reasonable basis for the projection given the hypothetical assumptions.*

- For an agreed-upon procedures engagement
  - A statement that the report is intended solely for the specified users, and should not be used by others.
  - An enumeration of the procedures performed and a reference to conformity with the arrangements made with the specified users.
  - If the agreed-upon procedures are less than those performed in an examination, a statement that the work performed was less in scope than an examination of a partial presentation in accordance with AICPA standards, and
    - For forecasted information, a disclaimer of opinion on whether the presentation is in conformity with AICPA presentation guidelines and on whether the underlying assumptions provide a reasonable basis for the forecast.
    - *For projected information, a disclaimer of opinion on whether the presentation is in conformity with AICPA presentation guidelines and on whether the underlying assumptions provide a reasonable basis for the projection given the hypothetical assumptions.*
  - A statement of the accountant's findings.<sup>24</sup>

.32 Chapters 14, 17, and 21 of the Guide describe circumstances where the accountant's standard report on a financial forecast may require modification. The guidance for modifying the accountant's standard reports included in those sections is generally applicable to partial presentations. Also, depending on the nature of the presentation, the accountant may decide to disclose that the partial presentation is not intended to be a forecast of financial position, results of operations, or cash flows. The following are the forms of the accountant's standard report when he or she has compiled, examined, or applied agreed-upon procedures to a partial presentation.<sup>25</sup>

### **Compilation Report on a Partial Presentation of Forecasted Information**

We have compiled the accompanying forecasted statement of net operating income before debt service, depreciation, and income taxes of AAA Hotel for the year ending December 31, 19X1 (the forecasted statement) in accordance with guidelines established by the American Institute of Certified Public Accountants.

The accompanying forecasted statement presents, to the best of management's knowledge and belief, the net operating income before debt service, depreciation, and income taxes of AAA Hotel for the forecast period. It is not intended to be a forecast of financial position, results of operations, or cash flows. The

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<sup>24</sup> The accountant may wish to state in his or her report that he or she makes no representation about the sufficiency of the procedures for the specified users' purposes.

<sup>25</sup> These report forms are appropriate whether the presentations are based on generally accepted accounting principles or on an other comprehensive basis of accounting.

accompanying forecasted statement and this report were prepared for the ABC Bank for the purpose of negotiating a proposed construction loan to be used to finance expansion of the hotel and should not be used for any other purpose.

A compilation is limited to presenting forecasted information that is the representation of management and does not include evaluation of the support for the assumptions underlying such information. We have not examined the forecasted statement and, accordingly, do not express an opinion or any other form of assurance on the accompanying statement or assumptions. Furthermore, there will usually be differences between forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

### **Compilation Report on a Partial Presentation of Projected Information**

*We have compiled the accompanying sales projection of XYZ Company for each of the years in the three-year period ending December 31, 19X1 in accordance with guidelines established by the American Institute of Certified Public Accountants.*

*The accompanying sales projection presents, to the best of management's knowledge and belief, the Company's expected sales during the projection period that would result if the Company achieved a 15 percent market share of the electric toaster market, as disclosed in items b and c of the summary of significant assumptions. The sales projection and this report were prepared for presentation to the Board of Directors of XYZ Company for its consideration of a new marketing program and should not be used for any other purpose.*

*A compilation is limited to presenting projected information that is the representation of management and does not include evaluation of the support for the assumptions underlying such information. We have not examined the sales projection and, accordingly, do not express an opinion or any other form of assurance on the accompanying sales projection or assumptions. Furthermore, even if the Company attained the 15 percent market share of the electric toaster market, there will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.*

### **Examination Report on a Partial Presentation of Forecasted Information**

We have examined the accompanying forecasted statement of net operating income before debt service, depreciation, and income taxes of the AAA Hotel for the year ending December 31, 19X1 (the forecasted statement). Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecasted statement.

The accompanying forecasted statement presents, to the best of management's knowledge and belief, the expected net operating income before debt service, depreciation, and income taxes of AAA Hotel for the forecast period. It is not

intended to be a forecast of financial position, results of operations, or cash flows. The accompanying forecasted statement and this report were prepared for ABC Bank for the purpose of negotiating a proposed construction loan to be used to finance expansion of the hotel and should not be used for any other purpose.

In our opinion, the forecasted statement referred to above is presented in conformity with the guidelines for presentation of forecasted information established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecasted statement. However, there will usually be differences between forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

### **Examination Report on a Partial Presentation of Projected Information**

*We have examined the accompanying sales projection of XYZ Company for each of the years in the three-year period ending December 31, 19X1. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the sales projection.*

*The accompanying sales projection presents, to the best of management's knowledge and belief, the Company's expected sales during the projection period that would result if the Company achieved a 15 percent market share of the electric toaster market, as disclosed in items b and c of the summary of significant assumptions. The sales projection and this report were prepared for presentation to the Board of Directors of XYZ Company for its consideration of a new marketing program and should not be used for any other purpose.*

*In our opinion, the sales projection referred to above is presented in conformity with the guidelines for presentation of projected information established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's projection of expected sales during the period assuming the Company were to achieve a 15 percent market share of the electric toaster market. However, even if the Company achieves a 15 percent market share, there will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.*

### **Agreed-Upon Procedures Report on a Partial Presentation of Forecasted Information**

At your request, we have performed certain agreed-upon procedures, as enumerated below, with respect to the sales forecast of XYZ Company for the year ending December 31, 19X1. These procedures, which were specified by the Boards of Directors of XYZ Company and ABC Corporation, were performed solely to assist you, and this report is solely for your information and should not be used by those who did not participate in determining the procedures.

- a. We assisted the management of XYZ Company in assembling the sales forecast.

- b. We read the sales forecast for compliance in regard to format with the AICPA presentation guidelines for a partial presentation of forecasted information.
- c. We tested the sales forecast for mathematical accuracy.

Because the procedures described above do not constitute an examination of a presentation of forecasted information in accordance with standards established by the American Institute of Certified Public Accountants, we do not express an opinion on whether the sales forecast is presented in conformity with AICPA presentation guidelines or on whether the underlying assumptions provide a reasonable basis for the presentation.

In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the format of the sales forecast should be modified or that the presentation is mathematically inaccurate. Had we performed additional procedures or had we made an examination of the sales forecast in accordance with standards established by the American Institute of Certified Public Accountants, matters might have come to our attention that would have been reported to you. Furthermore, there will usually be differences between forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.<sup>26</sup>

## Effective Date

.33 The provisions of this statement are effective for engagements to provide services on prospective financial statements for internal use only and partial presentations beginning on or after July 1, 1990.

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<sup>26</sup> See footnote 13.



## Appendix

### Illustrations of Partial Presentations

**A1.** The illustrative partial presentations of prospective financial information included in the following pages are presented in conformity with the presentation guidelines of the Guide, although other presentation formats could also be consistent with the Guide. For example, it may be appropriate to present the summary of significant assumptions and accounting policies in a less formal manner than that illustrated, such as computer-printed output (indicating data and relationships) from "electronic worksheets" and general purpose financial modeling software, as long as the responsible party believes that the disclosures and assumptions presented can be understood by users.

**A2.** The following is a brief summary of the illustrative partial presentations presented below:

- a. Example 1 illustrates a sales forecast prepared for the purpose of negotiating a retail company's lease override provisions.
- b. Example 2 illustrates a forecasted statement of net operating income before debt service and depreciation in connection with the contemplated construction of a new sports arena.

#### Example 1

#### ABC Retail Company Statement of Forecasted Sales for Each of the Three Years Ending December 31, 19X3<sup>†</sup>

	<u>Years Ending December 31,</u>		
	<u>19X1</u>	<u>19X2</u>	<u>19X3</u>
Forecasted sales . . . . .	<u>\$629,000</u>	<u>\$679,000</u>	<u>\$726,000</u>

This sales forecast presents, to the best of management's knowledge and belief, expected sales during the forecast period. Accordingly, the sales forecast reflects its judgment as of February 14, 19X1, the date of this forecast, of the expected conditions and its expected course of action. The sales forecast is for use in negotiating the Company's lease override provisions and should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the sales forecast. There will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

This sales forecast is based upon an expected average rate of overall increase in market demand for the Company's products, sporting goods equipment, of 3 percent per year. During the past five years, market demand for sporting goods equipment has increased approximately 3 percent per year and the Company expects this rate of industry growth to remain steady throughout the forecast period. The sales forecast is also based upon an expected increase in the Company's market share in its geographical selling region to 23 percent by

<sup>†</sup> Note: The summary of significant accounting policies is not illustrated.

19X3, which represents a 6 to 7 percent increase in market share over the forecast period. The Company's market share during the past three years has increased one to two percentage points each year and the Company expects this rate of increase to continue during the forecast period. The sales forecast is also based upon an expected 4 to 5 percent increase in the rate of inflation for each of the next three years. The Company expects that it will be able to increase the prices of its products to cover increased costs due to inflation.

The Company plans to maintain its advertising and marketing programs at current levels and has retail-floor space available to provide for the increase in the number of products it expects to sell.

Example 2

MARS Arena  
Forecasted Statement of Net Operating Income  
Before Debt Service and Depreciation for  
Years Ending December 31, 19X1 and 19X2  
(In thousands)

	<i>Reference</i>	<i>19X1</i>	<i>19X2</i>
Operating revenues	C	\$2,700	\$2,600
Operating expenses			
Salaries and wages	D	1,050	1,100
Office and general	E	700	650
Utilities	F	500	510
Operations and maintenance	G	150	160
Total operating expenses		2,400	2,420
Net operating income before debt service and depreciation		\$ 300	\$ 180

See Accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

MARS Arena  
Summary of Significant Forecast  
Assumptions and Accounting Policies  
for Years Ending December 31, 19X1 and 19X2

The accompanying forecasted statement presents, to the best of management's knowledge and belief, MARS Arena's expected net operating income before debt service and depreciation for the two-year period ending December 31, 19X2. Accordingly, the forecasted statement reflects management's judgment as of August 29, 19X0, the date of this forecasted statement, of the expected conditions and its expected course of action. This presentation is intended for use by the City of MARS in evaluating financing alternatives in connection with the contemplated construction of the new arena and should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the forecasted statement. There will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

The forecasted statement presents net operating income before debt service and depreciation. Accordingly, it is not intended to be a forecast of financial position, results of operations, or cash flows.

## A. Description of the Project

The City of MARS plans to build a new 10,000-seat arena at the southeast intersection of Maxwell Road and Rugby Road to replace their existing 8,000-seat arena (the City's existing arena). MARS Arena will have 3,000 available parking spaces.

## B. Summary of Significant Accounting Policies

[not illustrated]

## C. Operating Revenues

There are four basic types of events forecasted to generate operating income: sporting events, family shows (for example, circus, ice shows), concerts, and exhibitions. The significant sources of revenue for each type of event include arena rental, parking fees, food and beverage concessions, novelty and souvenir income, and advertising. Attendance during the initial year of operations is forecasted to be greater than the second year based on the "bonus" a new arena can enjoy as patrons come to see the new facility as well as to see the event. A summary of operating revenue by type of event follows.

<u>Year 1</u>	<u>Event Days</u>	<u>Average Attendance</u>	<u>Total Attendance</u>	<u>Total Revenue</u>
Sporting events	70	4,000	280,000	\$ 860,000
Family shows	45	4,500	202,500	515,000
Concerts	30	8,500	255,000	1,025,000
Exhibitions	25	2,500	62,500	180,000
Advertising				120,000
Totals	<u>170</u>		<u>800,000</u>	<u>\$2,700,000</u>

<u>Year 2</u>	<u>Event Days</u>	<u>Average Attendance</u>	<u>Total Attendance</u>	<u>Total Revenue</u>
Sporting events	70	3,900	273,000	\$ 835,000
Family shows	45	4,300	193,500	490,000
Concerts	30	8,200	246,000	990,000
Exhibitions	25	2,200	55,500	160,000
Advertising				125,000
Totals	<u>170</u>		<u>767,500</u>	<u>\$2,600,000</u>

The bases for the significant income assumptions are discussed below.

**Arena Rental.** Management estimates that the new arena will schedule approximately 170 event days in a representative year consisting of seventy sporting events, forty-five family shows, thirty concerts, and twenty-five exhibitions. Event days were forecasted based on discussions with users (such as sporting teams and event sponsors) and market research and analysis performed by an independent consultant. Also, the City of MARS recently obtained a commitment from the local minor league hockey team to play their home games in MARS Arena.

MARS Arena will be rented out on the basis of a percentage of the dollars generated by ticket sales (called a "percentage of gross receipts") or a fixed rent (called a "flat rate"). The percentage of gross gate receipts accruing to the facility are based on current average percentages retained by the City's existing arena. These percentages range from 10 to 50 percent depending on the type of event. Management expects ticket prices to increase between 5 and 15 percent over prices at the City's existing arena, depending on the type of event, as a result of the new modernized facility. Ticket prices forecasted for each type of event have been compared with those received by other facilities for similar events. Flat rate rentals are usually negotiated by users who do not charge an admission price or have a series of events. The flat rate rental for MARS Arena is forecasted to be between \$1,000 and \$4,000 and is based on an analysis of rates charged by other comparable arenas for the types of events forecasted. Management does not anticipate an increase in ticket prices or flat rate rentals during the second year of operations.

***Parking Fees.*** Management will operate and maintain the parking facility and, accordingly, all revenues accrue to MARS Arena. Consistent with experience at the City's existing arena, management estimates that 75 percent of all patrons will arrive by car for each event. The forecasted information assumes each car will carry an average of 2.7 persons and average parking rates will be \$3.50 per car.

***Food and Beverage Concessions.*** Management has negotiated a contract with ABC Company to supply and manage the food and beverage concessions. Concession income is forecasted to be 30 percent of gross concession revenue generated at each event, based on the contractual agreement with ABC Company. MARS Arena will provide all equipment and personnel necessary to operate the concessions. Patron's forecasted average expenditure per type of event ranges from \$0.75 to \$3.00 and is based on an analysis of data for comparable events and facilities, including the City's existing arena.

***Novelty and Souvenir Income.*** Similar to food and beverage concessions, management has negotiated a contract with ABC Company to supply and manage the novelty and souvenir concessions. Novelty and souvenir income is forecasted to be 30 percent of gross novelty revenue based on the contractual agreement. MARS Arena will provide all equipment and personnel necessary to operate the novelty and souvenir stands. Patron's forecasted average expenditure per type of event ranges from \$0.00 to \$5.25 and is based on an analysis of data for comparable events and facilities.

***Advertising.*** Advertising income will be generated primarily from signage on the interior and exterior of MARS Arena. Revenues included in the forecasted information are based on the signage capacity of MARS Arena, contract negotiations to date, and advertising revenues at the City's existing arena.

## **D. Salaries and Wages**

The forecasted information assumes that management will make maximum use of full-time staff rather than subcontract out services, such as facility management and security. Personnel requirements are based on staffing organizations at similar sports arenas and public assembly facilities. Pay for hourly workers is based on local wage levels and wage rates being paid to employees of the City's existing arena. Wage levels are expected to increase approximately 4 percent in the second year.

Salaries are forecasted on an individual by individual basis using expected salary rates during the forecast period. Part-time salaries and wages are assumed to be event-related expenses and passed through to tenants, except for 15 percent, which is absorbed by MARS Arena.

### **E. Office and General Expenses**

Office and general expenses consist of insurance, advertising, fees for services, and other office and general expenses. Insurance expense is based on costs at the City's existing arena and a review of insurance coverage proposals that include estimates of general liability, fire, workers' compensation, auto-business, liquor liability and boiler-machinery coverage. Advertising expenses are based on costs incurred by the City's existing arena, the number and type of forecasted events, and expected price increases from advertising agencies. Advertising expenses are expected to be higher in the first year of operations in order to promote the new facility. Fees for services include, but are not limited to, consulting fees, legal fees, and accounting and auditing fees. These fees are estimated based on expenses of the City's existing arena and plans by management to engage consultants to assist in starting up operations. Other office and general expenses are based on experience at comparable facilities and on costs incurred by the City's existing arena.

### **F. Utilities**

Utility expense has been estimated by the project team architects and engineers. Utilities expense includes fuel and gas, electricity, water, and sewer costs.

### **G. Operations and Maintenance Expenses**

Operations and maintenance expenses were estimated based on the requirements of facilities similar in construction and design, age, and intended use.

**Forecasts and Projections Task Force  
(1989)**

KENNETH J. DIRKES, *Chairman*  
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HARVEY J. GITEL  
ROBERT W. BERLINER  
ERNEST L. TEN EYCK  
RICHARD M. STEINBERG  
DON PALLAIS  
DAVID KUTSCHER

BRUCE BALTIM  
GERALD N. TUCH

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DAN M. GUY, *Vice President*  
*Auditing Standards*  
MIMI BLANCO-BEST, *Manager*  
*Auditing Standards*

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[The next page is 30,501.]

## Section 11,160

# **Statement of Position 90-2 Report on the Internal Control Structure<sup>\*</sup> in Audits of Futures Commission Merchants**

February, 1990

### **NOTE**

This statement of position presents the recommendations of the AICPA Stockbrokerage and Investment Banking Committee regarding the application of generally accepted auditing standards to reporting on the internal control structure in audits of futures commission merchants. It represents the considered opinion of the committee on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

## **Introduction**

[.01-.02] [Paragraphs deleted to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

## **Report on Internal Control Required by CFTC Regulation 1.16**

.03 The following is an illustration of the independent auditor's report on the internal control structure required by CFTC Regulation 1.16:

Board of Directors  
ABC Commodities Corporation

In planning and performing our audit of the consolidated financial statements of ABC Commodities Corporation (the "Corporation") for the year ended December 31, 19X1, we considered its internal control structure, including procedures for safeguarding customer and firm assets, in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on the internal control structure.

Also, as required by Regulation 1.16 of the Commodity Futures Trading Commission, we have made a study of the practices and procedures (including tests of compliance with such practices and procedures) followed by the Corporation that we considered relevant to the objectives stated in Regulation 1.16

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\* Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, revises the definition and description of internal control and makes conforming changes to relevant terminology. This SOP will be amended to conform to SAS No. 78 in a future edition of *Technical Practice Aids*.

in making (1) the periodic computations of minimum financial requirements pursuant to Regulation 1.17, (2) the daily computations of the segregation requirements of section 4d(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based on such computations, and (3) the daily computations of the foreign futures and foreign options secured amount requirements pursuant to Regulation 30.7 of the Commission.

The management of the Corporation is responsible for establishing and maintaining an internal control structure and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the Commission's above mentioned objectives. Two of the objectives of an internal control structure and the practices and procedures are to provide management with reasonable, but not absolute, assurance that assets for which the Corporation has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles. Regulation 1.16 lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in any internal control structure or the practices and procedures referred to above, errors or irregularities may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure, including procedures for safeguarding customer and firm assets, that we consider to be material weaknesses as defined above.<sup>1</sup>

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the Commission to be adequate for its purposes in accordance with the Commodity Exchange Act and related regulations, and that practices and procedures that

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<sup>1</sup> If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fifth paragraph of the report should be modified as follows:

However, we noted the following matters involving the [(control environment, accounting system, control procedures, or procedures for safeguarding customer and firm assets)] and its [(their)] operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the consolidated financial statements of the Corporation for the year ended December 31, 19X1, and this report does not affect our report thereon dated February 15, 19X2. [A description of the material weaknesses that have come to the auditor's attention and corrective action would follow.]



do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Corporation's practices and procedures were adequate at December 31, 19X1, to meet the Commission's objectives.<sup>2</sup>

This report is intended solely for the use of management, the Commodity Futures Trading Commission, and other regulatory agencies that rely on Regulation 1.16 of the Commodity Futures Trading Commission and should not be used for any other purpose.

Accounting Firm

New York, New York  
February 15, 19X2

## Effective Date

.04 This statement is effective for reports issued on or after March 1, 1990, with early application permissible.

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<sup>2</sup> Whenever inadequacies are described, the report should include the last sentence of the fifth paragraph as modified in the note above. The report should also describe material inadequacies the auditor becomes aware of that existed during the period but were corrected prior to the end of the period unless management already has reported them to the CFTC.

## Stockbrokerage and Investment Banking Committee (1989-1990)

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DAN M. GUY,  
*Vice President, Auditing*  
PATRICK L. MCNAMEE, *Director*  
*Audit and Accounting Guides*  
ALBERT GOLL,  
*Technical Manager*  
*Accounting Standards*

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[The next page is 30,521.]

## Section 11,220

# Statement of Position 92-2 Questions and Answers on the Term Reasonably Objective Basis and Other Issues Affecting Prospective Financial Statements

February, 1992

### NOTE

This Statement of Position presents the recommendations of the Forecasts and Projections Task Force regarding accountants' services on prospective financial information. It also includes recommendations regarding presentation and disclosure of prospective financial information. AICPA members may have to justify departures from the recommendations in this Statement of Position if their work is challenged.

## Responsible Party's Basis for Presenting a Financial Forecast

### Question

.01 Paragraph 7.03 of the *AICPA Guide for Prospective Financial Statements* (the Guide) requires a responsible party to have a reasonably objective basis for presenting a financial forecast.<sup>1</sup> What is the purpose of the term *reasonably objective basis*?

### Answer

.02 Financial forecasts are presentations of information about the future and are inherently less precise than information reporting past events. That "softness" of forecasted data is communicated to users of financial forecasts in the introduction to the summary of significant assumptions by including a caveat that the forecasted results may not be achieved.<sup>2</sup> Nevertheless, financial forecasts present, to the best of the responsible party's knowledge and belief, the entity's expected financial position, results of operations, and changes in financial position (cash flows).

.03 Because users expect financial forecasts to present the responsible party's "best estimate," the term *reasonably objective basis* was included in the Guide to communicate to responsible parties a measure of the quality of information necessary to present a forecast.

<sup>1</sup> This guidance applies only to financial forecasts. As discussed in paragraph 7.01P of the Guide, the responsible party does not need a reasonably objective basis for hypothetical assumptions used in a financial projection. However, this guidance should be useful in evaluating whether other assumptions used provide a reasonable basis for a projection, given the hypothetical assumptions.

<sup>2</sup> Paragraph 8.29 of the Guide illustrates the type of caveat to be included: "There will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material."

## Question

.04 In addition to establishing the term *reasonably objective basis*, the Guide indicates that the responsible party should develop appropriate assumptions to present a financial forecast (see paragraphs 6.30 through 6.36 of the Guide). How does a responsible party evaluate whether a reasonably objective basis exists for a financial forecast and whether the assumptions underlying a particular forecast are appropriate?

## Answer

.05 Considerable judgment is required to evaluate whether a reasonably objective basis exists to present a financial forecast. Accordingly, the responsible party should possess or obtain a sufficient knowledge of the reporting entity's business and industry to make the evaluation.

.06 Paragraph 4.07 of the Guide states that the responsible party has a reasonably objective basis for presenting a financial forecast if sufficiently objective assumptions can be developed for each key factor. (Paragraph 3.11 of the Guide defines *key factors* as the significant matters on which the entity's future results are expected to depend. Such factors are basic to the entity's operations and, thus, encompass matters that affect, among other things, its sales, production, service, and financing activities.) The following matters should be considered when evaluating whether such assumptions can be developed:

- Can facts be obtained and informed judgments be made about past and future events or circumstances in support of the underlying assumptions?
- Are any of the significant assumptions so subjective that no reasonably objective basis could exist to present a financial forecast?<sup>3</sup>
- Would people knowledgeable in the entity's business and industry select materially similar assumptions?
- Is the length of the forecast period appropriate?<sup>4</sup>

Other matters that responsible parties should consider when evaluating whether sufficiently objective assumptions can be developed are shown in the exhibit [paragraph .08].

.07 The evaluation of whether sufficiently objective assumptions can be developed for each key factor should be made within the following context:

- A factor is evaluated by considering its significance to the entity's plans as well as the dollar magnitude and pervasiveness of the related assumption's potential effect on forecasted results (for example, whether assumptions developed would materially affect the amounts and presentation of numerous forecasted amounts).
- The responsible party's consideration of which key factors have the greatest potential impact on forecasted results is a matter of judgment.

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<sup>3</sup> For example, the responsible party might have no reasonably objective basis for presenting a forecast that includes royalty income from products not yet invented or revenue from a thoroughbred being reared to race. In such cases, it would be inappropriate to present a forecast because of the lack of a reasonably objective basis.

<sup>4</sup> See paragraphs .44 through .46 of this Statement of Position (SOP).

ment, and is influenced by his or her perception of the needs of a reasonable person relying on the financial forecast. A key factor having the greatest potential impact on forecasted results is one in which an omission or misstatement of the related assumption would probably, in light of surrounding circumstances, change or influence the judgment of a reasonable person relying on the financial forecast.<sup>5</sup>

- The responsible party should seek out the best information that is reasonably available to develop the assumptions. Cost alone is an insufficient reason not to acquire needed information. However, the cost of incremental information should be commensurate with the anticipated benefit.
- A conclusion that a reasonably objective basis exists for a forecast may be easier to support if the forecast were presented as a range.

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<sup>5</sup> The more likely it is that an assumption will have a significant effect on the overall forecasted results and that the factors relating to the assumption indicate a less objective basis, the more likely it is that the forecast should be judged as not having a reasonably objective basis.

.08

Exhibit

Sufficiently Objective Assumptions—Matters to Consider

<i>Basis</i>	<i>Less Objective</i>	<i>More Objective</i>
Economy	Subject to uncertainty	Relatively stable
Industry	Emerging or unstable; high rate of business failure	Mature or relatively stable
Entity:		
• Operating history	Little or no operating history	Seasoned company; relatively stable operating history
• Customer base	Diverse, changing customer group	Relatively stable customer group
• Financial condition	Weak financial position; poor operating results	Strong financial position; good operating results
Management's experience with:		
• Industry	Inexperienced management	Experienced management
• The business and its products	Inexperienced management; high turnover of key personnel	Experienced management
Products or services:		
• Market	New or uncertain market	Existing or relatively stable market
• Technology	Rapidly changing technology	Relatively stable technology
• Experience	New products or expanding product line	Relatively stable products
Competing assumptions	Wide range of possible outcomes	Relatively narrow range of possible outcomes
Dependency of assumptions on the outcome of the forecasted results*	More dependency	Less dependency

\* Assumptions may depend on the achievement of other forecasted results. For example, the sales price of a real estate property in a forecast might be estimated by applying a capitalization rate to forecasted cash flows.

.09 As stated earlier, in addition to requiring a reasonably objective basis, the Guide requires a responsible party to develop appropriate assumptions to present a financial forecast. When evaluating whether assumptions underlying the financial forecast are appropriate, the responsible party should consider numerous factors, including whether—

- There appears to be a rational relationship between the assumptions and the underlying facts and circumstances (that is, the assumptions are consistent with past or current conditions).
- The assumptions are complete (that is, assumptions have been developed for each key factor).
- It appears that the assumptions were developed without undue optimism or pessimism.
- The assumptions are consistent with the entity's plans and expectations.
- The assumptions are consistent with each other.
- The assumptions, in the aggregate, make sense in the context of the forecast taken as a whole.

Assumptions that have no material impact on the presentation may not have to be evaluated individually; however, the aggregate impact of individually insignificant assumptions should be considered in making an overall evaluation of whether the assumptions underlying the forecast are appropriate.

.10 The following examples illustrate the facts and circumstances considered by the responsible party when evaluating whether there was a reasonably objective basis to present a financial forecast.

### **Example 1**

#### **Company Profile**

.11 An established builder of single-family homes has built two garden-apartment complexes in the last three years. This developer plans to build another garden-apartment complex and wishes to syndicate the project. Both of the existing garden-apartment complexes are approaching full occupancy. The local economy is strong and has a diversified base. Furthermore, real estate in the area generally appreciates in value. There has been significant development in the area and, if it continues, supply will exceed demand within four years. The developer has appropriately considered this factor, as well as the associated cost of maintaining the proposed facility, in planning the project and developing the forecast.

.12 In the past, the developer had financed each of his projects for five years at the maximum amount allowed by local financial institutions. Forecasts for the previous two projects assumed a five-year financing period and a hypothetical sale of the property at the end of the forecast period. For the proposed development, the developer has obtained a commitment for a three-year interest-only loan for an amount equal to 70 percent of the project's estimated cost. Current discussions with bankers have indicated their willingness to convert that loan to long-term financing for the project after rental stabilization, which is consistent with normal lending practices. The developer

has indicated that he plans to refinance the committed loan after three years for an amount that exceeds the loan by approximately 76 percent. Such additional amounts (net of refinancing costs) are to be returned to the investors as a cash distribution. The developer's other resources are not sufficient to provide a meaningful guarantee of the refinancing. The forecast will be for five years, and will include a projection illustrating a hypothetical sale at the end of the forecast period. The details can be summarized as follows:

	<i>(In thousands)</i>
• Estimated cost of the development to the partnership	<u>\$10,000</u>
• Committed financing (interest-only loans) at 70 percent of the estimated cost	<u>\$ 7,000</u>
• Proposed limited partnership investment	<u>\$ 3,000</u>
• Amount of proposed refinancing:	
— Long-term refinancing of the three-year committed loan	\$ 7,000
— Additional financing for payments to limited partners	5,000
— Cost of refinancing	300
	<u>\$12,300</u>
• Forecasted cash flow before debt service for the fourth year	<u>\$ 1,500</u>
• Capitalization rate (considered in this example to be acceptable under the circumstances)	<u>9%</u>
• Capitalized value at the end of the third year	<u>\$16,700</u>

## Question

.13 Does the developer (the responsible party) have a reasonably objective basis for forecasting the proposed refinancing?<sup>6</sup>

## Answer<sup>7</sup>

.14 This question can be divided into two further questions:

- a. Can the developer forecast a refinancing?
- b. Are the assumptions about the amount and terms of the refinancing sufficiently objective?

.15 *Forecast of Refinancing.* The developer has obtained a financing commitment for three years based on local lending practices, and bankers have indicated a willingness to provide permanent financing in a manner that is consistent with these lending practices. Accordingly, it appears that the developer would have a reasonably objective basis for forecasting the project's refinancing for a comparable amount in three years.<sup>8</sup> At that time, the building

<sup>6</sup> See paragraphs .57 and .58 of this SOP for a discussion of the responsibility that an accountant engaged to compile or examine a financial forecast has to evaluate whether a responsible party has a reasonably objective basis for presenting a financial forecast.

<sup>7</sup> This response is based on information presented in the question. Other information, such as that about the size and strength of the local economy, the precise location of the project, local planning regulations, and the availability of third-party guarantees on the proposed refinancing, could change the response.

<sup>8</sup> Support for forecasted interest rates may exist in the form of interest-rate forecasts and current interest-rate trends. If interest-rate fluctuations are a concern, a conclusion that sufficiently objective interest assumptions could be developed may be easier to support if forecasted results are presented as a range (through the use of a range forecast).



will still be considered relatively new and, based on maintenance plans, should be in good condition. Further, real estate in the area generally is expected to appreciate in value, and forecasted cash flows before debt service are consistent with a refinancing assumption.

**.16 Amount and Terms of Refinancing.** Although the developer may have a reasonably objective basis for a forecast that includes a refinancing for an amount approximating the original loan, it is not clear that such a basis exists for one that includes a refinancing significantly in excess of that amount. The following factors should be considered:<sup>9</sup>

- Although the local economy is strong and diversified, competing developments are being built and, in fact, there is some risk that supply could exceed demand.
- The developer has factored the effect of an increase in the supply of competing housing units into the forecast and may point to an estimated value of the project at the end of the third year, based on the application of a current capitalization rate to forecasted cash flows. However, capitalization rates may vary over time, and estimated values derived from the application of capitalization rates depend on the achievement of prospective cash flows.
- The developer is an experienced builder; however, both his experience with larger projects and his resources are limited.

**.17** In light of the facts presented, it appears that the developer's basis for refinancing the project at an amount significantly greater than the original loan would be highly dependent on future events and circumstances, such as anticipated cash flows, economic conditions, lending practices, and capitalization rates. Although forecasted results may be used as a basis for a refinancing assumption, in the absence of other supporting information, such results ordinarily would not provide a responsible party with a basis for concluding that the refinancing assumption was sufficiently objective. In this case, the developer's limited resources and the length of time until the refinancing is expected to take place are all risk factors that mitigate a reliance on forecasted results to provide support for the developer's assertion that a reasonably objective basis exists for the refinancing. Accordingly, in the absence of additional information, the facts in this case do not appear to support the developer's assertion that a reasonably objective basis exists for presenting a forecast that includes the proposed refinancing assumption.<sup>10</sup>

## Example 2

### Company Profile

**.18** ACTech, Inc. was established to produce a line of flat-panel, AC-plasma computer-display products for use when, because of their bulk and thickness, cathode-ray tubes (CRTs) would not be suitable. The company was incorporated in 19X0 by former members of a management team (the founders) who designed the product and operated the business as a division of BigCo. The

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<sup>9</sup> These items were developed by reference to the factors included in the exhibit [paragraph .08].

<sup>10</sup> In this example, the developer could consider including a refinancing for the committed amount (\$7,000,000) in the forecast, and supplementing the forecast with a financial projection illustrating prospective results if the permanent financing obtained were for the greater amount (\$12,300,000).

founders have purchased equipment and certain technology at a significant discount from BigCo with \$1 million in funds raised from private investors. ACTech's goal is to become a leader in the production and sale of AC-plasma-display products by utilizing newly developed but unproven technology to lower the cost of production and thereby compete more effectively with DC-plasma-display products. DC products are currently in common usage because of their lower unit cost, but they are inferior to AC-plasma-display products in brightness and resolution.

**.19 *Product Line and Competition.*** The mainstay of the ACTech product line will be a "plasma display system," which combines the AC-plasma-display panels with new low-cost drive circuitry. When compared to the most competitive product, the DC-plasma-display, ACTech's product is three times as bright with no flicker, consumes half the power for an equivalent level of light output, has a wider viewing angle, can be produced in much larger sizes, and has a longer life. DC panels are currently cheaper to produce, but with ACTech's circuitry and manufacturing expertise, management hopes to close the cost gap. ACTech is currently working on the implementation of its new technology. Prototypes have been successfully produced, but management estimates that, using the equipment purchased from BigCo, it will need about a year to design and install a high-volume production line.

**.20** Competition from other AC-plasma-display manufacturers will come primarily from ACpan, a very large manufacturer that uses most of its output in its own products. ACpan AC-plasma displays have been available for the past five years and are comparable in quality to those of ACTech. Despite continued efforts, ACpan has achieved very little market penetration because, like ACTech and other producers of AC-plasma-displays, ACpan has not been able to successfully design and install a high-volume production line. If successfully developed, ACTech's manufacturing process and the low-cost drive circuits will permit it to compete advantageously with ACpan. Other manufacturers of AC-plasma-displays charge prices that are higher than those of the ACpan products and cater to military and specialty markets. In the market for large-sized screens, management believes that there is no effective flat-panel competition.

**.21** Additionally, ACTech has received oral assurances from BigCo that it will purchase plasma displays from ACTech in sufficient quantities to meet its needs, which would account for about 5 percent of ACTech's estimated sales.

**.22 *Sales and Marketing.*** ACTech will sell primarily to equipment manufacturers via an internal sales force. Additionally, ACTech will utilize manufacturer's representatives or sales organizations to penetrate selected foreign markets. ACTech's products will be demonstrated at various trade shows and will be advertised in the appropriate trade journals.

**.23** ACTech has targeted specific markets for its primary growth. These markets include those for (a) mainframe interactive applications (ACTech, when it was a division of BigCo, had already established a small market in this area), (b) portable personal computers (ACTech is currently involved in discussions with several large companies in this market), (c) CAD/CAM/CAE workstations (ACTech is currently involved in discussions with producers serving both financial and design markets), and (d) manufacturing control products (ACTech is working with a company that uses a plasma panel with a touch screen to support the manufacturing process).

.24 ACTech has estimated sales of approximately \$600,000 in 19X2, \$16 million in 19X3, and \$40 million in 19X4. At anticipated levels of industry growth (provided from an outside source), these sales figures represent 0.3 percent, 6 percent, and 11 percent of the plasma-panel market, respectively.

.25 *Product Manufacture.* Management believes that the equipment purchased from BigCo by the founders is state of the art. ACTech is in the process of relocating the equipment to a new facility and setting up a modern, automated production line. This new facility, which requires some renovation, will allow ACTech to begin production on a limited scale in about six months. Ample room exists for future expansion. No significant problems are expected in relocating and setting up the new facility, assuming that design problems related to high-volume production can be overcome.

.26 Production is expected to be at 500 AC-plasma display-system units in 19X2, growing to 36,000 in 19X3 and 115,000 in 19X4.

.27 *Management and Personnel.* The ACTech management team is recognized throughout the computer industry as a leader in plasma-display technology and manufacturing. Together, the four founders have over fifty years of experience in the field of flat-panel displays. Additionally, the founders have demonstrated significant academic and manufacturing achievements in the field of display technology. At present, ACTech has three full-time and eleven part-time employees. Management plans to hire an additional thirty-five employees during 19X2, including three marketing and sales employees.

.28 Management expects employment to grow to about 250 by 19X4. Although production employees must be hired and trained, the labor market is sufficient to supply an adequate labor force with the basic technical skills needed to perform the required tasks, and management has experience in training. Further, management has had discussions with several candidates for the sales positions and does not anticipate difficulties in hiring qualified staff.

## Question

.29 Does management have a reasonably objective basis for presenting a financial forecast?<sup>11</sup>

## Answer<sup>12</sup>

.30 ACTech, Inc.'s financial forecast is based on two primary assumptions: (a) the successful design and installation of a high-volume production line, which would enable the company to significantly reduce unit costs; and (b) the timing and quantity of sales.

.31 *High-Volume Production.* ACTech is planning to manufacture and sell AC-plasma-display products for use in computer terminals. Its success will be highly dependent on its ability to produce those products in large quantities for sale at a price competitive with DC-plasma products. Although prototypes of the company's products have been produced, circuitry compatible with high-

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<sup>11</sup> See footnote 6 of this SOP.

<sup>12</sup> This response is based on information presented in the question. Other information about the status of engineering plans, the preproduction models, and marketing results could change the response. The response was developed by referring to the factors included in the exhibit (paragraph .08).

volume production has been developed, and experienced management has been hired, the company has yet to design and install the planned high-volume production line. As indicated previously, management's current estimate is that it will be at least twelve months before that work is completed. Further, the facts presented indicate that other manufacturers of AC-plasma-display units have not been successful in reducing production costs. BigCo's willingness to sell its AC-plasma-display division may also indicate uncertainty about its ability to reduce production costs.

.32 For the reasons discussed in the preceding paragraph, management's assumption that it will be able to achieve high-volume, low-cost production is relatively subjective. That assumption is critical to the company's sales assumptions, which depend on the reduction of production costs to a level that permits a pricing structure competitive with that of DC-plasma units. Without a competitive pricing structure, the company's sales assumptions do not appear to be valid. Accordingly, ACTech does not appear to have a reasonably objective basis for presenting a financial forecast.

.33 *Other Matters.* If the feasibility of establishing a high-volume production line capable of producing AC-plasma units at a cost that permits ACTech to competitively price its product could be reasonably assured, a reasonably objective basis might exist for presenting a financial forecast. Before that conclusion can be reached, consideration should be given to ACTech's assumptions regarding market penetration. ACTech has developed a sales and marketing plan; however, questions exist concerning its assumptions of an aggressive market penetration (for example, capturing 11 percent of the plasma-panel market by the end of 19X4). There are several factors that appear to support its sales assumption: the technological superiority of its products, competitive pricing, management's experience with the products, and the acceptability of the product to current users, such as BigCo. Nevertheless, it would be appropriate to gather additional information concerning marketing results to date before concluding whether a sufficiently objective basis exists for the assumptions regarding market penetration. Further, uncertainty concerning the company's sales assumptions may indicate that such assumptions would be easier to support if a range forecast were presented. (Exhibit 8.09 of the Guide illustrates a range forecast.)

### Example 3

#### Company Profile

*[Note: As indicated in paragraph .46 of this SOP, it may be difficult to support an assertion that a reasonably objective basis exists for presenting a financial forecast for certain start-up companies. The following example illustrates a situation in which a two-year forecast for a start-up company may be appropriate.]*

.34 Newco was established to manufacture wall panels with self-contained insulation for use in commercial and industrial projects. The panels provide a lightweight interior and exterior wall combination. The company was incorporated in 19X0 by a former executive of one of the leaders in the wall-panel market, and by an individual who helped develop the original technology ten years ago (the founders). The founders have invested \$1,000,000, which was used to order initial equipment and lease a building. Newco has sufficient capital to operate during the forecast period.

.35 Although more expensive than those using traditional materials, the panels have proven to be easier to install than rolled or blown-in insulation and

wall surface combinations. Therefore, the use of the insulated wall panels in construction has been increasing. Competitors in the wall-panel market include two divisions of publicly held corporations that produce the panels, along with a variety of other construction materials, in a number of plants. These competitors generally service the large-project market and are known to have significant backlogs. From interviews with industry sources, it has been determined that these companies have been unable to respond to small or rush orders. Newco believes that, as an entrepreneurial company having low overhead and specializing in one product, it can service the small-order market effectively and profitably.

.36 Sales would be generated through bid contracts advertised by a clearinghouse that provides information to contractors and through the establishment of long-term relationships with engineering and architectural professionals. After lengthy correspondence with these professionals, Newco has obtained commitments for approximately 5 percent of its production capacity for 19X1 and 19X2 (about 25 percent and 15 percent of forecasted sales in 19X1 and 19X2, respectively). In addition, the initial equipment installation has allowed Newco to respond to selected advertised bids and obtain contracts for one-third of the opportunities pursued. These contracts account for 10 to 12 percent of the plant's capacity and extend through 19X2 (representing 50 percent and 35 percent of forecasted sales in 19X1 and 19X2, respectively). Newco plans to expand its sales force to enable it to respond to additional opportunities.

.37 In estimating its sales, Newco considered the growth in the construction market, the increasing conversion to manufactured wall panels, its success rate in bidding opportunities, the planned growth in its sales force, and the number of orders received to date. Newco has estimated sales of approximately 20 and 33 percent of production capacity in 19X1 and 19X2, respectively. These sales figures would represent market shares of 2 to 3 percent of the bid market for insulated wall panels. In addition to clearinghouse data used to assess market growth and size, management has considered industry sources that provide significant information on construction and usage potentials in making its sales estimates.

.38 The application of the technology involved in the production process continues to serve as a deterrent to entering the small-order market. Newco's initial investment has allowed for limited-scale production, and no significant problems are expected in obtaining the additional equipment and achieving forecasted capacity. Further, the company has been able to manufacture a quality product within its range of estimated costs.

.39 The founders are recognized within the industry for their technological and manufacturing expertise. Management has hired financial and production management executives, and is in the process of making its selection of three additional salespeople from a number of candidates experienced in the industry. Although additional production employees must be hired and trained, the labor market is sufficient to supply an adequate labor force with the basic technical skills needed to perform the required tasks.

## Question

.40 Does management have a reasonably objective basis for presenting a financial forecast for 19X1 and 19X2?<sup>13</sup>

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<sup>13</sup> See footnote 6 of this SOP.

**Answer<sup>14</sup>**

.41 Yes. Given the facts in this case, it appears that Newco has a reasonably objective basis for forecasting its operations for the years 19X1 and 19X2.

.42 Newco's product currently exists in the market and represents a technologically proven alternative that competes with similar technologies and alternatives based upon price. Further, the quality of its production and costs incurred to date have been in line with management's expectations. Accordingly, Newco's ability to forecast operating results depends on the primary assumption of the timing and quantity of sales.

.43 Management's ability to identify competitors, analyze customers' buying motives, and evaluate the market as well as the potential end usage demand are important determinants in forecasting sales. However, it is management's demonstrated success in identifying and establishing a specific customer base and in establishing a bidding track record that provides an important validation of its assessments of competition, pricing, and industry practices; it also provides the basis for management's sales forecast capabilities. Current contracts and commitments would account for a substantial portion of forecasted sales for 19X1 and 19X2, and the company's bidding success rate, coupled with the imminent hiring of experienced sales personnel, appears to provide a basis for estimated increases in sales during those years.

## **Consideration of the Length of the Forecast Period**

**Question**

.44 In practice, financial forecasts have been presented for various periods of time, some of which exceed ten years. What factors should be considered in determining the time period to be covered by a financial forecast?

**Answer**

.45 The Guide does not specify any fixed minimum or maximum time period to be covered by a financial forecast. The period that appropriately may be covered depends to a large extent on the particular circumstances of the company involved.<sup>15</sup> In evaluating the period to be covered by a forecast, the responsible party should balance the information needs of users with his or her ability to estimate prospective results; however, a reasonably objective basis should exist for each forecasted period (month, quarter, or year) presented.<sup>16</sup>

.46 In order to be meaningful to users, the presentation of a financial forecast ordinarily should cover at least one full year of normal operations.<sup>17</sup> However, the degree of uncertainty generally increases with the time

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<sup>14</sup> This response is based on information presented in the question. Other information, such as that about the economy and its effect on Newco's industry and its forecasted results, could change this response. The response was developed by reference to the factors included in the exhibit [paragraph .08].

<sup>15</sup> SEC Regulation S-K, 229.10(b)(2) states that, for certain companies in certain industries, a (forecast) covering a two- or three-year period may be entirely reasonable. Other companies may not have a reasonable basis for (forecasts) beyond the current year. Accordingly, the responsible party should select the period most appropriate in the circumstances.

<sup>16</sup> See question entitled "Periods Covered by an Accountant's Report on Prospective Financial Statements," included in SOP 89-3, *Questions Concerning Accountants' Services on Prospective Financial Statements* [section 11,110.21 through .23].

<sup>17</sup> [Deleted.]

span of the forecast, and at some point, the underlying assumptions may become so subjective that no reasonably objective basis may exist for presenting a financial forecast. It ordinarily would be difficult to establish that a reasonably objective basis<sup>18</sup> exists for a financial forecast extending beyond three to five years,<sup>19</sup> and depending on the circumstances, a shorter period may be appropriate (for example, in the case of certain start-up or high-tech companies it may be difficult to support an assertion that a reasonably objective basis exists to present a financial forecast and, if so, for more than one year). If it is not practical to present a financial forecast for enough future periods to demonstrate the long-term results of an investment or other decision, the presentation should include a description of the potential effects of such results.<sup>20</sup>

## Disclosure of Long-Term Results

### Question

.47 Paragraph 8.34 of the Guide states that short-term forecasts may not be meaningful in situations in which long-term results are necessary to evaluate the investment consequences involved. However, because uncertainty generally increases with the time span, it may not be practical in all situations to present financial forecasts for enough future periods to demonstrate long-term results.<sup>21</sup> In those circumstances, the presentation should include a description of the potential effects of such results. What form of disclosure would be appropriate in such circumstances when a financial forecast for general use will be presented?

### Answer

.48 The Guide does not provide a standard format for disclosures<sup>22</sup> intended to demonstrate operating or other results beyond the forecast period (that is, post-forecast-period disclosures),<sup>23</sup> because it is not possible to anticipate all the circumstances that might arise in practice. However, such disclosures should be based on the responsible party's plans and knowledge of specific events or circumstances, at the date of the forecast, that are expected to have a material effect on results beyond the forecast period.

.49 Specific plans, events, or circumstances that might be disclosed include the following:

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<sup>18</sup> See paragraphs .01 through .43 of this SOP for a discussion of factors to be considered when evaluating whether a reasonably objective basis exists to present a financial forecast.

<sup>19</sup> Financial forecasts for longer periods may be appropriate, for example, when long-term leases or other contracts exist that specify the timing and amount of revenues, and when costs can be controlled within reasonable limits.

<sup>20</sup> See paragraph 8.34 of the Guide and paragraphs .47 through .56 of this SOP.

<sup>21</sup> See paragraphs .44 through .46 of this SOP for a discussion of matters to consider when evaluating the length of a forecast period.

<sup>22</sup> Exhibit 9.10 of the Guide illustrates a disclosure that is appropriate for describing long-term results of certain real estate projects. That illustration includes a projection that discloses the effect on limited partners of a hypothetical sale of the property at the end of the forecast period.

<sup>23</sup> Paragraph 4.05 of the Guide states that "because a financial projection is not appropriate for general use, it should not be distributed to those who will not be negotiating directly with the responsible party . . . unless the projection is used to supplement a financial forecast and is for a period covered by the forecast." A financial projection is defined in paragraph 3.05 of the Guide as prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and changes in financial position (cash flows), given one or more hypothetical assumptions.

- Scheduled increases in loan principal
- A planned refinancing
- Existing plans for future expansion of production or operating facilities or for the introduction of new products
- Expiration of a significant patent or contract
- The expected sale of a major portion of an entity's assets<sup>24</sup>
- Scheduled or anticipated taxes that have adverse consequences for investors

.50 Disclosures may be limited to a narrative discussion of the responsible party's plans, or they may include estimates of expected effects of future transactions or events. In all cases, however, the disclosure should be included in, or incorporated by a reference to, the summary of significant assumptions and accounting policies. It should also—

- Include a title indicating that it presents information about periods beyond the financial forecast period.
- Include an introduction indicating that the information presented does not constitute a financial forecast and indicating its purpose.
- Disclose significant assumptions and identify those that are hypothetical, as well as the specific plans, events, or circumstances that are expected to have a material effect on results beyond the forecast period.
- State that (a) the information is presented for analysis purposes only, (b) there is no assurance that the events and circumstances described will occur, and (c) if applicable, the information is less reliable than the information presented in the financial forecast.

.51 The purpose of the disclosures discussed herein is to provide users with additional information useful in analyzing forecasted results. However, the information relates to periods beyond the forecast period, and management generally does not have a reasonably objective basis for presenting it as forecasted information. Accordingly, the disclosures are less reliable than those that are included in a financial forecast. Such disclosures should not be presented comparatively to forecasted results on the face of the financial forecast or in related summaries of results (for example, in a summary of investor benefits), or as a financial projection,<sup>25</sup> since such presentations could be misleading. The following examples illustrate the types of disclosures that may be appropriate.

### Example 1

*Note A: Supplemental Information Related to the Three Years Ending December 31, 19X8*<sup>26</sup>

<sup>24</sup> See footnote 22 of this SOP.

<sup>25</sup> Paragraph 3.05 of the Guide provides the definition of a financial projection. Paragraph 4.05 states that a financial projection is not appropriate for general use unless it supplements a financial forecast and is for a period covered by the forecast. SOP 89-3, *Questions Concerning Accountants' Services on Prospective Financial Statements* (section 11,110), provides guidance for reporting on a projection that supplements a financial forecast and is for a period covered by the forecast.

<sup>26</sup> See exhibit 9.10 of the Guide and SOP 89-3 (section 11,110) for an alternate presentation of long-term results when a projection is used to supplement a financial forecast and is for a period covered by the forecast (for example, the projected sale of real estate on the last day of the forecasted period).



While management is unable to prepare a financial forecast for the three-year period ending December 31, 19X8, it believes that the following information is necessary for users to make a meaningful analysis of the forecasted results.

Management's forecast anticipates operation of each of the three properties described therein during the five-year period ending December 31, 19X5. Current plans are to continue operation of all three properties through December 31, 19X8, at which time the properties will be offered for sale. The following table illustrates the pre-tax effect to limited partners of a sale of properties at December 31, 19X8, and the subsequent liquidation of the partnership. The table is based on the following hypothetical assumptions:<sup>27</sup>

- Column A is based on the assumption that the property will be sold (or foreclosed) for the balance of the mortgage notes at December 31, 19X8.
- Columns B and C are based on the assumption that the properties will be sold at estimated market values, which are calculated by capitalizing estimated cash flows from operations for the year immediately preceding the sale at rates of 7 percent and 9 percent, respectively.
- The estimated balance of outstanding mortgage notes at December 31, 19X8, is based on the assumption that the partnership will continue to make payments in accordance with existing terms of the mortgage notes. Note 7 to the financial forecast describes the partnership's outstanding mortgage notes and related payment terms.
- Management has estimated net operating cash flow (in total and per unit) for the three years ending December 31, 19X8, using assumptions substantially the same as those used in its financial forecast for the five years ending December 31, 19X5. In preparing the estimate, 19X5 forecasted rental income and forecasted operating expenses and management fees were increased by 5 percent per year.

	<i>A</i>	<i>B</i>	<i>C</i>
	<i>Sale for Existing Mortgage Balance</i>	<i>Sale at a 7% Capitalization Rate</i>	<i>Sale at a 9% Capitalization Rate</i>
Cash distributions to limited partners:			
For the forecast period	\$XXX	\$XXX	\$XXX
For the three-year period ending December 31, 19X8	XXX	XXX	XXX
Net from sale and dissolution	XXX	XXX	XXX
Less original capital contribution	(XXX)	(XXX)	(XXX)
Net pre-tax cash flow from partnership	<u>\$XXX</u>	<u>\$XXX</u>	<u>\$XXX</u>
Taxable income—gains and losses:			
For the forecast period	<u>\$XXX</u>	<u>\$XXX</u>	<u>\$XXX</u>
For the three-year period ending December 31, 19X8	<u>\$XXX</u>	<u>\$XXX</u>	<u>\$XXX</u>
From sale and dissolution	<u>\$XXX</u>	<u>\$XXX</u>	<u>\$XXX</u>

<sup>27</sup> To be consistent with the purpose of disclosing the hypothetical sale of the entity's real estate investment, the capitalization rate assumed should be consistent with the assumptions used in the forecast as well as the entity's and the industry's experience.

This information is less reliable than the information presented in the financial forecast and, accordingly, is presented for analysis purposes only. Further, there can be no assurance that events and circumstances described in this analysis will occur.

## Example 2

*Note B: Supplemental Information Related to Periods Beyond the Forecast Period*

While management is unable to prepare a financial forecast for periods beyond 19X5, it believes that the following information is necessary for users to make a meaningful analysis of the forecasted results.

Management's forecast for the three years ending December 31, 19X5, anticipates sales of its Model 714 High Tech Laser Analyzers and related equipment in the amounts of \$13,500,000, \$14,000,000, and \$14,500,000, respectively. Such sales represent approximately 50 percent of the Company's sales for the forecast period and were the major reason for the Company's growth in 19X0 and 19X1. The Company is currently a leader in laser technology, and its Model 714 Analyzer is now widely used by the industry. However, the Company expects sales of this product to peak in 19X5 and decline in periods subsequent to the forecast period. The Company is currently developing the Model 714A High Tech Analyzer, which is an improvement on the Model 714 Analyzer, and an X series visual modulator and laser scanner.

This information is less reliable than the information presented in the financial forecast and, accordingly, is presented for analysis purposes only. Further, there can be no assurance that the events and circumstances described herein will occur.

## Question

.52 A responsible party may prepare a financial forecast that requires disclosures like those illustrated in paragraphs .47 through .51 of this SOP, and he or she may request an accountant to compile or examine the forecast. What is the accountant's responsibility for such disclosures when he or she provides a compilation or examination service?

## Answer

.53 In applying procedures to provide assurance that the forecast conforms to AICPA presentation guidelines in an examination, or in reading the forecast for conformity with the guidelines in a compilation, the accountant should consider whether such disclosures are required and, if so, whether they are made. The accountant is not required to design specific procedures to identify conditions and events that might occur beyond the forecast period. Rather, the accountant's consideration is based on information about management's existing plans, future events, and circumstances obtained during the course of the engagement.<sup>28</sup>

.54 Disclosures of long-term results are included in the notes to the financial forecast and are, therefore, covered by the accountant's standard report. Accordingly, the extent of procedures performed depends on whether the engagement is a compilation or an examination. Compilation and examination procedures for engagements for prospective financial statements are included in chapters 12 and 15 of the Guide, respectively. When those procedures are performed, consideration should be given to whether (a) the disclo-

<sup>28</sup> The accountant is not responsible for anticipating future events, circumstances, or management plans. Further, the accountant's report does not imply assurance that all such matters that might occur beyond the forecast period have been disclosed.

tures are consistent with management's existing plans and knowledge of future events and circumstances, and (b) the disclosures are presented in conformity with the guidelines in paragraph .50 of this SOP.

**.55** If, when performing a compilation engagement, the accountant concludes, on the basis of known facts, that the disclosures are obviously inappropriate, incomplete, or misleading, given their purpose, or the disclosures are not presented in conformity with the guidelines given in paragraph .50, the accountant should discuss the matter with the responsible party and propose an appropriate revision of the disclosures. If the responsible party does not agree to revise the disclosures, the accountant should follow the guidance in chapters 12 and 14 of the Guide.

**.56** If, when performing an examination engagement, the accountant has reservations about the disclosures or if he or she is unable to apply procedures to such disclosures considered necessary in the circumstances, the accountant should discuss such matters with the responsible party and propose appropriate revision of the disclosures. If the responsible party will not agree to revision of the disclosures, the accountant should follow the guidance in chapter 16 of the Guide.

## The Accountant's Consideration of Whether the Responsible Party Has a Reasonably Objective Basis for Presenting a Financial Forecast

### Question

**.57** Paragraph 10.14 of the Guide indicates that an accountant who has been engaged to compile or examine a financial forecast should consider whether the responsible party has a reasonably objective basis to present a forecast.<sup>29</sup> In considering whether the responsible party has a reasonably objective basis, the accountant would consider whether sufficiently objective assumptions can be developed for each key factor. Do the procedures in chapters 12 and 15 of the Guide, "Compilation Procedures" and "Examination Procedures," respectively, contemplate such a consideration?

### Answer

**.58** Yes. An accountant may become aware of information that raises questions about whether the responsible party has a reasonably objective basis for presenting a financial forecast as he or she performs the procedures required for a compilation (see paragraph 12.10 of the Guide), particularly when making inquiries about key factors (see paragraph 12.10c of the Guide), reading the forecast, and considering whether significant assumptions appear to be not obviously inappropriate (see paragraph 12.10(ii) of the Guide). In any event, paragraph 10.14 of the Guide states that whether the responsible party has a reasonably objective basis to present a forecast would be a factor in the accountant's consideration about whether the presentation would be misleading (see paragraph 12.10j of the Guide).<sup>30</sup> In an examination engagement, the

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<sup>29</sup> See paragraph 7.03 of the Guide.

<sup>30</sup> The accountant's compilation procedures do not contemplate an evaluation of the support for underlying assumptions, which is required in an examination of prospective information. Because of the limited nature of the procedures, a compilation does not provide assurance that the accountant will become aware of significant matters that might be disclosed by more extensive procedures.

accountant considers whether the responsible party has a reasonably objective basis for presenting a financial forecast when he or she evaluates the support underlying the assumptions thereto. In either case, the guidance for preparers given in paragraphs .01 through .43 of this SOP may be useful to the accountant.<sup>31</sup>

## Effective Date

.59 The presentation guidelines in this SOP are effective for prospective financial information prepared on or after August 31, 1992. The guidance on accountants' services is effective for engagements in which the date of completion of the accountants' services on prospective financial information is August 31, 1992, or later. Early application of the provisions of this statement is encouraged.

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<sup>31</sup> Often, an accountant considers whether a preparer has a reasonable objective basis to present a financial forecast before accepting an engagement to perform compilation or examination services. In that case, the guidance in paragraphs .01 through .43 of this SOP may be particularly useful.

## Forecasts and Projections Task Force (1991)

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The task force gratefully acknowledges the contributions made to the development of this statement of position by former task force members Richard M. Steinberg and Robert W. Berliner.

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[The next page is 30,551.]



## Section 11,230

# **Statement of Position 92-4 Auditing Insurance Entities' Loss Reserves**

May, 1992

### **NOTE**

This Statement of Position presents the recommendations of the Auditing Insurance Entities' Loss Reserves Task Force of the Insurance Companies Committee regarding the audit of the liability for loss reserves on the financial statements of property and liability insurance entities in an audit conducted in accordance with generally accepted auditing standards. It has been reviewed by the chairman of the Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this Statement of Position if their work is challenged.

## **Introduction**

.01 This statement of position (SOP) is designed to assist auditors in developing an effective audit approach when auditing loss reserves of insurance entities. It is intended to supplement the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* (audit guide). The SOP assumes the reader is familiar with the audit guide, particularly those sections in chapter 4 that describe the claims cycle.

## **Scope**

.02 The guidance in this SOP applies to audits of property and liability insurance enterprises (stock and mutuals), reciprocal or interinsurance exchanges, pools, syndicates, captive insurance companies, and other similar organizations such as public entity risk pools. The overall concepts discussed herein are applicable to all lines of insurance; however, this study uses examples and illustrations from the more traditional lines of property and liability insurance.

.03 This SOP does not cover certain auditing issues tangentially related to loss reserves, including the evaluation of—

- Premium deficiencies.
- Transfer of risk.
- Credit risk on reinsurance contracts.
- Effects of discounting loss reserves.
- Other financial statement amounts that may be affected by loss reserves such as contingent commissions.

**30,552**

**Statements of Position**

**Effective Date**

**.04** This statement of position is effective for audits of financial statements for periods ending after December 15, 1992.



## Chapter 1

### ACCOUNTING FOR LOSS RESERVES

.05 This chapter provides background on accounting for loss reserves and describes the applicable authoritative literature in this area. The audit guide (paragraphs 4.01 through 4.04) presents the following description of generally accepted accounting principles and statutory accounting practices for insurance entities.

#### Accounting Practices

4.01 The specialized industry accounting principles for insurance enterprises are described in FASB Statement No. 60, FASB Statement No. 97, FASB Statement No. 113, SOP 92-5, *Accounting for Foreign Property and Liability Reinsurance*, SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, and SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*.

4.02 Under GAAP, liabilities for the cost of unpaid claims, including estimates of the cost of claims incurred but not reported, are accrued when insured events occur. The liability for unpaid claims should be based on the estimated ultimate cost of settling the claims (that is, the total payments expected to be made) and should include the effects of inflation and other social and economic factors. Estimated recoveries on unpaid claims, such as salvage, subrogation, and reinsurance, are deducted from the liability for unpaid claims. A liability for those adjustment expenses expected to be incurred in the settlement of unpaid claims should be accrued when the related liability for unpaid claims is accrued. Changes in estimates of the liabilities resulting from their periodic review and differences between estimates and ultimate payments are reflected in the income of the period in which the estimates are changed or the claim is settled. If the liabilities for unpaid claims and claim-adjustment expenses are discounted (that is, the liabilities are not recorded at their ultimate cost because the time value of the money is taken into consideration), the amount of the liabilities presented at present value in the financial statements and the range of interest rates used to discount those liabilities are required to be disclosed. For public companies, the SEC staff issued Staff Accounting Bulletin No. 62, *Discounting by Property/Casualty Insurance Companies*, which discusses the appropriate accounting and financial reporting when a company adopts or changes its policy with respect to discounting certain unpaid claims liabilities related to short-duration insurance contracts. The SEC issued Financial Reporting Release No. 20, *Rules and Guide for Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters*, which requires additional disclosures concerning the underwriting and claims reserving experience of property-casualty underwriters. The SEC staff also issued Staff Accounting Bulletin No. 87, *Contingency Disclosures on Property/Casualty Insurance Reserves for Unpaid Claim Costs*, which provides guidance concerning those uncertainties surrounding property and casualty loss reserves that may require FASB Statement No. 5 contingency disclosures and Staff Accounting Bulletin No. 92, *Accounting and Disclosures Relating to Loss Contingencies*, which provides the SEC staff's interpretation of current accounting literature relating to the following:

- Offsetting of probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties

- Uncertainties in estimation of the extent of environmental or product liability
- The appropriate discount rate for environmental or product liability, if discounting is appropriate
- Accounting for exit costs
- Financial statement disclosures and disclosure of certain information outside the basic financial statements

### *Statutory Accounting Practices*

4.03 Statutory accounting practices (SAP), which vary by state, are similar to GAAP for transactions in the claims cycle—estimated liabilities for unpaid claims, including IBNR [incurred but not reported] and claim-adjustment expenses, are accrued when the insured events occur; however, there are certain differences. Under SAP, reinsurance recoverable on unpaid losses is deducted from the liability for unpaid claims. For certain lines of insurance, such as auto liability, general liability, medical malpractice, and workers' compensation, a minimum statutory reserve may be required. The formula for determining this reserve is described in the footnotes to Schedule P in the NAIC Annual Statement. If it is determined that an additional statutory reserve is needed, this amount is reported as a separate liability and a reduction from surplus.

4.04 Discounting of loss reserves varies by state. SAP generally permits discounting settled lifetime workers' compensation claims and accident and health long-term disability claims at discount rates of 4 percent or less. In some states, medical malpractice liability claims may also be discounted. For statutory reporting purposes, reinsurance recoverable balances are segregated between those recoverable from companies authorized by the state to transact reinsurance and those recoverable from other companies, called unauthorized reinsurers. Insurance companies are required to provide a reserve by a charge to surplus for reinsurance that is recoverable from unauthorized companies. The reserve is provided to the extent that funds held or retained for account of such companies are exceeded or not secured by trust accounts or by letters of credit.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## Chapter 2

### THE LOSS RESERVING PROCESS

#### Types of Business and Their Effect on the Estimation Process

.06 The reporting and payment characteristics of a company's losses will differ depending on the types of policies written. Insurance policies may be categorized in several different ways:

- By policy duration (short duration or long duration)
- By type of coverage provided (occurrence basis or claims-made basis)
- By kind of insurance underwritten (for example, property, liability, workers' compensation, and reinsurance)<sup>1</sup>

#### Policy Duration

.07 Insurance policies are considered to be either short-duration or long-duration. Policies are considered short-duration when the contract provides for insurance coverage for a fixed period of short duration and enables the insurer to cancel the contract or adjust the provisions of the contract at the end of the contract period. Policies are considered long-duration when the contract provides for insurance coverage for an extended period and is not generally subject to unilateral changes in its provisions. Because most policies written by property and liability insurance companies are short-duration policies, only short-duration contracts are considered in this SOP.

#### Type of Coverage

.08 Insurance policies may be issued on either an occurrence basis or a claims-made basis. Occurrence-basis policies provide coverage for insured events occurring during the contract period, regardless of the length of time that passes before the insurance company is notified of the claim. Under occurrence-basis policies, claims may be filed months or years after the policy contract has expired, making it difficult to estimate the eventual number of claims that will be reported. Theoretically, a pure claims-made policy only covers claims reported to the insurer during the contract period; however, in practice, claims-made policies generally cover claims reported to either the insurer or the insured during the contract period. As a result, claims may be reported to the insurer after the contract expires. Even if claims have been reported to the insurer during the contract period, it may take several months for the insurer to investigate and establish a case reserve for reported claims. In practice, most claims-made insurance policies contain "extended reporting" clauses or endorsements that provide for coverage, in specified circumstances, of claims occurring during the contract period but reported after the expiration of the policy. In many states, a claims-made insurance policy is required to (a) contain an extended-reporting clause, (b) provide for the purchase, at the policyholder's option, of "tail coverage," that is, coverage for events occurring

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<sup>1</sup> The terms *line of business* and *type of risk* are used interchangeably to mean kind of insurance underwritten.

during the policy term but reported after the initial policy expires, or (c) provide for automatic tail coverage upon the death, disability, or retirement of the insured. Thus, in practice, claims-made policies can resemble occurrence-basis policies. If a claims-made insurance policy provides for coverage of claims incurred during the policy period but reported to the insurer after the end of the policy period, loss reserve requirements for such claims should be considered.

## **Kind of Insurance Underwritten, Line of Business, or Type of Risk**

.09 The kind of insurance underwritten by property and liability insurance companies may be broadly categorized into five classes of coverage: property, liability, workers' compensation, surety, and fidelity. Additionally, policies may be written as primary coverage or reinsurance assumed. Paragraphs 4.09 through 4.13 in chapter 4 of the audit guide describe the loss characteristics of different types of coverage.

.10 Some lines of insurance are commonly referred to as "long-tail" lines because of the extended time required before claims are ultimately settled. Examples of long-tail lines are automobile bodily injury liability, workers' compensation, professional liability, and other lines such as products and umbrella. Lines of insurance in which claims are settled relatively quickly are called "short-tail" lines. It is generally more difficult to estimate loss reserves for long-tail lines because of the long period that elapses between the occurrence of a claim and its final disposition, and the difficulty of estimating the settlement value of the claim.

## **Components of Loss Reserves**

.11 Loss reserves are an insurer's estimate of its liability for the unpaid costs of insured events that have occurred. An insurance company's loss reserves consist of one or more of the components described below. All of these components should be considered in the loss-reserving process but may not have to be separately estimated.

*Case-basis reserves*—The sum of the values assigned by claims adjusters to specific known claims that were recorded by the insurance company but not yet paid at the financial statement date. Chapter 4 of the audit guide describes the most common methods used by companies to establish case-basis reserves.

*Case-development reserves*—The difference between the case-basis reserves and the estimated ultimate cost of such recorded claims. This component recognizes that case-basis reserves, which are estimates based on incomplete or preliminary data, will probably differ from ultimate settlement amounts. Accordingly, a summation of case-basis reserve estimates may not produce the most reasonable estimate of their ultimate cost.

*Incurred but not reported (IBNR)*—The estimated cost to settle claims arising from insured events that occurred but were not reported to the insurance company as of the financial statement date. This component includes reserves for claims "in transit," that is, claims reported to the company but not yet recorded and included in the case-basis reserve.

*Reopened-claims reserve*—The cost of future payments on claims closed as of the financial statement date that may be reopened due to circumstances unforeseen at the time the claims were closed.

Sometimes, case-development reserves, IBNR, and the reopened-claims reserve are calculated as a single reserve and broadly referred to as IBNR. In addition to the basic components of loss reserves, a company will also need to estimate the effect of the following components:

*Reserves for loss adjustment expenses (LAE).* These include the following:

- *Allocated loss adjustment expenses (ALAE)*—Expenses incurred in the claim settlement process that can be directly associated with specific claims, such as legal fees or outside adjuster fees. If this reserve is estimated on a case basis, a reserve for ALAE development, IBNR, and reopened claims should be provided.
- *Unallocated loss adjustment expenses (ULAE)*—Expenses incurred in the claim settlement process that cannot be directly associated with specific claims, such as costs incurred by the insurer's claims operations to record, process, and adjust claims.

*Reduction for salvage*—The estimated amount recoverable by the insurer from the disposition of damaged or recovered property. Potential salvage on paid and unpaid losses should be considered in this estimate.

*Reduction for subrogation*—The estimated amount recoverable from third parties from whom the insured may have the right to recover damages. The insured, having collected benefits from the insurer, is required to subrogate such rights to the insurer.

*Drafts outstanding*—Some insurance companies may elect to pay claims by draft rather than by check and may not record the drafts as cash disbursed until the drafts are presented to the insurer by the bank. A liability for drafts outstanding is required only if cash disbursements and claim statistical information are not recorded concurrently, thereby creating a timing difference. Because the claim statistical information is updated to reflect the payment, no loss reserve is recorded for the claim; however, because the draft has not been presented, a drafts outstanding liability is required.

*Reserves for assessments based on paid losses*—The estimated amount of future assessments relating to payments on losses incurred prior to the financial statement date. An example is assessments by state workers' compensation second-injury funds. Such assessments are recorded as losses and should be considered in the loss reserving process.

*Reinsurance receivables*—Amounts that will be recovered from reinsurers for losses and LAE accrued, including IBNR losses accrued. Amounts receivable from reinsurers on paid and unpaid losses are generally classified as assets.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.12 Many insurance companies do not separately value each of the reserve components listed above. Frequently, an insurance company's reserve for case development is combined with its reserve for IBNR claims. Reinsurance and other recoveries may be netted against claim payments in the insurance company's records. In those situations, all reserve estimates are also net of recoveries; separate analysis is then performed to determine the appropriate amount to record as the reinsurance receivable asset. ALAE may be combined with loss payments and included in these components. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## Estimating Methods

.13 Various analytical techniques exist to assist management, consulting actuaries, and independent auditors in estimating and evaluating the reasonableness of loss reserves. These techniques generally consist of statistical analyses of historical experience and are commonly referred to as loss reserve projections.

.14 Loss reserve projections are used to develop loss reserve estimates. Understanding and assessing the variability of these estimates and the reliability of historical experience as an indicator of future loss payments require a careful analysis of the historical loss data and the use of projection methods that are sensitive to the particular circumstances.

.15 The data used for projections is generally grouped by line of business and may be further classified by attributes such as geographic location, underwriting class, or type of coverage to improve the homogeneity of the data within each group. The data is then arranged chronologically. The following are dates that are key to classifying the chronology of the data.

*Policy date*—The date on which the contract becomes effective (also referred to as the underwriting date).

*Accident date*—The date on which the accident (or loss) occurs.

*Report date*—The date on which the company first receives notice of the claim.

*Record date*—The date on which the company records the claim in its statistical system.

*Closing date*—The date on which the claim is closed.

.16 After the data has been grouped by line of business and by chronology, it may then be arrayed to facilitate the analysis of the data, highlight trends, and permit ready extrapolation of the data. The following are examples of types of data that are commonly arrayed and analyzed:

- Losses paid
- Losses incurred
- Case reserves outstanding
- Claim units reported
- Claim units paid
- Claim units closed
- Claim units outstanding
- ALAE paid
- ALAE outstanding
- Salvage and subrogation recovered
- Reinsurance recovered
- Reinsurance receivable
- Premiums earned
- Premiums in force
- Exposures earned
- Policies in force

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.17 The data may be cumulative or incremental, gross or net of reinsurance, gross or net of salvage and subrogation, or combined with allocated loss adjustment data. The data may be stratified by size of loss or other criteria. Because claim data and characteristics such as dates, type of loss, and claim counts significantly affect reserve estimation, controls should be established over the recording, classification, and accumulation of historical data used in the determination of loss reserves. Exhibit B-2 in appendix B of the audit guide presents examples of such control activities. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.18 Loss reserve projections can be performed using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models. Projection methods basically fall into three categories:

- Extrapolation of historical loss dollars
- Projection of separate frequency and severity data (the number of claims that will be paid or closed and the average costs of these claims)
- Use of expected loss ratios

.19 Within each of these methods, there are a variety of techniques and loss data that may be used; there are also methods that combine features of these basic methods. No single projection method is inherently better than any other in all circumstances.

.20 Following is a brief summary of some commonly used projection methods.

<u>Method</u>	<u>Basis</u>
Loss Extrapolation	
Paid loss	Uses only paid losses. Outstanding case reserves are not considered.
Incurred loss	Uses paid losses plus reserves on outstanding claims.
Average Severities	Uses various claim count and average cost per claim data on either a paid or incurred basis.
Loss Ratio	Uses various forms of expected losses in relation to premiums earned.

.21 The decision to use a particular projection method and the results obtained from that method should be evaluated by considering the inherent assumptions underlying the method and the appropriateness of these assumptions to the circumstances. Stability and consistency of data are extremely important. Changes in variables, such as rates of claim payments, claim department practices, case-basis reserving adequacy, claim reporting rates, mix of business, reinsurance retention levels, and the legal environment, may have a significant effect on the projection and may produce distortions or conflicting results. Reference should be made to the section in this chapter titled "Changes in the Environment" for a discussion of how changes in variables may affect the loss-reserving process. The results of any projection should be reviewed for reasonableness by analyzing the resultant loss ratios and losses per measure of exposure.

Illustrative Projection Data

.22 The following tables are simple illustrations of the use of the loss extrapolation method to estimate ultimate losses, as well as the effects of considering the results of more than one projection. In these illustrations, the result of extrapolating incurred-loss data is compared with the result of extrapolating paid-loss data. These tables are presented solely for the purpose of illustrating the mathematical mechanics of the two projections. They do not illustrate the required analysis of the data, and consideration of internal and external environmental variables that may affect the claim payment and loss reserving process.

.23 Table 1 presents an illustration of historical incurred-loss data. It reflects, as an example, that the sum of paid losses and case reserves outstanding at the end of 19X0 was \$2,054; that sum increased to \$2,717 in the next year and increased to \$3,270 five years later.

.24 This incurred-loss data is first used to calculate historical period-to-period incurred-loss development factors. These factors are used to compare the amount of incurred losses at successive development stages, and are illustrated in table 2, part 1.

.25 The calculation of average historical period-to-period incurred-loss development factors may be based on the use of simple averages of various period-to-period factors or may be based on more complex weighting or trending techniques. These techniques can significantly affect the reserving process and require judgment, understanding, and experience. In this example, a simple average of the latest three period-to-period factors has been calculated and is presented in table 2, part 2.

Table 1

Case-Basis Incurred-Loss Data as of 12/31/X9

Accident Year	Development Period (in months)									
	12	24	36	48	60	72	84	96	108	120
19X0	\$2,054	\$2,717	\$2,979	\$3,095	\$3,199	\$3,348	\$3,270	\$3,286	\$3,299	\$3,301
19X1	2,213	2,980	3,269	3,461	3,551	3,592	3,631	3,643	3,651	
19X2	2,341	3,125	3,513	3,695	3,798	3,849	3,872	3,876		
19X3	2,492	3,502	3,928	4,177	4,313	4,369	4,392			
19X4	2,964	4,246	4,859	5,179	5,315	5,376				
19X5	3,394	4,929	5,605	5,957	6,131					
19X6	3,715	5,433	6,162	6,571						
19X7	4,157	5,912	6,771							
19X8	4,573	6,382								
19X9	4,785									

.26 Once historical period-to-period incurred-loss development factors are calculated, future period-to-period incurred-loss development factors must be selected. The future period-to-period factors must reflect anticipated differences between historical and future conditions that affect loss development, such as changes in the underlying business, different inflation rates, or case-basis reserving practices. In the example, no differences are anticipated and the average historical factors have been chosen as the selected factors as shown in table 2, part 2. The selected future period-to-period factors are then used to produce ultimate incurred development factors. The ultimate factors are presented in table 2, part 3.



Table 2

## Period-to-Period Incurred-Loss Development Factors as of 12/31/X9

Accident Year	Development Period (in months)									Est.* Tail
	12-24	24-36	36-48	48-60	60-72	72-84	84-96	96-108	108-120	
Part 1: Period-to-Period Historical Loss Development Factors										
19X0	1.323 <sup>†</sup>	1.096	1.039	1.034	1.047	0.977	1.005	1.004	1.001	
19X1	1.347	1.097	1.059	1.026	1.012	1.011	1.003	1.002		
19X2	1.335	1.124	1.052	1.028	1.013	1.006	1.001			
19X3	1.405	1.122	1.063	1.033	1.013	1.005				
19X4	1.433	1.144	1.066	1.026	1.011					
19X5	1.452	1.137	1.063	1.029						
19X6	1.462	1.134	1.066							
19X7	1.422	1.145								
19X8	1.396									
Part 2: Period-to-Period Average Development Factors										
Simple Average of Latest Three										
	1.427	1.139	1.065	1.029	1.012	1.007	1.003	1.003	1.001	1.000
Selected Factors										
	1.427	1.139	1.065	1.029	1.012	1.007	1.003	1.003	1.001	1.000
Part 3: Ultimate Development Factors Selected for the Projection										
	1.828 <sup>‡</sup>	1.281	1.125	1.056	1.026	1.014	1.007	1.004	1.001	1.000

\* Applies when the development period is determined to be longer than the period covered by the model (assumed to be 1.000 in this illustration).

<sup>†</sup> The 24-month developed losses are divided by the 12-month developed losses from table 1 (\$2,717/\$2,054 = 1.323).

<sup>‡</sup> The product of the remaining factors ( $1.427 \times 1.139 \times 1.065 \times 1.029 \times 1.012 \times 1.007 \times 1.003 \times 1.003 \times 1.001 \times 1.000 = 1.828$ ) or the product of the 12-24 selected factor times the 24-36 ultimate factor ( $1.427 \times 1.281 = 1.828$ ).

.27 The loss reserve analysis has now reached the point where an initial projection of ultimate losses, as well as an indicated provision for unreported losses for each accident year, can be made by using the historical incurred-loss data and the ultimate incurred-loss development factors. This initial projection of ultimate losses is presented in table 3.

.28 Tables 4 and 5 present paid-loss data for the same company whose incurred-loss data was presented in table 1. The array of paid-loss period-to-period development factors presented in table 5 is derived from table 4 using the same calculation methods used for incurred losses in table 2. The importance of the use of a tail factor in this calculation is apparent from the period-to-period historical loss development factors calculated in table 5. The tail factor represents an estimate of the development of losses beyond the period covered by the data array. In this instance, a tail factor of 1.01 was selected to project an additional 1 percent of losses to be paid from the tenth development year to ultimate. Selection of a tail factor requires careful judgment based on consideration of industry experience for the line of business, actuarial studies, case reserves, and any other relevant information.

.29 The initial projection of ultimate losses, using the historical paid losses and the paid-loss ultimate development factors, is presented in table 6.

.30 Table 7 compares the results of extrapolating paid-loss data (table 6) with the results of extrapolating incurred-loss data (table 3).

.31 Although all accident periods should be analyzed and trends evaluated, it is clear that additional analysis of accident year 19X9 losses is required. The difference between the results obtained from the two different projections is significant. Initial inspection will trace the source of the difference to the high level of losses paid in 19X9 for accident year 19X9 relative to case-basis incurred losses for the same period. The loss reserving analysis must focus on whether the increase in payments represents an acceleration of payment activity or an increase in the overall level of losses incurred in 19X9. The benefit of using more than one projection is that it allows for this kind of analysis and comparison in the evaluation of loss reserves.

Table 3

## Incurred-Loss Projection as of 12/31/X9

Accident Year	Case-Basis Incurred Losses as of 19X9 <sup>*</sup>	Ultimate Incurred-Loss Development Factors <sup>†</sup>	Projected Ultimate Losses (2) × (3)	Projected Unreported Losses (4) - (2)
(1)	(2)	(3)	(4)	(5)
19X0	\$ 3,301	1.000	\$ 3,301	\$ 0
19X1	3,651	1.001	3,655	4
19X2	3,876	1.004	3,892	16
19X3	4,392	1.007	4,423	31
19X4	5,376	1.014	5,451	75
19X5	6,131	1.026	6,290	159
19X6	6,571	1.056	6,939	368
19X7	6,771	1.125	7,617	846
19X8	6,382	1.281	8,175	1,793
19X9	4,785	1.828	8,747	3,962
Total	<u>\$51,236</u>		<u>\$58,490</u>	<u>\$7,254</u>

\* From table 1

† From table 2, part 3

Table 4

## Paid-Loss Data as of 12/31/X9

Accident Year	Development Period (in months)									
	12	24	36	48	60	72	84	96	108	120
19X0	\$ 896	\$1,716	\$2,291	\$2,696	\$3,041	\$3,096	\$3,185	\$3,235	\$3,262	\$3,276
19X1	872	1,840	2,503	2,973	3,261	3,429	3,538	3,589	3,624	
19X2	968	1,975	2,683	3,185	3,494	3,670	3,763	3,819		
19X3	968	2,130	2,968	3,571	3,942	4,147	4,274			
19X4	1,201	2,580	3,673	4,421	4,860	5,114				
19X5	1,348	2,996	4,207	5,115	5,632					
19X6	1,340	3,146	4,520	5,496						
19X7	1,384	3,428	4,960							
19X8	1,568	3,696								
19X9	2,243									

Table 5  
Period-to-Period Paid-Loss Development Factors as of 12/31/X9

Accident Year	Development Period (in months)									Est.* Tail
	12-24	24-36	36-48	48-60	60-72	72-84	84-96	96-108	108-120	
Part 1: Period-to-Period Historical Loss Development Factors <sup>†</sup>										
19X0	1.915	1.335	1.177	1.128	1.018	1.029	1.016	1.008	1.004	
19X1	2.110	1.360	1.188	1.097	1.052	1.032	1.014	1.010		
19X2	2.040	1.358	1.187	1.097	1.050	1.025	1.015			
19X3	2.200	1.393	1.203	1.104	1.052	1.031				
19X4	2.148	1.424	1.204	1.099	1.052					
19X5	2.223	1.404	1.216	1.101						
19X6	2.348	1.437	1.216							
19X7	2.477	1.447								
19X8	2.357									
Part 2: Period-to-Period Average Development Factors										
Simple Average of Latest Three										
	2.394	1.429	1.212	1.101	1.051	1.029	1.015	1.009	1.004	1.010
Selected Factors										
	2.394	1.429	1.212	1.101	1.051	1.029	1.015	1.009	1.004	1.010
Part 3: Ultimate Development Factors Selected for the Projection <sup>†</sup>										
	5.127	2.142	1.499	1.237	1.123	1.069	1.039	1.023	1.014	1.010

\* Applies when the development period is determined to be longer than the period covered by the model (assumed to be 1.010 in this illustration).  
† Computations are the same as those explained in table 2.

Table 6

**Paid-Loss Projection as of 12/31/X9**

<i>Accident Year</i>	<i>Paid Losses as of 19X9</i>	<i>Ultimate Loss Development Factors</i>	<i>Projected Ultimate Losses (2) × (3)</i>	<i>Projected Unreported Losses*</i>
(1)	(2)	(3)	(4)	(5)
19X0	\$ 3,276	1.010	\$ 3,309	\$ 8
19X1	3,624	1.014	3,675	24
19X2	3,819	1.023	3,907	31
19X3	4,274	1.039	4,439	47
19X4	5,114	1.069	5,465	89
19X5	5,632	1.123	6,325	194
19X6	5,496	1.237	6,796	225
19X7	4,960	1.499	7,434	663
19X8	3,696	2.142	7,916	1,534
19X9	2,243	5.127	11,500	6,715
Total	<u>\$42,134</u>		<u>\$60,766</u>	<u>\$9,530</u>

\* Represents the projected ultimate losses from table 6, column 4, less the recorded case-basis incurred losses from table 3, column 2.

Table 7

**Alternative Projections of Ultimate Losses and Unreported Losses as of 12/31/X9**

<i>Accident Year</i>	<i>Ultimate Losses</i>		<i>Unreported Losses</i>	
	<i>Incurred</i>	<i>Paid</i>	<i>Incurred</i>	<i>Paid</i>
19X0	\$ 3,301	\$ 3,309	\$ 0	\$ 8
19X1	3,655	3,675	4	24
19X2	3,892	3,907	16	31
19X3	4,423	4,439	31	47
19X4	5,451	5,465	75	89
19X5	6,290	6,325	159	194
19X6	6,939	6,796	368	225
19X7	7,617	7,434	846	663
19X8	8,175	7,916	1,793	1,534
19X9	8,747	11,500	3,962	6,715
Total	<u>\$58,490</u>	<u>\$60,766</u>	<u>\$7,254</u>	<u>\$9,530</u>

## Loss Adjustment Expense Reserves

.32 Loss adjustment expense reserves are the costs that will be required to settle claims that have been incurred as of the valuation date. As explained in paragraph .11, loss adjustment expenses (LAE) can be classified into two broad categories: allocated loss adjustment expenses (ALAE) and unallocated loss adjustment expenses (ULAE).

### ALAE Reserve Calculation Approaches

.33 ALAE is generally analyzed by line of business; however, it is also important to monitor the composition of the paid ALAE by cost component. A shift in the composition of the costs in relation to the total might affect the statistical data used in the related loss projections. This shift would need to be considered in future loss reserve projections.

.34 Many companies calculate ALAE reserves based on the relationship of ALAE to losses. Underlying this approach is a basic assumption that ALAE will increase or decrease in proportion to losses. The setting of reserves for ALAE based on the relationship of paid ALAE to paid losses is referred to as the "paid-to-paid ratio" approach. Separate ratios are normally developed for each accident year. Inflation in ALAE is not typically evaluated separately; rather, it is estimated to occur at the same rate as the rate of inflation in the losses. The validity of this assumption can be tested by reviewing historical relationships between ALAE and losses over time. The effects of a pattern of increasing or decreasing ratio of ALAE to losses should be considered in establishing ALAE reserves. An understanding of the claim department's operations and philosophy over time is essential to a proper interpretation of the data.

.35 Other approaches to ALAE reserve calculation and analysis include (a) analyzing ALAE entirely apart from the related loss costs using methods that compare the development of ALAE payments at various stages and (b) using combined loss and ALAE data in situations where it appears likely that this would produce more accurate estimates (e.g., when the company has changed its claim defense posture so that defense costs increase and loss costs decrease). In this latter approach, statistical tests and projections are based on the combined data for losses and ALAE.

.36 Some companies establish case-basis reserves for certain types of ALAE or increase case-basis loss reserves by a stated percentage to provide for ALAE. In either case, additional ALAE reserves should be provided for the development of case-basis reserves and IBNR.

### ULAE Reserve Calculation Approaches

.37 ULAE reserves are often provided for by using the calendar year paid-to-paid method rather than the accident year paid-to-paid method used for ALAE reserves. Although the paid-to-paid ratios establish the relationship of the ULAE payments to the loss payments, the timing of the ULAE payments is also critical to estimation of the ULAE reserves. For example, some companies assume that a portion of ULAE costs is incurred when a claim is placed on the books and the remaining portion is incurred when the claim is settled. For reported claims, the cost of placing the claim on the books has been incurred, so it is only necessary to provide a reserve for the remaining portion at settlement. For IBNR claims, it is necessary to provide for all of the ULAE. Some companies perform internal studies to establish the methods and ratios to be used in their calculations.

.38 The ULAE reserves should provide for inflation. The assumption that ULAE will inflate at a rate equal to the rate at which losses inflate should be periodically reviewed. The rate should also be adjusted for expected technological or operational changes that might cause economies or inefficiencies in the claim settlement process.

.39 If paid-to-paid ULAE ratios will be calculated for each line of business, a reasonable basis for allocating paid ULAE by line of business should be established.

## Changes in the Environment

.40 Loss reserve projections are used to estimate loss reporting patterns, loss payment patterns, and ultimate claim costs. An inherent assumption in such projections is that historical loss patterns can be used to predict future patterns with reasonable accuracy. Because many variables can affect past and future loss patterns, the effect of changes in such variables on the results of loss projections should be carefully considered.

.41 Identification of changes in variables and consideration of their effect on loss reserve projections are critical steps in the loss reserving process. The evaluation of these factors requires the involvement of a loss reserve specialist as well as input from various operating departments within the company such as the marketing, underwriting, claims, actuarial, reinsurance, and legal departments. Management's use of a specialist in determining loss reserves is discussed in paragraphs .44 through .47 of this SOP.

.42 Variables to be considered in evaluating the results of loss reserve projections include those variables affecting inherent and control risk described in the Appendix [paragraph .107] of this SOP. If changes in variables have occurred, mechanical application of loss projection methods may result in unreasonable estimates of ultimate claim costs. Changes in variables can be considered in the loss reserving process in a variety of ways, including—

- *Selection of loss projection method(s).* Loss projection methods vary in their sensitivity to changes in the underlying variables and to the length of the claim emergence pattern. When selecting a loss projection method, consideration should be given to how a change in the underlying data will affect that method. For example, if management has adopted a policy to defer or accelerate the settlement of claims, a paid-loss extrapolation method will probably produce unreliable results. In that case, an incurred-loss extrapolation or other methods may produce better estimates of ultimate losses.
- *Adjustment of underlying historical loss data.* In certain cases, the effect of changed variables can be isolated and appropriately reflected in the historical loss data used in the loss projection. For example, if policy limits are relatively consistent for all policies in a block of business, and if these limits have recently been reduced by a constant amount, historical loss data can be adjusted to exclude amounts in excess of the revised policy limits.
- *Further segregation of historical loss data.* Certain changes in variables can be addressed by further differentiating and segregating historical loss data. For example, if a company begins to issue claims-made policies for a line of business for which it traditionally issued occurrence-basis policies, segregation of data between the two types of

policies should minimize the effect of the different reporting patterns. Such segregation should produce more accurate loss reserve projections for the occurrence-basis policies. (However, loss development data relating to the claims-made policies will be limited in the initial years.)

- *Separate calculation of the effect of variables.* The effect of certain changes in variables can be isolated and separately computed as an adjustment to the results of other loss projection methods. For example, if claim cost severity has increased (an increase in auto repair costs) or is expected to increase beyond historic trends, an additional reserve can be separately computed to reflect the effect of such actual or anticipated increases.
- *Qualitative assessments.* In many instances, the magnitude or effect of a change in a variable will be uncertain. The establishment of loss reserves in such situations requires considerable judgment and knowledge of the company's business. Following is an example of an environmental variable that may have uncertain effects on loss reserve estimates.

Superfund legislation enacted by Congress seeks recovery from anyone who ever owned or operated a particular contaminated site or from anyone who ever generated or transported hazardous materials to a site. These parties are commonly referred to as potentially responsible parties, or PRPs. Potentially, the liability can extend to subsequent owners or to the parent company of a PRP.

Estimates of the cost of cleaning up hazardous waste sites currently on the so-called Superfund list are in the hundreds of billions of dollars. Third-party damages, legal defense costs, and cleanup expenses for non-Superfund sites will add significantly to this figure. It is conceivable, but by no means certain, that some portion of these costs will ultimately be borne by the insurance industry under pre-1986 liability coverages because insurance companies that wrote general liability or commercial multiperil policies prior to 1986 used policy forms that did not contain the "absolute" pollution exclusion currently in standard use within the industry. Some insureds are arguing that coverage should be afforded under these contracts for their potential liability for the cleanup of inactive hazardous waste sites or other similar environmental liabilities. Most insurers are vigorously resisting such arguments with mixed success in the courts. Although some major U.S. corporations and specialized industries have begun to litigate pollution liability coverage issues, these cases may represent only the tip of the iceberg. Potential for additional litigation exists in the form of non-Superfund claims that will be reported to insurers in the future.

Although the largest environmental liabilities are likely to arise from chemical producers, petroleum processors, and other "heavy" industries, any company writing liability coverage has some environmental liability exposure for service stations, dry cleaners, hardware stores, paint stores, gardening supply stores, small metal plating operations, and the like. Even homeowners' policies are potentially exposed to the cleanup costs for leaks from underground heating oil storage tanks.

The development of environmental and similar claims may not follow the usual development pattern of general liability claims, with which they are usually grouped. When the activity of these claims is sufficient to distort the recorded



development of the company, the distorting activity should be isolated from the development history so that an accurate projection of the remaining claims can be made. Management's process of assessing its environmental and similar exposure should include procedures to—

- Insure that all data elements are recorded on each incoming claim or precautionary notice.
- Assess the company's exposure to these types of liability claims by considering such factors as the types of risks historically written, layers of coverage provided, the policy language employed, and recent decisions rendered by courts.
- Determine whether any portion of potential liability costs is probable and reasonably estimable.

.43 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, provide guidance for the accounting and disclosure of loss contingencies.

## Use of Specialists by Management in Determining Loss Reserves

.44 Management is responsible for making the accounting estimates included in the financial statements. As explained in the previous sections of this chapter, the process of estimating loss reserves is complex and involves many subjective judgments. Accordingly, the determination of loss reserves should involve an individual with a sufficient level of competence and experience in loss reserving, including knowledge about the kind(s) of insurance for which a reserve is being established and an understanding of appropriate methods available for calculating loss reserve estimates. These individuals are referred to as "loss reserve specialists" in this SOP. The specialist's level of competence and experience should be commensurate with the complexity of the company's business, which is affected by such factors as the kind(s) of insurance underwritten and the environmental and risk considerations listed in the Appendix [paragraph .107] of this SOP. Criteria that may be considered in determining whether an individual qualifies as a loss reserve specialist include the aforementioned as well as the following:

- Knowledge of various projection techniques, including their strengths and weaknesses and applicability to various lines of insurance
- Knowledge of changes in the environment in which the company operates, including regulatory developments, social and legal trends, court decisions, and other factors described in more detail in the Appendix and the effect that these factors will have on the emergence and ultimate cost of these claims

.45 The Casualty Actuarial Society (CAS) offers a course of study and examinations that are designed to train individuals to be, among other things, loss reserve specialists. In addition, the American Academy of Actuaries establishes qualification standards for its members who practice in this area. Although many casualty actuaries may therefore be qualified to be loss reserve specialists, other individuals, through their experience and training, may also be qualified. Training and experience should provide individuals with knowl-

edge about different policy forms and coverages, current developments in insurance, and environmental factors that might affect the loss reserving process. Training and experience should also provide individuals with knowledge that will enable them to apply appropriate methods of estimating loss reserves. The extent of this knowledge and ability should be commensurate with the complexity and kinds of business written.

**.46** Many insurance companies use loss reserve specialists who are employees or officers of the company. In addition, many companies engage consulting casualty actuaries to either assist in the determination of the loss reserve estimate or to perform a separate review of the company's loss reserve estimate. The scope of work to be performed by the consulting actuary is a matter of judgment by company management. Usually, the consulting actuary will issue a report summarizing the nature of the work performed and the results. Since 1990, the Annual Statement has required a Statement of Actuarial Opinion relating to loss and loss adjustment expense reserves.

**.47** Because the process of estimating loss reserves is complex and involves many subjective judgments, the absence of involvement by a loss reserve specialist in the determination of management's estimate may constitute a reportable condition and possibly a material weakness in the entity's internal control structure. Statement on Auditing Standards (SAS) No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, describes the auditor's responsibility to communicate reportable conditions to the audit committee. A discussion of the auditor's use of loss reserve specialists is included in chapter 4.

## Chapter 3

### AUDIT PLANNING

#### Audit Objectives

.48 SAS No. 57, *Auditing Accounting Estimates*, states that the auditor's objective when evaluating accounting estimates is to obtain sufficient competent evidential matter to provide reasonable assurance that—

- a. All accounting estimates that could be material to the financial statements have been developed.
- b. Those accounting estimates are reasonable in the circumstances.
- c. The accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.

.49 When auditing loss reserves, the auditor is primarily concerned with obtaining sufficient competent evidential matter to support the assertions inherent in a company's financial statements. SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, describes the relationship between assertions embodied in the financial statements, audit objectives, and substantive audit procedures. The financial statement assertions related to loss reserves are set forth below. This listing supplements the illustrations of financial statement assertions for the claims cycle presented in exhibit B-2 in appendix B of the audit guide. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

<u>Financial Statement Assertions</u>	<u>Audit Objectives</u>
Existence, Rights, Obligations	<ul style="list-style-type: none"> <li>● Claims represent valid obligations of the insurance company. The policy is in force when the loss is incurred and covers the related risk event. Claimants and others receiving payment are bona fide and entitled to payments within applicable policy provisions.</li> <li>● Guidelines for adjusting claims and authorizing payment are established and being followed.</li> </ul>
Completeness and Valuation	<ul style="list-style-type: none"> <li>● Loss reserves are established for all losses resulting from insured events (reported and unreported) that occurred prior to the balance sheet date.</li> <li>● Appropriate reserving methods are accurately applied and result in loss reserve estimates that represent the ultimate cost of settling all probable losses. Appropriate reductions in reserves have been taken for reinsurance ceded and salvage and subrogation recoverable.</li> </ul>

*Financial Statement  
Assertions*

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*Audit Objectives*

Presentation and  
Disclosure

- All relevant claims data, including payment and recovery data, are appropriately recorded in the underlying financial and statistical records.
- All loss reserves are appropriately recorded on the balance sheet and the income statement reflects the changes therein.
- Loss reserves are properly accumulated in the underlying financial records.
- Claims transactions are properly accumulated in the underlying financial and statistical records.
- Payments and recoveries are recorded in the proper period; a proper cutoff is established.
- Loss reserves and related components have been properly summarized, classified, and described and all matters necessary to a proper understanding of these items have been disclosed.

## Audit Planning

**.50** In planning the audit, the auditor should obtain a thorough understanding of the company's overall operations and its claim reserving and payment practices. In addition, the auditor should obtain or update his or her knowledge of the entity's business and the various economic, financial, and organizational conditions that create risks for companies in the insurance industry.

**.51** The auditor performing or supervising the audit of loss reserves should have knowledge about loss reserving including knowledge about the kind(s) of insurance for which a reserve is being established and an understanding of the appropriate methods available for calculating loss reserves. Knowledge about loss reserving is ordinarily obtained through experience, training courses, and by consulting sources such as industry publications, textbooks, periodicals, and individuals knowledgeable about loss reserving. As stated in paragraph .98 of this SOP, if the auditor is not a loss reserve specialist, he or she should use the work of an outside loss reserve specialist in the audit. The auditor should obtain a level of knowledge about loss reserving that would enable him or her to understand the methods or assumptions used by the specialist.

**.52** Ordinarily, audit procedures performed to obtain sufficient evidence to support assertions about loss reserves are time consuming and may be performed most efficiently when initiated early in the fieldwork.

**.53** The auditor should determine that all loss reserve components, all lines of business, and all accident years that could be material to the financial

statements have been considered in developing the overall reserve estimate. The components of loss reserves are described in chapter 2 of this SOP.

.54 The estimate of loss reserves will frequently affect other accounting estimates contained in the financial statements. While these other accounting estimates are not the subject of this SOP, the auditor should also evaluate accounting estimates for such items as contingent commissions, retrospective premium adjustments, policyholder dividends, recoverability of deferred acquisition costs, premium deficiencies, state assessments based on losses paid, minimum statutory reserves, and the liability or allowance for unauthorized or uncollectible reinsurance.

## Audit Risk and Materiality

.55 Audit risk and materiality are the key criteria in determining the nature, timing, and extent of audit procedures to be performed and in evaluating whether the financial statements taken as a whole are presented fairly. Considerations of audit risk and materiality should be addressed in the planning stage of an audit and should be used to develop and support an audit approach. For most insurance companies, the largest liability on the balance sheet is loss reserves, and the largest expense on the income statement is incurred losses; therefore, both are material to the financial statements. In addition, loss reserve estimates are based on subjective judgments and, therefore, involve a high level of inherent risk. For these reasons, loss reserves typically are the area with the highest audit risk in a property and liability insurance entity. Reference should be made to the Appendix [paragraph .107] of this SOP for examples of factors that may affect the auditor's assessment of inherent and control risk.

## Audit Risk

.56 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, provides guidance on audit risk and materiality as they relate to planning and performing an audit. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person relying on the financial statements. Some factors to be considered in establishing materiality levels for estimates such as loss reserves are the company's operating results and the company's financial position. The auditor should also consider the measurement bases that external financial statement users will focus on when making decisions. [Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.57 SAS No. 47 states that the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are material to the financial statements are detected. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, provides specific guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by fraud. [Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.58 SAS No. 82 requires the auditor to assess the risk of material misstatement due to fraud and consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both (a) misstatements arising from fraudulent financial reporting and (b) misstatements arising from misappropriation of assets in the following categories:

*Fraudulent Financial Reporting*

- Management's characteristics and influence over the control environment.
- Industry conditions.
- Operating characteristics and financial stability.

*Misappropriation of Assets*

- Susceptibility of assets to misappropriation.
- Controls.

[Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.59 In addition to requiring the auditor to assess the risk of material misstatement due to fraud, SAS No. 82 provides guidance on how the auditor responds to the results of that assessment, provides guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud, describes related documentation requirements, and provides guidance regarding the auditor's communication about fraud to management, the audit committee, and others. [Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.60 SAS No. 47 defines audit risk as "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated." In other words, audit risk is the risk that the auditor will give an unqualified opinion on financial statements that are materially incorrect. SAS No. 47 states that audit risk consists of three components (see paragraphs .61 through .63 below). [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.61 *Inherent Risk.* Inherent risk is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related balances or classes than for others. In addition to those factors that are peculiar to a specific assertion for an account balance or class of transactions, factors that relate to several or all of the balances or classes may influence the inherent risk related to an assertion for a specific balance or class. Loss reserves generally are based on subjective judgments about the occurrence of certain events that have not yet been fully reported, developing trends, and the outcome of future events. Due to the subjectivity and inherent imprecision involved in making such judgments, estimating loss reserves requires considerable analytical ability and an extensive understanding of the business. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.62 *Control Risk.* Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely

basis by the entity's controls. That risk is a function of the effectiveness of the design and operation of controls in achieving the entity's broad control objectives relevant to an audit of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control. The degree of control risk associated with significant accounting estimates is usually greater than the risk for other accounting processes because accounting estimates involve a greater degree of subjectivity, are less susceptible to control, and are more subject to management influence. It is difficult to establish controls over errors in assumptions or estimates of the future outcome of events in the same way that controls can be established over the routine accounting for completed transactions. In addition, there is a potential for management to be biased about their assumptions; accordingly, a high level of professional skepticism should be exercised by the auditor. The likelihood that loss reserve estimates will contain misstatements of audit importance can be reduced by using competent people in the estimation process and by implementing practices to enhance the reasonableness of estimates, such as requiring that persons making the estimates retain documented explanations and other support for assumptions and methodologies used, and perform retrospective tests of past performance. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

**.63 Detection Risk.** Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion. Detection risk is a function of the effectiveness of an auditing procedure and of its application by the auditor. It arises partly from uncertainties that exist when the auditor does not examine 100 percent of an account balance or class of transactions and partly because of other uncertainties that exist even if he or she were to examine 100 percent of the balance or class. Such other uncertainties arise because an auditor might select an inappropriate auditing procedure, misapply an appropriate procedure, or misinterpret the audit results. These other uncertainties can be reduced to a negligible level through adequate planning and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards. Due to the relatively high inherent and control risk associated with loss reserves, detection risk is significant in the audit of loss reserves but may be mitigated by adequate planning, supervision, and conduct of the audit. Adequate planning should identify the existing inherent and control risk factors so that they may be adequately addressed in the audit. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## Materiality

**.64 SAS No. 47** provides guidance on audit risk and materiality as they relate to planning and performing an audit. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person relying on the financial statements. Some factors to be considered in establishing materiality levels for loss reserve estimates are the company's operating results and the company's financial position. The auditor should also consider the measurement bases that external financial statement users will focus on when making decisions. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## Chapter 4

### AUDITING LOSS RESERVES

#### Auditing the Claims Data Base

**.65** The historical experience of an insurance entity is generally the primary source of information on which loss reserve estimates are based; therefore, the creation of reliable data bases, within an insurance company, is extremely critical to the determination of loss reserve estimates. When evaluating loss reserves, the auditor should consider the reliability of the historical information generated by the insurance company. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

**.66** The auditor should determine what historical data and methods have been used by management in developing the loss reserve estimate and whether he or she will rely on the same data or other statistical data in evaluating the reasonableness of the loss reserve estimate. After identifying the relevant data, the auditor should obtain an understanding of the controls related to the completeness, accuracy, and classification of the loss data; assess control risk for assertions about loss reserves; and determine the nature, timing, and extent of substantive tests that will be performed for these assertions. Because claim data and characteristics such as dates and type of loss can significantly influence reserve estimation, the auditor should test the completeness, accuracy, and classification of the claim loss data. Chapter 4 and exhibit B-2 in appendix B of the audit guide provide more extensive guidance on auditing the claims cycle. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

#### Evaluating the Reasonableness of the Estimate

##### Selecting an Audit Approach

**.67** SAS No. 57 states that the auditor should obtain an understanding of how management developed the accounting estimates included in the financial statements. The loss reserve estimate is a significant estimate on the financial statements of an insurance entity. Accordingly, regardless of the approach used to audit the loss reserve estimate, the auditor should gain an understanding of how management developed the estimate. The auditor should use one or a combination of the following approaches in evaluating the reasonableness of the accounting estimates:

- a. Review and test the process used by management to develop the estimate.
- b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- c. Review subsequent events or transactions occurring prior to completion of fieldwork.

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]



.68 When auditing loss reserve estimates, usually approach *a*, *b*, or a combination of the two is used. Normally, approach *c* alone is insufficient to provide reasonable assurance because claims are usually reported to insurance companies and settled over a period of time extending well beyond a normal opinion date. However, approach *c* may provide additional information concerning the reasonableness of loss reserve estimates, particularly for short-tail lines of business, when used in combination either with approach *a* or *b* or with both. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.69 When planning the audit, the auditor chooses to use either approach *a* or *b*, or a combination of both approaches, depending on his or her expectation of what approach will result in sufficient competent evidential matter in the most cost-effective manner. Either approach can be used and, depending on client circumstances, either approach may be effective. However, when management has not used the services of a loss reserve specialist in developing its loss reserve estimate, approach *a*, reviewing and testing management's process, is not appropriate. In this circumstance, approach *b*, developing an independent expectation, should be used. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

### **Reviewing and Testing the Process Used by Management to Develop the Estimate**

.70 The auditor may assess the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. This approach may be appropriate when loss reserve estimates are recommended by an outside loss reserve specialist and management accepts those recommendations, when loss reserve specialists employed by the company are responsible for recommending the estimates, or when both outside and internal specialists are used. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.71 A company that uses an outside loss reserve specialist to develop loss reserve recommendations may engage the specialist to evaluate only the company's major lines of business or only certain components of the loss reserves. In either circumstance, the auditor should determine whether a different approach is needed for auditing the items not reported on by the loss reserve specialist. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.72 If the auditor reviews and tests the process used by management to develop its estimate, and management's estimate differs significantly from the recommendations developed by its specialists, appropriate procedures should be applied to the factors and assumptions that resulted in the difference between management's estimate and the specialists' recommendations. Such procedures should include discussion with management and its specialists. It is management's responsibility to record its best estimate of loss reserves in the financial statements. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.73 SAS No. 57 identifies the following as procedures the auditor may consider performing when using this approach. Some of the procedures listed

below apply to the process management uses to supply data to the loss reserve specialist, some apply to the process used by the specialist to develop recommendations, some apply to the process used by management to review and evaluate those recommendations, and some apply to the process management uses to translate the specialist's recommendations into the loss reserve estimates recorded in the financial statements.

- a. *Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.* Controls over the preparation of accounting estimates may include—

- Procedures for selecting independent loss reserve specialists or hiring internal specialists, including procedures for determining that the specialist has the requisite competence in loss reserving, knowledge of the company's types of business, and understanding of the different methods available for calculating loss reserve estimates.
- Procedures for reviewing and evaluating the recommendations of the loss reserve specialist.
- Procedures to ensure that the methods used to calculate the loss reserve estimate are appropriate and sufficient in the circumstances.

Controls over the preparation of supporting data, in addition to those discussed in chapter 4 and exhibit B-2 in appendix B of the audit guide, may include—

- Procedures for verifying that data used by the loss reserve specialist is appropriately summarized and classified from the company's claims data base.
  - Procedures for ensuring that data actually used by the loss reserve specialist is complete and accurate.
  - Procedures to substantiate and determine the appropriateness of industry or other external data sources used in developing assumptions (for example, data received from involuntary risk pools).
- b. *Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose, based on information gathered in other audit tests.* Sources of data and factors used may include—
- Company historical claims data from its own data bases, including changes and trends in the data.
  - Company information on reinsurance levels and changes from prior years' reinsurance programs.
  - Data received from involuntary risk pools such as the National Council on Compensation Insurance.
  - Industry loss data from published sources.
  - Internal company experience or information from published sources concerning recent trends in socioeconomic factors affecting claim payments, such as—

- General inflation rates and specific inflation rates for medical costs, wages, automobile repair costs, and the like.
- Judicial decisions assessing liability.
- Judicial decisions regarding noneconomic damages.
- Changes in legislation affecting payment levels and settlement practices.

Consider whether the company's data is sufficient to have adequate statistical credibility (e.g., to allow the "law of large numbers" to work for the company's estimates). Consider whether the types of industry data used in developing assumptions are relevant to the company's book of business, considering policy limits, reinsurance retention, geographic and industry concentrations, and other appropriate factors.

- c. *Consider whether there are additional key factors or alternative assumptions about the factors.* Key factors and potential alternative assumptions that might be considered include—

- Changes in the company's experience or trends in loss reporting and settlements. Increases in the speed of the settlement of claims may lead to assumptions that paid development levels will be lower in the future, or may indicate changes in the company's procedures for processing claims that could lead to increased development in the future.
- Divergence in company experience relative to industry experience. Such divergence might later result in company development experience that reduces the divergence or might be indicative of a change in a company's experience with a book of business.
- Changes in a company's practices and procedures relating to recording and settling claims.
- A company's reinsurance programs and changes therein.
- Changes in a company's underwriting practices such as new or increased use of managing general agents.
- New or changed policy forms or coverages.
- Recent catastrophic occurrences.

- d. *Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.* Assumptions that should be evaluated include not only explicit assumptions but also the assumptions inherent in various loss projection methods.

- Paid loss projection methods assume that a company's historical experience relating to the timeliness of settlement will be predictive of future results.
- Reported (incurred) loss development projection methods assume that a company's experience in estimating case-basis reserves will be repeated in the future.

- e. *Analyze historical data used in developing the assumptions to assess whether it is comparable and consistent with data of the period under audit, and consider whether the data is sufficiently reliable for the purpose.* Consider whether the company's past methods of estimating loss reserves have resulted in appropriate estimates and whether current data (for example, current-year development factors) indicate changes from prior experience. Consider how known changes in the company's loss reporting procedures and settlement practices have been factored into the estimate. Consider how changes in reinsurance programs, in the current period and during historical periods, have been factored into management's estimates.
- f. *Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.* Consider such changes as—
- New lines of business and classes of business within lines.
  - Changes in reinsurance programs.
  - Changes in the regulatory environment, such as premium rate rollbacks and regulation.
  - Changes in the method of establishing rates and changes in methods of underwriting business.
- g. *Review available documentation of the assumptions used in developing the accounting estimates, inquire about any other plans, goals, and objectives of the entity, and consider their relationship to the assumptions.* A company's practices concerning loss settlement, such as a practice of vigorously defending suits or of quickly settling suits, can have a significant effect on a company's loss experience.
- h. *Consider using the work of a specialist regarding certain assumptions.* Using the work of a specialist is discussed in SAS No. 73, *Using the Work of a Specialist*, and in paragraphs .98 through .100 of this SOP.
- i. *Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.* Consider whether all lines of business and accident years are included in the loss reserve estimate. Consider how reinsurance recoverable, salvage, and subrogation have been included.

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## Developing an Independent Expectation of the Estimate

.74 Based on his or her understanding of the facts and circumstances, the auditor may independently develop an expectation of the estimate by using other key factors or alternative assumptions about those factors. This approach is required whenever management has not used the services of a loss reserve specialist in developing its loss reserve estimate and may be appropriate to assist the auditor in assessing the variability of the loss reserve estimates, even when management does use a loss reserve specialist. The auditor frequently develops independent projections because this method may result in a more cost-effective method of obtaining sufficient competent evidential matter. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.75 When this approach is used, the auditor should use an outside loss reserve specialist (the auditor may also be a loss reserve specialist) to develop the independent expectation of the loss reserve estimate. The use of a specialist is discussed in paragraphs .98 through .100 of this SOP. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## Analytical Procedures

.76 Various analytical procedures may be used in the evaluation of loss reserve trends and data, such as the analysis of—

- Loss ratios.
- Loss frequency and severity statistics.
- Claim cost by exposure units.
- Adequacy/redundancy of prior year reserves.
- Average case reserves.
- Claim closure rates.
- Paid to incurred ratios.

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.77 Such analyses include comparison of trends and data with industry averages or other expectations. Evaluation would normally be performed by line of business and accident or report year. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## Loss Reserve Ranges

.78 As stated in SAS No. 57:

Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.

Accordingly, loss reserves may develop in a number of ways and a reserve for a particular line of business or accident year may prove to be redundant or deficient when analyzed in a following period. Loss reserves considered to be adequate in prior periods may need to be adjusted at a later date as a result of events outside the control of the insurance company that create the need for a change in estimate. Such events include future court decisions and periods of inflation, in which rates may change significantly from period to period and affect the payout of claims. As a result of the circumstances described above, the need to adjust loss reserve estimates in future periods because of future events that are not predictable at the balance sheet date should not be interpreted as evidence of an error or poor loss reserving practices in the past. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.79 Because the ultimate settlement of claims is subject to future events, no single loss reserve estimate can be considered accurate with certainty. An audit approach should address the inherent variability of loss reserve estimates and the effect of that variability on audit risk. The development of a single loss reserve projection, by itself, does not address the concept of variability and may not provide sufficient evidence to evaluate the reasonableness of the loss reserve provision in the financial statements. An analysis of the reasonableness of loss reserve estimates ordinarily should include an analysis of the amount of variability in the estimate. One way to perform this analysis is to consider a range of loss reserve estimates bounded by a high and a low estimate. The high and low ends of the range should not correspond to an absolute best-and-worst-case scenario of ultimate loss settlements, because such estimates may be the result of unlikely assumptions. The range should be realistic and therefore should not include the set of all possible outcomes but instead only those outcomes that are considered reasonable. Extreme projections should be critically analyzed and, if appropriate, be adjusted, given less credence, or discarded (this would apply to projections outside a cluster of other logical projections that fall within a narrower range). [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.80 Another way to address the variability of the loss reserve estimate is to develop a best estimate and to supplement it with qualitative analysis that addresses the variability of the estimate. Qualitative analysis involves consideration of the factors affecting the variability of loss reserves and integrating such factors into a determination of the range of reasonable estimates around a best estimate. Such factors, among others, include the mix of products underwritten, losses incurred by the insurance industry for similar coverages and underwriting years, and the correlation between past and current business written. In any analysis, a thorough working knowledge of the risk factors is a prerequisite to setting a realistic range. Whether the auditor prepares a formal reserve range or a selected estimate, factors affecting the variability of the recorded loss reserve should be considered. The audit procedures performed for this purpose will vary based on the characteristics of the business, the controls the company uses to monitor such variability, and other audit procedures used. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.81 The size of the loss reserve range will vary by line of business. For example, automobile physical damage claims may be estimated with greater precision than product liability claims. In extreme cases, the top-to-bottom range could extend to 50 percent and upward of the amount provided. An example of an extreme case might be a newly formed company that writes primarily volatile types of business. The results of operations in such a situation are sensitive to future fluctuations since the loss reserve estimate is based primarily on assumptions that will undoubtedly change over time. More important, however, is the strain that any extremely adverse loss development would place on such a company's surplus. In an opposite extreme case, the top-to-bottom range might only be 5 percent of the amount provided for a company that only writes automobile physical damage coverages. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.82 When evaluating the variability of loss reserves for an entity, the auditor should be aware that variability within an individual risk group or line of business may be mitigated by the variability within other risk groups or lines

of business. In other words, it is unlikely that ultimate claim settlements for each line of business will fall at the same end of the range. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

### **Risk Factors and Developing a Range**

.83 Because loss reserves represent both reported and unreported claims that have occurred as of the valuation date, the auditor needs to gain an understanding of the company's exposure to risk through the business it writes as well as an understanding of environmental factors that may affect the company's loss development at the valuation date. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.84 Some risk factors existing within the company that may affect the variability of the company's loss reserves are—

- *The frequency and severity of claims associated with a line of business.* Medical malpractice, directors' and officers' liability, and other lines of business that typically produce few claims with large settlement amounts tend to have a high degree of variability.
- *Policy characteristics.* Individual lines of business can be written on different policy forms. For example, loss reserving and its related variability for medical malpractice written on an occurrence basis will differ markedly when the policy is written on a claims-made basis, especially during the early years of conversion from an occurrence to a claims-made basis.
- *Retention levels.* The greater a company's retention level, the more variable the results are likely to be. This increased variability is due to the effect that one or several large losses can have on the overall book of business. For reinsurance assumed, the concepts analogous to retention levels are referred to as attachment points and limits.
- *The mix of a company's business with respect to long-tail liability lines and short-tail property lines.* Typically, loss reserves on business with longer tails exhibit greater variability than on business with shorter tails because events affecting ultimate claim settlements may occur at a later date.

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.85 Some external factors that may affect the variability of loss reserves are—

- Catastrophes or major civil disorders.
- Jury awards and social inflation arising from the legal environment in principal states in which a company's risks are underwritten.
- The effect of inflation.

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.86 Other risk factors that may affect the variability of loss reserve estimates are described in the Appendix [paragraph .107] of this SOP. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.87 The auditor should obtain an understanding of both internal and external risk factors. This may be accomplished by a review of contracts, inquiries of underwriters, a review of pertinent trade publications, and any other procedures deemed necessary under the circumstances. The auditor should consider these factors in evaluating a reasonable loss reserve range. The best estimate may not necessarily be midway between the highest and lowest estimates in the range, because certain factors (for example, risk retention limits and retrospectively rated contracts) may reduce the variability at one end of the range but not at the other. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.88 When analyzing the variability of loss reserves, the auditor should be aware of potential offsets that may serve to reduce the financial statement effects of misstatements in the recorded loss reserves. Two common examples are ceded reinsurance and retrospectively rated contracts (primary or reinsurance). Such offsets, if material, should be included in an analysis of reserve ranges to quantify the true income statement or balance sheet effect that results from an increase or decrease in loss reserves. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.89 As noted previously in the discussion of internal risk factors and per-risk retention levels, a lower net retention level typically would translate into a lower variability of reserves. In addition, the auditor should consider the workings of all significant reinsurance ceded contracts and the effect that these contracts have on best estimates and high and low points in a range. In considering the effect of reinsurance ceded agreements on loss reserves, the auditor should also consider the effect on ceded reinsurance premiums. See paragraphs .104 through .106 of this SOP for a discussion of the effects of ceded reinsurance on loss reserve estimates. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.90 A retrospectively rated feature in an insurance contract means that increases or decreases in incurred losses may be wholly or partially offset by changes to earned but unbilled premiums. As a result of such a clause, an increase in loss reserves may lead to a receivable for additional premiums while a decrease in loss reserves may be offset by a reduction in premiums. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## **Evaluating the Financial Effect of a Reserve Range**

.91 To determine the amount of variability that is significant to the financial statements, the financial leverage of a company should be analyzed. Financial leverage refers to items such as reserve-to-surplus ratios. The financial position of a company with a 2-to-1 reserve-to-surplus ratio is less affected by variability in its loss reserves than is a company operating at a 4-to-1 ratio. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.92 Additionally, an analysis comparing the difference between recorded loss reserves and the high and low ends of a range with key financial statement balances, such as surplus or recorded loss reserves, might be performed. Combining financial leverage with other materiality factors pertinent to the



company (for example, loan covenant agreements) may provide insights into the amount of variability that is acceptable to the auditor. Because of the imprecise nature of estimating loss reserves, the acceptable range of loss reserve estimates will generally be higher than that of a more tangible balance such as accounts receivable or payable. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.93 According to SAS No. 47, "If the auditor believes the estimated amount included in the financial statements is unreasonable, he should treat the difference between the estimate and the closest reasonable estimate as a likely misstatement and aggregate it with other likely misstatements." Therefore, if the recorded loss reserve is outside the realistic range, the difference between the recorded reserve and the nearer end of the realistic reserve range should be treated as an audit difference. This audit difference should be considered with any other audit differences to evaluate the materiality of the effects on the financial statements. If the difference is deemed material, the auditor should first ask management for additional information that may have been overlooked in the original evaluation. Then, if still necessary, the auditor should attempt to persuade management to make an appropriate adjustment. If management does not make an appropriate adjustment, the auditor should consider modifying his or her report on the financial statements. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.94 SAS No. 47 also states, "Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement." Accordingly, if the recorded loss reserve is within the reasonable range developed by the auditor, an audit adjustment may not be appropriate. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.95 The significance of the variability within a realistic reserve range should also be evaluated against the financial statements. If the difference between the company's recorded reserve and the farther end of the reserve range is deemed significant, the auditor should consider extending audit procedures to obtain additional evidential matter relating to the reserve estimate. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.96 Management must select a single loss reserve estimate that represents its judgment about the most likely circumstances and events. If management develops a reasonable range, the amount recorded should be the best estimate within that range. The auditor should obtain an understanding of the process used by management in arriving at this estimate. In determining the reasonableness of loss reserves, the auditor also should consider the consistency of reserve estimates and any changes in the degree of conservatism of recorded reserves. A change in the degree of conservatism of management's estimate may be indicative of a change in management's reserve process. SAS No. 32, *Adequacy of Disclosure in Financial Statements*, discusses the auditor's responsibility to consider whether the financial statements include adequate disclosure of material matters in light of the circumstances and facts of which the auditor is aware. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## **Auditor Uncertainty About the Reasonableness of Management's Estimate and Reporting Implications**

.97 Ordinarily, the auditor would look to historical data to obtain evidential matter that will provide reasonable assurance that management's estimate of loss reserves is reasonable in the circumstances. Such historical data may not currently exist for certain new companies, for companies writing significant amounts of new lines of business, or for companies with a low volume of claims. When the historical data is not sufficient to resolve uncertainty about the reasonableness of management's estimate of loss reserves and the auditor is unable to resolve that uncertainty through other means, the auditor should consider whether management has adequately disclosed the uncertainty in the notes to the financial statements as required by FASB Statement No. 5, *Accounting for Contingencies*, and paragraphs 4 and 6 of FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, and SOP 94-6. A matter involving an uncertainty is one that is expected to be resolved at a future date at which time conclusive evidential matter concerning its outcome would be expected to become available. Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertion about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate. If the auditor is unable to obtain sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualification or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## **Use of Specialists by Auditors in Evaluating Loss Reserves**

.98 It is the auditor's responsibility to evaluate the reasonableness of the loss reserve established by management. The procedures that the auditor should consider in evaluating the reasonableness of the loss reserve are described in SAS No. 57. One of the procedures the auditor may consider in evaluating the reasonableness of the loss reserve is using the work of a special-

ist. SAS No. 73 provides guidance to the auditor who uses the work of a specialist in performing an audit of financial statements. It states that the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. The Statement also states that the auditor should evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity. When a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability. Although SAS No. 73 does not preclude the auditor from using the work of a specialist who is related to the client, because of the significance of loss reserves to the financial statements of insurance companies and the complexity and subjectivity involved in making loss reserve estimates, the audit of loss reserves requires the use of an outside loss reserve specialist, that is, a specialist who is not an employee or officer of the company. The term *loss reserve specialist* is defined in paragraphs .44 and .45 of this SOP. When the auditor has the requisite knowledge and experience in loss reserving, the auditor may serve as the loss reserve specialist. If the auditor does not possess the level of competence in loss reserving to qualify as a loss reserve specialist, the auditor should use the work of an outside specialist. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.99 In accordance with SAS No. 73, whenever the auditor uses the work of a specialist, the auditor should fulfill certain fundamental requirements. The auditor should satisfy himself or herself concerning the professional qualifications and reputation of the specialist by inquiry or other procedures. The auditor also should consider the relationship, if any, of the specialist to the client. An understanding should be established between the auditor, the client, and the specialist as to the scope and nature of the work to be performed by the specialist and the form and content of the specialist's report. The auditor has the responsibility to obtain an understanding of the methods or assumptions used by the specialist to determine whether the findings of the specialist are suitable for corroborating representations in the financial statements. These responsibilities apply to all the situations described in paragraph .100. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.100 The following are descriptions of situations involving the presence or absence of a loss reserve specialist in management's determination of loss reserves and the recommended response by the auditor in each situation.

*Situation 1*—The company has no loss reserve specialist involved in the determination of loss reserves.

*Auditor response to situation 1*—As stated in paragraph .47, this situation may constitute a reportable condition and possibly a material weakness in the internal control. The auditor should use an outside loss reserve specialist to develop an independent expectation of the loss reserve estimate recorded by the company.

*Situation 2*—The company has an in-house loss reserve specialist who is involved in the determination of loss reserves and the company does not use an outside loss reserve specialist.

*Auditor response to situation 2*—The auditor would be required to use an outside loss reserve specialist to evaluate the reasonableness of the company's loss reserve estimate.

*Situation 3*—The company has no in-house specialist but involves an outside loss reserve specialist in the determination of loss reserves.

*Auditor response to situation 3*—The auditor should evaluate the relationship, if any, of the specialist to the company. If the specialist is related to the client, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or should use an outside specialist for that purpose.

*Situation 4*—The company involves an in-house loss reserve specialist in the determination of loss reserves and involves an outside loss reserve specialist to separately review the loss reserves.

*Auditor response to situation 4*—The auditor could use the separate review performed by the outside loss reserve specialist.

[Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## Evaluating the Reasonableness of Loss Adjustment Expense Reserves

.101 Evaluation of the reasonableness of LAE reserves involves many of the same skills that are needed to evaluate the reasonableness of loss reserves; therefore, such an evaluation ordinarily requires the use of an outside loss reserve specialist. Frequently, both ALAE reserves and ULAE reserves are calculated based on formulas related to paid losses; therefore, in conjunction with the audit of loss adjustment expenses, the auditor should perform sufficient procedures to obtain assurance about the reliability of the paid-loss data. Although ALAE and ULAE frequently are calculated using formulas based on paid losses, they are calculated differently; accordingly, different procedures are used in the evaluation of these two types of reserves. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.102 In most circumstances, a development test cannot be used as a test of the reasonableness of the ULAE reserve. The reasonableness of the ULAE reserve is primarily dependent on the application of sound techniques of cost accounting and expense allocation. The basis of this allocation should be reviewed by the auditor because the way that the company allocates its expenses will have an effect on the ULAE reserve calculation. This review should focus on the allocation of costs to the loss adjustment classification as well as the allocation within that classification to the individual lines of business. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## Ceded Reinsurance Receivable

.103 This section discusses certain concepts and procedures that the auditor should be aware of to make a proper evaluation of the reasonableness of reinsurance receivable. This section does not address the following items, which are discussed in detail in the audit guide. Reference should be made to the audit guide for information about—

- The purpose and nature of reinsurance.
- Forms and types of reinsurance.
- Generally accepted accounting practices for reinsurance transactions.

- Internal control structure considerations relating to ceded and assumed reinsurance and a description of audit procedures to verify the integrity of recorded transaction data pursuant to such agreements.

[Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## **Understanding an Insurance Company's Reinsurance Program**

**.104** The audit guide recommends that the auditor obtain an understanding of an insurance company's reinsurance program to properly perform audit procedures to verify the accuracy and completeness of recorded cessions and assess the ability of reinsurers to meet their financial obligations under such agreements. This understanding is also essential to properly evaluate the reasonableness of reinsurance receivable balances. The scope of this understanding should not be limited to the reinsurance program currently in effect but should also include reinsurance program(s) in effect during historical periods from which loss experience will be used to project current year net ultimate losses and reinsurance recoveries. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

**.105** Net loss development patterns will vary to the extent that current reinsurance arrangements (coverages, levels of retention, and type and form of reinsurance) differ from arrangements in effect during the claim experience period used to project losses. Accordingly, the effect of such differences on reinsurance receivables will need to be carefully assessed by the auditor. The level of complexity involved in making this assessment is largely dependent on the types of reinsurance used and the amount of experience available under the program. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

**.106** Special difficulties arise in estimating reinsurance receivable on excess of loss reinsurance arrangements in which claim frequency is sporadic, retention levels have changed, and aggregate excess of loss arrangements is used. Estimates of reinsurance receivables are generally easiest for primary coverages (first dollar coverage of either property or casualty business). Additionally, relying on expected loss ratios as a guide for estimating recoveries on excess reinsurance arrangements will not be very helpful if the pricing of such arrangements has varied from year to year with little correlation to the underlying economics of these agreements. Some companies separately project reinsurance receivable on IBNR by stratifying the data base by size of loss. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

## Appendix

### Inherent and Control Risk Factors Affecting Loss Reserves

This Appendix describes various factors that may affect the auditor's assessment of inherent and control risk when auditing insurance entities' loss reserves.

#### Factors Affecting Inherent Risk

- A company's product mix may have a significant effect on the variability of loss reserves. It is more difficult to estimate loss reserves for long-tail lines of business than it is to estimate reserves for short-tail lines of business because events affecting ultimate claim settlement amounts will occur at a later date.
- New products or new types of risks generally will add to the subjectivity of the loss reserving process because of the company's lack of experience with the new product and relative lack of relevant historical data.
- Deductibles, policy limits, and the retention level of specific lines of business may have a significant effect on the volatility of losses to be settled.
- Policy lines with a low frequency and high severity of claim settlements may exhibit more variability than policy lines associated with a high frequency and low severity of claim settlements.
- Future inflation may result in ultimate loss settlements different from the amounts originally anticipated.
- Social inflation, which arises from the legal environment, as well as recent jury awards have the potential to increase ultimate loss settlements.
- The level and consistency of backlogs in processing claims affect the stability of loss reserve analyses.
- The degree of management's optimism or skepticism when establishing loss reserve assumptions may lead to fluctuations in reserves.
- The introduction of new policy forms may result in an unanticipated expansion of coverage. In addition, the company may lack historical data for losses under the new policy forms.
- Changes in regulations may cause insurance companies to change their claims adjusting practices; for example, a change in regulations may require an increase in the waiting period before workers' compensation benefits begin, or "bad faith" claim settlement laws may alter settlement practices.
- Catastrophic or unusual losses may distort historical experience. Reserves for catastrophic losses, particularly losses that occur near the end of the period, are difficult to estimate.

- Insurance company cash flow considerations may result in a change in loss payment practices.

## Factors Affecting Control Risk

- The quality and experience of personnel reviewing a company's loss reserves affect the overall control environment. For example, a company that employs a qualified actuary or an experienced loss reserve specialist to review reserves is usually better equipped to estimate loss reserves than is a company that uses a less qualified individual to perform that task.
- The proper functioning of controls over claim processing will reduce the possibility of error in the data underlying loss reserve estimates. The risk of error in the claims data base will be minimized if controls are functioning as designed.
- The completeness and accuracy of a company's data base will affect the risk of misstatement in assertions about loss reserves.
- The accuracy and reliability of claims data received from outside sources (cedants, reinsurers, voluntary and involuntary risk pools, etc.) will also affect the risk of misstatement in assertions about loss reserves.
- The adequacy of information and data produced by a company is critical in projecting loss reserves. For example, a company capable of accumulating only basic data on premium and loss experience generally poses a greater risk, all other things being equal, than does a company that is capable of accumulating and analyzing more sophisticated data.
- Significant decentralization of operations and reliance on intermediaries may increase control risk.
- A high level of delegation of claims processing or adjusting functions to intermediaries or outside adjusters, without adequate supervision, may result in inefficient claim handling and inappropriate case reserve estimates.
- Changes in delegated responsibilities may result in changes in claims settlement patterns and thereby invalidate historical claim experience.
- The quality of a company's underwriting and claims staff and its knowledge of the industry and control over the company's exposure to loss will have a significant effect on the loss reserving process.
- Existing manual or computerized systems may not be able to cope with a change in the volume of claims.
- Changes in the insurance company's claims processing system may invalidate the historical data used to develop and evaluate loss reserves. Types of changes that may have this result include—
  - Changes in claim classification, such as counting claimants instead of counting claims, considering reopened claims as IBNR claims rather than as development on reported claims, and changing the definition of claims closed without payment.

- Changes in settlement patterns, such as slowing down the payment of claims to increase the holding period of investable assets or speeding up the payment of claims to decrease the effects of inflation.
- Changes in case reserving methodologies, either explicit or implicit, such as a change from estimating case basis reserves on an ultimate cost basis to estimating case-basis reserves on a current cost basis.
- Changes in computerized information systems that result in faster or slower recognition and payment of claims.

[Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]



**Auditing Insurance Entities' Loss Reserves Task Force**

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**Insurance Companies Committee  
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Also, the contributions of Arnold Brousell and Carolyn Monchelli are greatly appreciated.

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[The next page is 30,761.]



## Section 11,250

# **Statement of Position 92-8 Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions**

October, 1992

### **NOTE**

This Statement of Position presents the recommendations of the Insurance Companies Committee regarding the audit of property/casualty insurance entities' statutory financial statements in applying certain requirements of the National Association of Insurance Commissioners' (NAIC's) Annual Statement Instructions. It has been reviewed by the chairman of the Auditing Standards Board for consistency with auditing standards. AICPA members may have to justify departures from the recommendations in this Statement of Position if their work is challenged.

## **Applicability**

.01 This statement of position (SOP) provides guidance on the impact of certain requirements of the National Association of Insurance Commissioners' (NAIC's) Annual Statement Instructions—Property and Casualty on the auditor's procedures in the audit of statutory financial statements of property/casualty insurance entities.

## **Introduction**

.02 The NAIC's Annual Statement Instructions direct property/casualty insurers to require their independent certified public accountants to subject the current Schedule P-Part 1 (excluding those amounts related to bulk and incurred-but-not-reported [IBNR] reserves and claim counts) to the auditing procedures applied in the audit of the current statutory financial statements to determine whether Schedule P-Part 1 is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole. Schedule P-Part 1 includes Part 1-Summary and Part 1A-1R.

.03 Although no separate report on Schedule P-Part 1 is required by the NAIC, the auditor should consider the provisions of SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, and the provisions of this SOP. However, the requirements of this SOP do not preclude an auditor from issuing a report similar to that illustrated in paragraph 12 of SAS No. 29.

## **Auditing Procedures**

.04 Certain of the information in Schedule P-Part 1 is typically subjected to auditing procedures applied in the audit of the basic statutory financial state-

ments (for example, premiums earned and losses paid). Other information not directly related to the basic statutory financial statements is also presented (for example, lines of business classifications for immaterial lines). Although such information may not have been subjected to auditing procedures applied in the audit of the basic statutory financial statements in all instances, such information may have been derived from accounting records that have been tested by the auditor.

.05 Paragraph 7 of SAS No. 29 states that although an auditor is not required by generally accepted auditing standards to apply auditing procedures to information presented outside of the basic financial statements, he or she may choose to modify or redirect certain of the procedures to be applied in the audit of the basic financial statements.

.06 In applying auditing procedures to the information presented in Schedule P-Part 1, the guidance about auditing the claims data base in paragraphs 4.1 and 4.2 of AICPA's SOP 92-4, *Auditing Insurance Entities' Loss Reserves* [section 11,230.61 and .62], applies. The auditor should also refer to chapter 4 and exhibit B-2 in appendix B of the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*.

.07 As stated in paragraph 4.2 of SOP 92-4 [section 11,230.62], because claim data and characteristics such as dates and types of loss can significantly influence reserve estimation, the auditor should test the completeness, reliability, and classification of the claim loss and loss expense data during the audit of the statutory financial statements. In extending those procedures to Schedule P-Part 1, the auditor should determine that—

- a. The data presented on Schedule P-Part 1 is properly reconciled to the statistical records of the company.
- b. Changes between the prior-year and current-year Schedule P-Part 1 are properly reconciled to the current-year audited statutory financial statements.
- c. The source of the data for the auditing procedures applied to the claim loss and loss adjustment expense data during the current calendar year (for example, tests of payments on claims for all accident years that were paid during the current calendar year) is the same as (or reconciles to) the statistical records that support the data presented on Schedule P-Part 1.

.08 If, as a result of the procedures performed during the audit of the statutory financial statements, the auditor becomes aware that Schedule P-Part 1 is not fairly stated in relation to the financial statements taken as a whole, the auditor should communicate to the company's management and the opining actuary that Schedule P-Part 1 is not fairly stated and should describe the misstatement. If the company will not agree to revise Schedule P-Part 1, the auditor should issue a report on Schedule P-Part 1 and should include a description of the misstatement in that report. (The auditor should refer to SAS No. 29 when a report will be issued.) The auditor should consider the impact of a misstatement in Schedule P-Part 1 on the auditor's report on the statutory financial statements.

## Effective Date

.09 This SOP is effective for audits of statutory-basis financial statements of property/casualty insurance entities for periods ending after December 15, 1992.

**Insurance Companies Committee  
(1991-1992)**

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## Section 11,270

# Statement of Position 93-5

## Reporting on Required Supplementary Information Accompanying Compiled or Reviewed Financial Statements of Common Interest Realty Associations

April 23, 1993

**NOTE**

This Statement of Position presents the recommendations of the AICPA Accounting and Review Services Committee on the application of Statements on Standards for Accounting and Review Services to compilations and reviews of financial statements of common interest realty associations. It has been reviewed by the chairman of the Accounting and Review Services Committee for consistency with existing compilation and review standards. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

.01 The American Institute of Certified Public Accountants (AICPA) has issued the Audit and Accounting Guide *Common Interest Realty Associations* (the CIRA guide), which requires common interest realty associations (CIRAs) to disclose certain supplementary information outside the basic financial statements. This requirement also applies to nonpublic CIRAs whose financial statements are compiled or reviewed in accordance with Statements on Standards for Accounting and Review Services (SSARSs). Paragraph 43 of SSARS 1, *Compilation and Review of Financial Statements*, describes the accountant's responsibility when the financial statements are accompanied by information voluntarily presented for supplementary analysis purposes; however, SSARSs do not address the accountant's responsibility when the financial statements are accompanied by required supplementary information. This statement of position (SOP) amends chapter 8, "Review and Compilation Engagements," of the CIRA guide by providing accountants with performance and reporting guidance when required supplementary information accompanies the basic financial statements in a compilation or review engagement.

.02 Paragraph 4.31 of the CIRA guide describes the required supplementary information that should accompany the basic financial statements. That information consists of—

- Estimates of current or future costs of future major repairs and replacements of all existing components, such as roofs, including estimated amounts required, methods used to determine the costs, the basis for calculations (including assumptions, if any, about interest and inflation rates), sources used, and the dates of studies made for this purpose, if any.<sup>1</sup>

<sup>1</sup> There is no requirement for CIRAs to obtain studies prepared by professional engineers. Estimates made by the board of directors or estimates obtained from licensed contractors are satisfactory, as discussed in paragraphs 3.06 and 3.07 of the CIRA guide, *Common Interest Realty Associations*.

- A presentation of components to be repaired and replaced, estimates of the remaining useful lives of those components, estimates of current or future replacement costs, and amounts of funds accumulated for each to the extent designated by the board.

.03 When the basic financial statements have been compiled or reviewed, the required supplementary information accompanying the basic financial statements should, at a minimum, be compiled. If the entity chooses to omit the required supplementary information, the guidance in paragraph .06 should be followed. To compile the required supplementary information, the accountant should—

- a. Establish an understanding with the entity regarding the services the accountant will perform with respect to the required supplementary information and how that information will affect the report the accountant expects to render.
- b. Consider what supplementary information is required by the CIRA guide and how that information is to be presented.
- c. Obtain an understanding of how the required supplementary information was developed. This understanding ordinarily includes the following:
  - The source of the information, for example, engineering reports, estimates obtained from licensed contractors, tables in technical manuals on useful lives
  - Whether the required supplementary information is based on current or future replacement costs
  - The interest and inflation rates used to determine funding requirements if the information is based on future replacement costs
- d. Consider whether it will be necessary to perform other accounting services in order to compile the required supplementary information.
- e. Read the required supplementary information and consider whether it appears to be appropriate in form and free from obvious material error.
- f. Obtain additional or revised information, if the accountant becomes aware that the required supplementary information is incorrect, incomplete, or otherwise unsatisfactory.
- g. If the entity is unable or refuses to provide additional or revised information, consider whether a modification of the standard report is adequate to disclose the deficiency in the measurement or presentation of the required supplementary information. If modification of the standard report is adequate to disclose the deficiency, the accountant should follow the guidance in paragraph .05. If modification of the standard report is not adequate to disclose the deficiency, the accountant should withdraw from the engagement.

.04 When the basic financial statements have been compiled or reviewed and the accompanying required supplementary information has been compiled, the accountant should indicate in the report, or in a separate report, the



degree of responsibility he or she is taking for the supplementary information. The report should—

- a. Identify the required supplementary information accompanying the financial statements. (Identification may be by descriptive title or page number of the document.)
- b. State that the supplementary information is not a required part of the basic financial statements but is supplementary information required by the AICPA.
- c. State that the accountant has compiled the accompanying supplementary information from information that is the representation of management, without audit or review.
- d. State that the accountant does not express an opinion or any other form of assurance on the supplementary information.

An example of an additional paragraph that may be added to a compilation report follows:

The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by the American Institute of Certified Public Accountants. We (I) have compiled [*identify the supplementary information*] from information that is the representation of management of XYZ Company, without audit or review. Accordingly, we (I) do not express an opinion or any other form of assurance on the supplementary information.

.05 If, on the basis of facts known to him or her, the accountant becomes aware that the supplementary information has not been measured or presented in accordance with prescribed guidelines, the accountant should indicate in his or her report that the information does not conform to the guidelines and should describe the nature of any material departure(s). An example of a sentence that might be added to the illustrative paragraph presented in paragraph .04 follows:

However, we (I) did become aware that the supplementary information about future major repairs and replacements of common property is not presented in conformity with the guidelines established by the American Institute of Certified Public Accountants because [*describe the material departure from the AICPA guidelines*].

.06 When the compiled or reviewed financial statements are not accompanied by the required supplementary information, a paragraph should be added to the compilation or review report indicating that the required supplementary information has been omitted. The accountant need not present the supplementary information in the accountant's report. The following is an example of a paragraph that the accountant might use in these circumstances:

The American Institute of Certified Public Accountants has determined that supplementary information about future major repairs and replacements of common property is required to supplement, but not required to be a part of, the basic financial statements. The Association has not presented this supplementary information.

.07 In an engagement to review the basic financial statements, the required supplementary information is not subjected to the inquiry and analytical procedures applied in the review of the basic financial statements; therefore,

SSARs are not applicable to the review of this information. If the accountant has been engaged to review the required supplementary information, he or she may do so in accordance with Statement on Standards for Attestation Engagements No. 1, *Attestation Standards*.

## **Effective Date**

.08 This SOP is effective for compilations and reviews of financial statements for periods ending on or after December 15, 1993. Earlier application is encouraged.

**Accounting and Review Services Committee  
(1992-1993)**

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[The next page is 30,951.]



## Section 11,280

# ***Statement of Position 93-8 The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises***

December 29, 1993

### **NOTE**

This Statement of Position presents the recommendations of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards to audits of financial statements of insurance enterprises. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

## **Introduction and Scope**

.01 Life insurance enterprises operate in a highly regulated environment. The regulation of life insurance enterprises is directed primarily toward safeguarding policyholders' interests and maintaining public confidence in the safety and soundness of the life insurance system. One of the primary tools used by state insurance departments for ensuring that those objectives are being achieved is risk-based capital (RBC).

.02 This Statement of Position (SOP) addresses the auditors' responsibility that arises from the RBC requirements imposed on life insurance enterprises. These RBC requirements affect audits of life insurance enterprises in the following three primary areas:

- a. Audit planning
- b. Going-concern considerations
- c. Other reporting considerations

## **Overview of Risk-Based Capital**

.03 Regulation of life insurance enterprises has historically focused on their capital. The National Association of Insurance Commissioners (NAIC) requires life insurance enterprises to disclose RBC in their statutory filings. The RBC calculation serves as a benchmark for the regulation of life insurance enterprises' solvency by state insurance regulators. RBC requirements set forth dynamic surplus formulas similar to target surplus formulas used by commercial rating agencies. The formulas specify various weighting factors that are applied to financial balances or various levels of activity based on the perceived degree of risk. Such formulas focus on four general types of risk:

- a. The risk related to the insurer's assets (asset or default risk)

- b. The risk of adverse insurance experience with respect to the insurer's liabilities and obligations (insurance or underwriting risk)
- c. The interest rate risk from the insurer's business (asset/liability matching)
- d. All other business risks (management, regulatory action, and contingencies)

The amount determined under such formulas is called the authorized control level RBC (ACLC).

.04 RBC requirements establish a framework for linking various levels of regulatory corrective action to the relationship of a life insurance entity's total adjusted capital (TAC) (equal to the sum of statutory capital and surplus and such other items, if any, as the NAIC's RBC instructions<sup>1</sup> may provide) to the calculated ACLC. The levels of regulatory action, the trigger point, and the corrective actions are summarized as follows:

***Risk-Based Capital Levels and Corrective Actions***

<i>Level</i>	<i>Trigger</i>	<i>Corrective Action</i>
Company Action Level RBC (CALC)	TAC is less than or equal to $2 \times \text{ACLC}$ , or TAC is less than or equal to $2.5 \times \text{ACLC}$ with negative trend	The life insurance enterprise must submit a comprehensive plan to the insurance commissioner.
Regulatory Action Level RBC (RALC)	TAC is less than or equal to $1.5 \times \text{ACLC}$ , or unsatisfactory RBC Plan	In addition to the action above, the insurance commissioner is required to perform an examination or analysis deemed necessary and issue a <i>corrective order</i> specifying corrective actions required.
Authorized Control Level RBC (ACLC)	TAC is less than or equal to $1 \times \text{ACLC}$	In addition to the actions described above, the insurance commissioner is permitted but not required to place the life insurance enterprise under regulatory control.
Mandatory Control Level RBC (MCLC)	TAC is less than or equal to $.7 \times \text{ACLC}$	The insurance commissioner is required to place the life insurance enterprise under regulatory control.

<sup>1</sup> The NAIC's RBC instructions may be amended by the NAIC from time to time in accordance with procedures adopted by the NAIC.

.05 Under the RBC requirements, the comprehensive financial plan should—

- a. Identify the conditions in the insurer that contribute to the failure to meet the capital requirements.
- b. Contain proposals of corrective actions that the insurer intends to take and that would be expected to result in compliance with capital requirements.
- c. Provide projections of the insurer's financial results in the current year and at least the four succeeding years, both in the absence of proposed corrective actions and giving effect to the proposed corrective actions.
- d. Identify the key assumptions impacting the insurer's projections and the sensitivity of the projections to the assumptions.
- e. Identify the quality of, and problems associated with, the insurer's business, including but not limited to its assets, anticipated business growth and associated surplus strain, extraordinary exposure to risk, mix of business, and use of reinsurance in each case, if any.

## Audit Planning

.06 The objective of an audit of a life insurance enterprise's financial statements is to express an opinion on whether they present fairly, in all material respects, the enterprise's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles (GAAP). To accomplish that objective, the auditor assesses the risk that the financial statements contain material misstatements and plans and performs audit procedures to provide reasonable assurance that the financial statements are free of material misstatements. Because of the importance of RBC to life insurance enterprises, RBC should be considered in assessing risk and planning the audit. The auditor should ordinarily obtain and review the client's RBC reports and should understand the RBC requirements for preparing such reports and the actual regulations associated with RBC.

## Going-Concern Considerations

.07 Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires auditors to evaluate, as part of every audit, whether there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the financial statement date. A significant consideration in the auditor's evaluation of a life insurance enterprise's ability to continue as a going concern is whether the enterprise complies with regulatory RBC requirements.<sup>2</sup>

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<sup>2</sup> Auditors should evaluate a life insurance enterprise's ability to continue as a going concern even if the enterprise meets the minimum RBC standards. There are other conditions and events that may indicate that there could be substantial doubt about a life insurance enterprise's ability to continue as a going concern, such as recurring operating losses, indications of strained liquidity, concerns expressed by regulators, and indications of strained relationships with regulators. However, this SOP discusses only failure to meet RBC standards.

.08 In view of the serious ramifications of noncompliance with regulatory RBC requirements for life insurance enterprises (see paragraph .04), such failure is a condition that indicates that there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Accordingly, the auditor should obtain information about management's plans that are intended to mitigate the adverse effects of the noncompliance with regulatory RBC capital requirements or events that gave rise to the condition and assess the likelihood that such plans can be implemented. In evaluating management's plans, the auditor should consider—

- a. The life insurance enterprise's existing regulatory capital position.
- b. Whether a comprehensive financial plan has been filed and, if so, whether it has been accepted by the regulators.

.09 The auditor should consider the amount of any RBC capital deficiency. In general, the lower the ratio of total adjusted capital to authorized control level RBC, the greater the doubt about the enterprise's ability to continue as a going concern for a reasonable period. The auditor should, however, also assess the likelihood that the life insurance enterprise's regulatory capital position will improve or deteriorate in the next twelve months.

.10 The auditor should also consider the nature or source (asset quality, underwriting, asset/liability matching, or other) of the deficiency. Curing deficiencies from certain sources may be more within the control of the management of the life insurance enterprise than curing deficiencies from other sources.

.11 Furthermore, the auditor should ascertain whether a comprehensive financial plan has been filed and accepted by the commissioner. If the commissioner has accepted the comprehensive financial plan, the auditor should identify those elements of the comprehensive financial plan that are particularly significant to overcoming the adverse effects of the failure to comply with regulatory RBC requirements and should identify and perform auditing procedures to obtain evidential matter about the significant elements. For example, the auditor should consider the adequacy of support regarding an enterprise's ability to obtain additional capital or a planned disposal of assets. When prospective financial information is particularly significant to management's plans, the auditor should request that management provide the information and should consider the adequacy of support for significant assumptions that underlie it. Further, the auditor should identify those elements of the comprehensive financial plan and conditions placed on the life insurance enterprise by the commissioner that are most difficult to achieve and consider the likelihood that the life insurance enterprise will not be able to implement the elements successfully.

.12 If the commissioner has rejected the comprehensive financial plan, the auditor should consider the commissioner's reasons for rejecting it, any revisions proposed by the commissioner to render the comprehensive financial plan satisfactory, management's intentions for revising the comprehensive financial plan, and possible regulatory sanctions. If the commissioner has not yet notified the insurer whether the comprehensive financial plan has been accepted,<sup>3</sup> the auditor should review related communication between the commissioner and the life insurance enterprise and make inquiries of both management and regulatory officials to determine the current status of the

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<sup>3</sup> The RBC Requirements require the commissioner to notify the insurer whether the comprehensive financial plan is accepted or is unsatisfactory within sixty days of submission of the plan.



comprehensive financial plan. If the life insurance enterprise has not filed a financial plan with the commissioner,<sup>4</sup> the auditor should make inquiries of management officials about their comprehensive financial plan and their plans for filing.

.13 After the auditor has evaluated management's plans, the auditor should conclude whether substantial doubt about the life insurance enterprise's ability to continue as a going concern for a reasonable period of time remains or is alleviated. This is often a complex judgment requiring considerable professional experience.

### Substantial Doubt Remains

.14 If the auditor concludes that substantial doubt about the life insurance enterprise's ability to continue as a going concern for a reasonable period of time remains, the auditor should (a) consider the possible effects on the financial statements and the adequacy of the related disclosures<sup>5</sup> and (b) modify his or her report.

### Independent Auditor's Reports

.15 The auditor's report should either (a) include an explanatory paragraph (following the opinion paragraph) to reflect the auditor's conclusion about the existence of substantial doubt that the entity can continue as a going concern for a reasonable period of time (see paragraph .17) or (b) disclaim an opinion (see paragraph .18).

.16 The illustrative auditors' reports in this SOP are presented to assist auditors in drafting their reports under various RBC circumstances. Each illustration intentionally describes the same general fact situation to avoid suggesting that particular facts always lead to a particular form of opinion. The appropriate form of opinion depends on the auditor's judgment as to the severity and most probable outcome of the matter described.

.17 The following is an illustration of an auditor's report (unqualified opinion) on the financial statements of a life insurance enterprise with an explanatory paragraph added because of the existence of substantial doubt about the enterprise's ability to continue as a going concern.

#### Independent Auditor's Report<sup>6</sup>

To the Board of Directors and Shareholders  
ABC Life Company

We have audited the accompanying balance sheets of ABC Life Company as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial

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<sup>4</sup> The RBC Requirements require that a comprehensive financial plan be filed with the commissioner within forty-five days of the failure to meet RBC standards.

<sup>5</sup> Auditors of publicly held life insurance enterprises should consider SEC Financial Reporting Release No. 16, *Rescission of Interpretation Relating to Certification of Financial Statements*, which states, "... filings containing accountants' reports that are qualified as a result of questions about the entity's continued existence must contain appropriate and prominent disclosure of the registrant's financial difficulties and viable plans to overcome these difficulties."

<sup>6</sup> The circumstances described in the fourth paragraph of this illustrative report represent assumptions made for purposes of illustration only. They are not intended to provide criteria or other guidelines to be used by independent auditors in deciding whether an explanatory paragraph should be added to their reports.

statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

The accompanying financial statements have been prepared assuming that ABC Life Company will continue as a going concern. As discussed in Note XX to the financial statements, [State of Domicile's Insurance Regulatory Body] imposes risk-based capital requirements on life insurance enterprises, including the Company. At December 31, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [State of Domicile's Insurance Regulatory Body]. The Company has filed a comprehensive financial plan with the commissioner outlining the Company's plans for attaining the required levels of regulatory capital by December 31, 19XX. To date, the Company has not received notification from the commissioner regarding acceptance or rejection of its comprehensive financial plan. Failure to meet the capital requirements and interim capital targets included in the Company's plan would expose the Company to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and placing the Company under regulatory control. These matters raise substantial doubt about the ability of ABC Life Company to continue as a going concern. The ability of the Company to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of the Company's comprehensive financial plan. Management's plans in regard to these matters are described in Note XX. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[Signature]

[Date]

.18 SAS No. 59 states that inclusion of an explanatory paragraph (following the opinion paragraph) in the auditor's report as described above serves adequately to inform users of the financial statements of the auditor's substantial doubt. Nonetheless, SAS No. 59 does not preclude the auditor from declining to express an opinion in cases involving uncertainties. If the auditor disclaims an opinion, the uncertainties and their possible effects should be disclosed in an appropriate manner and the auditor's report should state all of the substantive reasons for the disclaimer of opinion. The following is an illustration of an auditor's report containing a disclaimer of opinion as the result of uncertainties relating to an auditor's substantial doubt about a life insurance enterprise's ability to continue as a going concern for a reasonable period of time.

Independent Auditor's Report<sup>7</sup>

To the Board of Directors and Shareholders  
XYZ Life Company

We have audited the accompanying balance sheets of XYZ Life Company as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to report on these financial statements based on our audits.

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

The accompanying financial statements have been prepared assuming that XYZ Life Company will continue as a going concern. As discussed in Note XX to the financial statements, [State of Domicile's Insurance Regulatory Body] imposes risk-based capital requirements on life insurance enterprises, including the Company. At December 31, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [State of Domicile's Insurance Regulatory Body]. The Company has filed a comprehensive financial plan with the commissioner outlining its plans for attaining the required levels of regulatory capital by December 31, 19XX. To date, the Company has not received notification from the commissioner regarding acceptance or rejection of its comprehensive financial plan. Failure to meet the capital requirements and interim capital targets included in the Company's plan would expose the Company to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and placing the Company under regulatory control. These matters raise substantial doubt about the ability of XYZ Life Company to continue as a going concern. The ability of the Company to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of the Company's comprehensive financial plan. Management's plans in regard to these matters are described in Note XX. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Because of the significance of the uncertainty discussed above, we are unable to express, and we do not express, an opinion on the financial statements for the year ended December 31, 19X2.

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

[Signature]

[Date]

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<sup>7</sup> The circumstances described in the third paragraph of this illustrative report represent assumptions made for purposes of illustration only. They are not intended to provide criteria or other guidelines to be used by independent auditors in deciding whether to disclaim an opinion on financial statements.

## Substantial Doubt Alleviated

.19 If the auditor concludes that substantial doubt about the life insurance enterprise's ability to continue as a going concern for a reasonable period of time is alleviated, the auditor should consider the adequacy of disclosure in the financial statements of the principal conditions or events that initially raised the substantial doubt. The auditor should follow the guidance in SAS No. 59, paragraphs .10 and .11. Furthermore, the auditor may wish to add an emphasis of matter paragraph to the auditor's report (see paragraphs .27 and .28, below).

## Other Reporting Considerations

### Uncertainties

.20 A matter involving an uncertainty is one that is expected to be resolved at a future date, at which time conclusive evidential matter concerning its outcome would be expected to become available. Uncertainties include, but are not limited to, contingencies covered by FASB Statement No. 5, *Accounting for Contingencies*, and matters related to estimates covered by SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640]. [Paragraph revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.21 Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. An audit includes an assessment of whether the evidential matter is sufficient to support management's analysis. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate. [Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.22 If the auditor is unable to obtain sufficient evidential matter to support management's assertion about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualified opinion or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management. [Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.23 Scope limitations related to uncertainties should be differentiated from situations in which the auditor concludes that the financial statements are materially misstated due to departures from GAAP related to uncertainties. Such departures may be caused by inadequate disclosure concerning the uncertainty, the use of inappropriate accounting principles, or the use of unreasonable accounting estimates. [Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.24 The auditor's decision to add an explanatory paragraph to the auditor's report because of the existence of such an uncertainty that affects the financial statements is one that requires a high degree of professional judgment. Prior to considering whether an explanatory paragraph should be added to the auditor's report because of the existence of a material uncertainty, the auditor should have concluded that substantial doubt about the life insurance enterprise's ability to continue as a going concern does not exist (see paragraphs .07 to .19, above). An explanatory paragraph for a material uncertainty should not be used for situations in which the auditor's uncertainty involves substantial doubt about the ability of the life insurance enterprise to continue as a going concern. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.25 Because its resolution is prospective, management generally cannot estimate the effect of the uncertainty on the entity's financial statements. Uncertainties should not be confused with future events that generally are susceptible to reasonable estimation by management in preparing financial statements. If the auditor believes that financial statements are materially misstated as a result of the use of inappropriate accounting principles, the auditor should express a qualified or adverse opinion. A scope limitation should result in a qualified opinion or a disclaimer of opinion. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.26 If the auditor decides to include an explanatory paragraph(s) in the report because of the existence of a material uncertainty that affects the financial statements, the explanatory language should follow the opinion paragraph and should describe the matter giving rise to the uncertainty and indicate that its outcome cannot presently be determined. The explanatory language may be shortened by referring to disclosures made in a note to the financial statements. No reference to the uncertainty should be made in the introductory, scope, or opinion paragraphs of the auditor's report. The following is an illustration of an auditor's report (unqualified opinion) on the financial statements of a life insurance enterprise with an explanatory paragraph because of the existence of a material uncertainty as a result of possible regulatory sanctions.

#### Independent Auditor's Report<sup>8</sup>

To the Board of Directors and Shareholders  
GHI Life Insurance Company

We have audited the accompanying balance sheets of GHI Life Insurance Company as of December 31, 19X2 and 19X1, and the related statements of

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<sup>8</sup> The circumstances described in the fourth paragraph of this illustrative report represent assumptions made for purposes of illustration only. They are not intended to provide criteria or other guidelines to be used by independent auditors in deciding whether an explanatory paragraph should be added to their reports.

income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to report on these financial statements based on our audits.

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

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

As discussed in Note XX to the financial statements, [State of Domicile's Insurance Regulatory Body] imposes risk-based capital requirements on life insurance enterprises, including the Company. At December 31, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [State of Domicile's Insurance Regulatory Body]. The ultimate outcome of this situation cannot presently be determined. Accordingly, no adjustments that may result from the ultimate resolution of this uncertainty have been made in the accompanying financial statements.

[Signature]

[Date]

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

## Emphasis of a Matter

.27 In some circumstances, the auditor may wish to emphasize a matter regarding the financial statements, but nevertheless intends to express an unqualified opinion. An example of such a circumstance is the failure to comply with regulatory RBC requirements. Prior to considering whether an emphasis of a matter paragraph should be added to the auditor's report for a failure to comply with regulatory RBC requirements, however, the auditor should have concluded that the matter being emphasized does not create substantial doubt about the life insurance enterprise's ability to continue as a going concern (see paragraphs .07 to .19, above) and does not reflect a material uncertainty (see paragraphs .20 to .26, above). [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.28 Emphasis of a matter should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this type. The following is an illustration of an unqualified opinion with an emphasis of a matter paragraph regarding the possible effects of a life insurance enterprise's failure to comply with regulatory RBC requirements on its financial statements.

Independent Auditor's Report<sup>9</sup>

To the Board of Directors and Shareholders  
DEF Life Company

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

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

As discussed in Note XX to the financial statements, [State of Domicile's Insurance Regulatory Body] imposes risk-based capital requirements on life insurance enterprises, including the Company. At December 31, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [State of Domicile's Insurance Regulatory Body].

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

[Signature]

[Date]

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

## Effective Date

.29 This statement of position is effective for audits of life insurance enterprises' financial statements for periods ending after December 15, 1993. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

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<sup>9</sup> The circumstances described in the third paragraph of this illustrative report represent assumptions made for purposes of illustration only. They are not intended to provide criteria or other guidelines to be used by independent auditors in deciding whether an emphasis paragraph should be added to their reports.

**Insurance Companies Committee  
(1992-1993)**GARY W. ROUBINEK, *Chairman*

SHIRLEY L. ABEL

EDWARD F. BADER

RICHARD H. BERTHOLDT

ANTHONY R. BIELE

JOSEPH P. BRANDON

DARREN F. COOK

WILLIAM C. FREDA

ROBERT W. GRANOW

WAYNE R. HUNEKE

R. LARRY JOHNSON

PETER E. JOKIEL

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## Section 11,290

# Statement of Position 94-1 Inquiries of State Insurance Regulators

April 20, 1994

### NOTE

This statement of position presents the recommendations of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards to audits of financial statements of insurance enterprises. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

## Introduction

.01 This statement of position (SOP) addresses the auditor's consideration of regulatory examinations as a source of evidential matter in conducting an audit of an insurance enterprise's financial statements and the auditor's evaluation of material permitted statutory accounting practices.

## Applicability

.02 This SOP applies to audits of financial statements of life insurance enterprises,<sup>1</sup> property and casualty insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. It amends chapter 2 ("Audit Considerations") of the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* and chapter 9 ("Auditing Procedures") of the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*.<sup>2</sup>

## Auditor's Consideration of State Regulatory Examinations

.03 Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates*, states that the auditor should consider evaluating "information con-

<sup>1</sup> FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, clarifies that FASB Statements and Interpretations and Accounting Principles Board (APB) Opinions apply to mutual life insurance enterprises, except when specifically exempted, that prepare financial statements in conformity with generally accepted accounting principles. This SOP applies to audits of mutual life insurance enterprises.

<sup>2</sup> The AICPA's Insurance Companies Committee technical agenda includes a project to supersede the Industry Audit Guide *Audits of Stock Life Insurance Companies*. The new Audit and Accounting Guide *Audits of Life and Health Insurance Enterprises* will include the guidance contained in this SOP.

tained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies." SAS No. 54, *Illegal Acts by Clients*, notes that "the auditor may encounter specific information that may raise a question concerning possible illegal acts, such as . . . violations of laws or regulations cited in reports of examinations by regulatory agencies that have been available to the auditor." Accordingly, it is appropriate that the auditor review examination reports and related communications between regulators and the insurance enterprises to obtain competent evidential matter.

**.04** The auditor should review reports of examinations and communications between regulators and the insurance enterprise and make inquiries of the regulators. The auditor should—

- Request that management provide access to all reports of examinations and related correspondence including correspondence relating to financial conditions.
- Read reports of examinations and related correspondence between regulators and the insurance enterprise during the period under audit through the date of the auditor's report.
- Inquire of management and communicate with the regulators, with the prior approval of the insurance enterprise, when the regulators' examination of the enterprise is in process or a report on an examination has not been received by the insurance enterprise regarding conclusions reached during the examination.

**.05** A refusal by management to allow the auditor to review communications from, or to communicate with, the regulator would ordinarily be a limitation on the scope of the audit sufficient to preclude an unqualified opinion. (See SAS No. 58, *Reports on Audited Financial Statements*.) A refusal by the regulator to communicate with the auditor may be a limitation on the scope of the audit sufficient to preclude an unqualified opinion, depending on the auditor's assessment of other relevant facts and circumstances.

## Auditor's Consideration of Permitted Statutory Accounting Practices

**.06** Prescribed statutory accounting practices currently include state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state; the National Association of Insurance Commissioners (NAIC) Annual Statement Instructions; the NAIC *Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC *Examiners' Handbook*.

**.07** Permitted accounting practices include practices not prescribed in paragraph .06 but allowed by the domiciliary state insurance department. Insurance enterprises may request permission from the domiciliary state insurance department to use a specific accounting practice in the preparation of their statutory financial statements (a) when the enterprise wishes to depart from the prescribed statutory accounting practices, or (b) when prescribed statutory accounting practices do not address the accounting for the transaction(s). Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

.08 Auditors should exercise care in concluding that an accounting treatment is *permitted*, and should consider the adequacy of disclosures in the financial statements regarding such matters.<sup>3</sup> For each examination, auditors should obtain sufficient competent evidential matter to corroborate management's assertion that permitted statutory accounting practices that are material to an insurance enterprise's financial statements are permitted by the domiciliary state insurance department.

.09 Sufficient competent evidential matter consists of any one or combination of—

- Written acknowledgment sent directly from the regulator to the auditor. (This type of corroboration includes letters similar to attorneys' letters and responses to confirmations.
- Written acknowledgment prepared by the regulator, but not sent directly to the auditor, such as a letter to the client.
- Direct oral communications between the regulator and the auditor, supported by written memorandum. (If the auditor, rather than the regulator, prepares the memorandum, the auditor should send such memorandum to the regulator to make sure it accurately reflects the communication.)

Auditors should use judgment to determine the type of corroboration that is necessary in the circumstances.

.10 If the auditor is unable to obtain sufficient competent evidential matter to corroborate management's assertion regarding a permitted statutory accounting practice that is material to the financial statements, the auditor should qualify or disclaim an opinion on the statutory financial statements because of the limitation on the scope of the audit. (See SAS No. 58, *Reports on Audited Financial Statements*.)

## Effective Date

.11 This SOP should be applied to audits of financial statements performed for periods ending on or after December 15, 1994.

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<sup>3</sup> The AICPA has issued an exposure draft of a statement of position, *Disclosures of Certain Matters in Financial Statements of Insurance Enterprises*, that would require insurance enterprises to disclose information about permitted statutory accounting practices in their financial statements prepared in conformity with generally accepted accounting principles.

**Insurance Companies Committee  
(1993-1994)**

GARY W. ROUBINEK, *Chairman*  
JOSEPH P. BRANDON  
ROBERT E. BROATCH  
PETER S. BURGESS  
DARREN F. COOK  
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## Section 11,300

### **Statement of Position 95-4 Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule**

November 3, 1995

#### **NOTE**

This Statement of Position presents the recommendations of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards to audits of financial statements of insurance enterprises. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

## **Introduction**

.01 This Statement of Position (SOP) provides guidance to auditors on the form and content of communications with state insurance regulators. Such communications are required by the National Association of Insurance Commissioners (NAIC) *Annual Statement Instructions Requiring Annual Audited Financial Statements*, which incorporates the January 1991 *Model Rule (Regulation) Requiring Annual Audited Financial Reports* (reissued in July 1995) (hereinafter called the Model Audit Rule). The Model Audit Rule was designed by the NAIC to promote uniformity in state laws and regulations dealing with audits of insurance enterprises' statutory financial statements. Though some states have laws or regulations that differ from the Model Audit Rule, this SOP addresses only the requirements of the Model Audit Rule.

.02 To the extent that the Model Audit Rule is changed in the future, the illustrations in this SOP may need to be changed to reflect the revised provisions of the Model Audit Rule. For example, at the time of this SOP, the NAIC is in the process of codifying statutory accounting practices for certain insurance enterprises. The *Annual Statement Instructions Requiring Annual Audited Financial Statements* currently requires that statutory financial statements be prepared using accounting practices prescribed or otherwise permitted by the insurance department of the state of domicile. It is expected that when the NAIC completes the codification of statutory accounting practices, the Model Audit Rule will be amended to require auditors to express opinions on statutory financial statements as to their conformity with the newly codified statutory accounting principles rather than as to their conformity with statutory accounting practices prescribed or permitted by the insurance department of the state of domicile.

## Scope

.03 This SOP applies to audits of financial statements of all insurance companies that file audited financial statements with state insurance departments in accordance with the NAIC's Model Audit Rule. It amends the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* and the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*.<sup>1</sup>

## Conclusions—Form and Content

### Awareness

.04 Section 6 of the Model Audit Rule requires that the insurer notify the insurance commissioner of the state of domicile of the name and address of the insurer's independent certified public accountant (hereinafter referred to as *auditor*). In connection with that notification, the insurer is required to obtain an awareness letter from its auditor stating that the auditor—

- a. Is aware of the provisions of the insurance code and the rules and regulations of the insurance department of the state of domicile that relate to accounting and financial matters.
- b. Will issue a report on the financial statements in terms of their conformity to the statutory accounting practices prescribed or otherwise permitted by the insurance department of the state of domicile, specifying exceptions as appropriate.

.05 The following is an illustration of the awareness letter:

To the Board of Directors of ABC Insurance Company:

We have been engaged by ABC Insurance Company (the Company) to perform annual audits in accordance with generally accepted auditing standards of the Company's statutory financial statements. In connection therewith, we acknowledge the following:

We are aware of the provisions relating to the accounting and financial reporting matters in the Insurance Code of [name of state of domicile] and the related rules and regulations of the Insurance Department of [name of state of domicile] that are applicable to audits of statutory financial statements of insurance enterprises. Also, after completion of our audits, we expect that we will issue our report on the statutory financial statements of ABC Insurance Company as to their conformity with accounting practices prescribed or permitted by the Insurance Department of [name of state of domicile].

This letter is intended solely for the information and use of the Insurance Department of [name of state of domicile] and other state insurance departments and is not intended to be and should not be used by anyone other than these specified parties.

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

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<sup>1</sup> The AICPA has a project under way to prepare an Audit and Accounting Guide *Audits of Life and Health Insurance Entities* which covers audits of mutual life insurance companies as well as stock life insurance companies. The new Audit and Accounting Guide would replace the Industry Audit Guide *Audits of Stock Life Insurance Companies* and would incorporate the guidance in this Statement of Position.

## Change in Auditor

.06 Section 6 of the Model Audit Rule requires that insurers notify the insurance department of the state of domicile within five business days of the dismissal or resignation of the auditor for the immediately preceding filed audited statutory financial statements. Within ten business days of that notification, the insurer also is required to provide a separate letter stating whether, in the twenty-four months preceding that event, there were any disagreements, subsequently resolved or not, with the former auditor on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of the former auditor, would have caused the auditor to make reference to the subject matter of the disagreement in connection with the auditor's opinion. The Model Audit Rule requires that the insurer provide the insurance department of the state of domicile a letter from the former auditor to the insurer indicating whether the auditor agrees with the statements in the insurer's letter and, if not, stating the reasons for the disagreement.

.07 The following is an illustration of the change in auditor letter:

To the Board of Directors of DEF Insurance Company:

We previously were auditors for DEF Insurance Company and, under the date of [report date], we reported on the statutory financial statements of DEF Insurance Company as of and for the years ended December 31, 19X1 and 19X0.<sup>2</sup> Effective [date of termination], we are no longer auditors of DEF Insurance Company. We have read DEF Insurance Company's statements in its letter dated [date of insurer's letter], which is attached hereto, and we agree with the statements therein. [However, if the auditor is (a) not in a position to agree or disagree or (b) does not agree with the insurer's statement, the auditor's letter should state that the auditor is not in a position to agree or disagree or that the auditor does not agree with such statements and give the reasons.]<sup>3</sup>

## Qualifications

.08 Section 12 of the Model Audit Rule requires the auditor to provide a letter to the insurer to be included in the annual financial report stating—

- a. The auditor is independent with respect to the insurer and conforms with the standards of his or her profession as contained in the Code of Professional Conduct and pronouncements of the AICPA and the Rules of Professional Conduct of the appropriate state board of public accountancy.
- b. The background and experience in general and of the individuals used for an engagement and whether each is a certified public accountant.

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<sup>2</sup> If the auditor had not reported on any financial statements, the first sentence should be modified as follows:

We previously were engaged to audit the statutory financial statements of DEF Insurance Company as of and for the year ending December 31, 19X1.

<sup>3</sup> The insurer's letter may contain a statement, such as—

In connection with the audits of the statutory financial statements of the Company for the years ended December 31, 19X2 and 19X1, and the subsequent interim period through [date of termination], there were no disagreements with [CPA Firm] on any matter of accounting principles, statutory accounting practices prescribed or permitted by the Insurance Department of [name of state of domicile], financial statement disclosure, or auditing scope or procedures, which disagreements if not resolved to their satisfaction would have caused them to make reference to the subject matter of the disagreement in their reports.

- c. The auditor understands that the annual audited statutory financial statements and his or her opinion thereon will be filed in compliance with the requirement of the Model Audit Rule and that the domiciliary commissioner will be relying on the information in the monitoring and regulating of the financial position of insurers.
- d. The auditor consents to the workpaper requirements contained in the Model Audit Rule and agrees to make the workpapers available for review by the domiciliary commissioner or the commissioner's designee under the auditor's control.<sup>4</sup>
- e. The engagement partner is licensed by an appropriate state licensing authority and is a member in good standing of the AICPA.
- f. The auditor meets the qualifications and is in compliance with the "Qualifications of Independent Certified Public Accountant" section of the Model Audit Rule.

.09 The following is an illustration of the qualification letter:

To the Board of Directors of GHI Insurance Company:

We have audited, in accordance with generally accepted auditing standards, the statutory financial statements of GHI Insurance Company (the Company) for the years ended December 31, 19X1 and 19X0, and have issued our report thereon dated [date of report]. In connection therewith, we advise you as follows:

- a. We are independent certified public accountants with respect to the Company and conform to the standards of the accounting profession as contained in the Code of Professional Conduct and pronouncements of the American Institute of Certified Public Accountants, and the Rules of Professional Conduct of the [state] Board of Public Accountancy.
- b. The engagement partner and engagement manager, who are certified public accountants, have [ ] years and [ ] years, respectively, of experience in public accounting and are experienced in auditing insurance enterprises. Members of the engagement team, most (some) of whom have had experience in auditing insurance enterprises and [X] percent of whom are certified public accountants, were assigned to perform tasks commensurate with their training and experience.
- c. We understand that the Company intends to file its audited statutory financial statements and our report thereon with the Insurance Department of [name of state of domicile] and other state insurance departments in states in which the Company is licensed and that the insurance commissioners of those states will be relying on that information in monitoring and regulating the statutory financial condition of the Company.

While we understand that an objective of issuing a report on the statutory financial statements is to satisfy regulatory requirements, our audit was not planned to satisfy all objectives or responsibilities of insurance regulators. In this context, the Company and insurance commissioners should understand that the objective of an audit of statutory financial statements in accordance with generally accepted au-

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<sup>4</sup> Refer to AICPA, *Professional Standards*, vol. 1, AU 9339, *Working Papers: Auditing Interpretations of Section 339*.



ding standards is to form an opinion and issue a report on whether the statutory financial statements present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus, results of operations and cash flow in conformity with accounting practices prescribed or permitted by the Insurance Department of [name of state of domicile]. Consequently, under generally accepted auditing standards, we have the responsibility, within the inherent limitations of the auditing process, to plan and perform our audit to obtain reasonable assurance about whether the statutory financial statements are free of material misstatement, whether caused by error or fraud, and to exercise due professional care in the conduct of the audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on financial statements. Audit procedures that are effective for detecting errors, if they exist, may be ineffective for detecting misstatements resulting from fraud. Because of the characteristics of fraud, particularly those involving concealment and falsified documentation (including forgery), a properly planned and performed audit may not detect a material misstatement resulting from fraud. In addition, an audit does not address the possibility that material misstatements resulting from fraud may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may exist that would have been assessed differently by insurance commissioners.

It is the responsibility of the management of the Company to adopt sound accounting policies, to maintain an adequate and effective system of accounts, and to establish and maintain an internal control structure that will, among other things, provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of [name of state of domicile].

The Insurance Commissioner should exercise due diligence to obtain whatever other information that may be necessary for the purpose of monitoring and regulating the statutory financial position of insurers and should not rely solely upon the independent auditor's report.

- d. We will retain the workpapers<sup>5</sup> prepared in the conduct of our audit until the Insurance Department of [name of state of domicile] has filed a Report of Examination covering 19X1, but not longer than seven years. After notification to the Company, we will make the workpapers available for review by the Insurance Department of [name of state of dom-

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<sup>5</sup> Section 13 of the Model Audit Rule defines workpapers as follows:

Workpapers are the records kept by the independent certified public accountant of the procedures followed, the tests performed, the information obtained, and the conclusions reached pertinent to the accountant's examination of the financial statements of an insurer. Workpapers, accordingly, may include audit planning documentation, work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents and schedules or commentaries prepared or obtained by the independent certified public accountant in the course of his or her examination of the financial statements of an insurer and which support the accountant's opinion.

[Footnote added, September 1997, to reflect the issuance of the Notice to Practitioners on communications with state insurance regulators.]

icile] at the offices of the insurer, at our offices, at the Insurance Department or at any other reasonable place designated by the Insurance Commissioner. Furthermore, in the conduct of the aforementioned periodic review by the Insurance Department of [name of state of domicile], photocopies of pertinent audit workpapers may be made (under the control of the accountant) and such copies may be retained by the Insurance Department of [name of state of domicile].<sup>6</sup>

- e. The engagement partner has served in that capacity with respect to the Company since [year that current "term" started], is licensed by the [state name] Board of Public Accountancy, and is a member in good standing of the American Institute of Certified Public Accountants.
- f. To the best of our knowledge and belief, we are in compliance with the requirements of section 7 of the NAIC's *Model Rule (Regulation) Requiring Annual Audited Financial Reports* regarding qualifications of independent certified public accountants.

This letter is intended solely for the information and use of the Insurance Department of [name of state of domicile] and other state insurance departments and is not intended to be and should not be used by anyone other than these specified parties.

[Amended, September 1997 and September 1998, to reflect the issuance of Notices to Practitioners.]

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

## Notification of Adverse Financial Condition

.10 Section 10 of the Model Audit Rule requires that the auditor notify the insurer's board of directors or audit committee in writing within five business days of a determination that (a) the insurer has materially misstated its financial condition as reported to the domiciliary commissioner as of the balance-sheet date currently under examination or (b) the insurer does not meet the minimum capital and surplus requirements of the state insurance statute as of the balance-sheet date. The Model Audit Rule also requires the insurer to provide (a) to the insurance commissioner of the state of domicile a copy of the notification of adverse financial condition within five days of its receipt and (b) to the auditor evidence that the notification has been provided to the insurance commissioner. If the auditor receives no such evidence, the Model Audit Rule requires the auditor to send the notification to the insurance commissioner directly within the next five business days.

.11 The following is an illustration of the auditor's notification of adverse financial condition letter when the audit is complete:<sup>7</sup>

To the Board of Directors of MNO Insurance Company:

We have audited, in accordance with generally accepted auditing standards, the statutory financial statements of MNO Insurance Company (the Company) as of December 31, 19X1 and 19X0, and have issued our report thereon dated [date of report].

<sup>6</sup> See footnote 4. [Footnote renumbered, September 1997, to reflect the issuance of the Notice to Practitioners on communications with state insurance regulators.]

<sup>7</sup> A determination that financial statements filed with a state insurance department contain a material misstatement does not necessarily always occur when an audit is complete. The Model Audit Rule requires notification to be provided within five business days of such determination. The language in this illustrative letter should be modified depending on the relevant facts and circumstances. [Footnote renumbered, September 1997, to reflect the issuance of the Notice to Practitioners on communications with state insurance regulators.]

In connection with our audit, we determined that capital and surplus reflected in the statement of admitted assets, liabilities, and capital and surplus of the Company as of December 31, 19X1, as reported on the 19X1 Annual Statement filed with the Insurance Department of [name of state] is materially misstated because [provide explanation]. Statutory capital and surplus of \$ reported on the 19X1 Annual Statement should be reduced by \$ as a result of the matter in the preceding sentence.<sup>8</sup>

If we do not receive evidence that the Company has forwarded a copy of this letter to the insurance commissioner of [name of state] within five business days of receipt, we are required to give the insurance commissioner a copy of this letter within the next five business days.

This letter is intended solely for the information and use of the Insurance Department of [name of state of domicile] and other state insurance departments and is not intended to be and should not be used by anyone other than these specified parties.

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

## Report on Internal Controls

.12 Section 11 of the Model Audit Rule requires that insurers provide the insurance commissioner of the state of domicile a written report describing significant deficiencies in the insurer's internal control structure noted during the audit. Auditors should follow the guidance in Statement on Auditing Standards No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*. Additionally, the Model Audit Rule requires insurers to provide a description of remedial actions taken or proposed to correct significant deficiencies, if not covered in the auditor's report. The reports on internal controls should be filed by the insurer within sixty days after filing the annual audited financial statements. No report is required to be issued if the auditor does not identify significant deficiencies.

## Effective Date

.13 This SOP should be applied to audits of statutory financial statements performed for periods ending on or after December 15, 1995. Early application is encouraged.

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<sup>8</sup> The wording of this paragraph is intended for those situations in which audit adjustments would not cause minimum capital and surplus of an insurer to fall below statutory requirements. The paragraph should be reworded if the company did not meet minimum capital and surplus requirements as presented on its Annual Statement as filed with the domiciliary commissioner. [Footnote renumbered, September 1997, to reflect the issuance of the Notice to Practitioners on communications with state insurance regulators.]

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(1994-1995)**

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[The next page is 31,011.]

## Section 11,310

# **Statement of Position 95-5 Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises**

December 21, 1995

### **NOTE**

This Statement of Position presents the recommendations of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards to audits of financial statements of insurance enterprises. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

## **Introduction and Background**

.01 All states require domiciled insurance enterprises to submit to the state insurance commissioner an annual statement on forms developed by the National Association of Insurance Commissioners (NAIC). The states also require that audited statutory financial statements be provided as a supplement to the annual statements. Currently, statutory financial statements are prepared using accounting principles and practices "prescribed or permitted by the insurance department of the state of domicile," referred to in this Statement of Position (SOP) as *prescribed-or-permitted statutory accounting*.

.02 The NAIC is in the process of codifying statutory accounting practices for certain insurance enterprises. When the NAIC completes the codification of statutory accounting practices (the codification), it is expected that the states will require that statutory financial statements be prepared using accounting practices "prescribed in the NAIC's *Accounting Practices and Procedures Manual*," referred to in this SOP as *NAIC-codified statutory accounting*.

.03 This SOP is intended to apply to audits of statutory financial statements pre- and post-codification. The term *statutory basis of accounting* is used in this SOP to refer to whatever is accepted as the statutory basis of accounting; currently, that is prescribed-or-permitted statutory accounting. When codification is complete, it is expected that the statutory basis of accounting will be NAIC-codified statutory accounting.

## **Prescribed-or-Permitted Statutory Accounting**

.04 Prescribed statutory accounting practices currently are included in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state; the NAIC *Annual Statement Instructions*; the NAIC *Accounting Practices and Procedures Manuals*;

the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC *Examiners' Handbook*.

.05 Permitted statutory accounting practices include practices not prescribed in the sources described in paragraph .04, above, but allowed by the domiciliary state insurance department. Insurance enterprises may request permission from the domiciliary state insurance department to use a specific accounting practice in the preparation of the enterprises' statutory financial statements (a) when it wishes to depart from the prescribed statutory accounting practices, or (b) when prescribed statutory accounting practices do not address the accounting for the transaction(s).

## NAIC-Codified Statutory Accounting

.06 The NAIC undertook the project to codify statutory accounting practices because the current prescribed-or-permitted statutory accounting model results in practices that may vary widely—not only from state to state, but for insurance enterprises within a state. The codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance enterprises. Current statutory accounting practices are considered an other comprehensive basis of accounting (OCBOA) under Statement on Auditing Standards (SAS) No. 62, *Special Reports*. When codification is complete, it is anticipated that a statutory basis of accounting for insurance enterprises other than NAIC-codified statutory accounting will be considered neither generally accepted accounting principles (GAAP) nor OCBOA.<sup>1</sup> SAS No. 62, paragraphs 27 to 30, provides guidance on reporting on financial statements prepared on a basis of accounting prescribed in an agreement that results in a presentation that is not in conformity with GAAP or OCBOA. That guidance is for financial statements prepared in accordance with an agreement (for example, a loan agreement) and that form of report should not be used for statutory financial statements of insurance enterprises.

## Other Relevant AICPA Pronouncements

.07 During 1994, the AICPA issued the following two pronouncements that address statutory accounting practices and statutory financial statements.

- a. SOP 94-1, *Inquiries of State Insurance Regulators* [section 11,290], requires, for each audit, auditors to obtain sufficient competent evidential matter to corroborate management's assertion that permitted statutory accounting practices that are material to an insurance enterprise's financial statements are permitted by the insurance department of the state of domicile.
- b. SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises* [section 10,630], requires insurance enterprises to disclose information about permitted statutory accounting practices in their financial statements.

## Applicability

.08 This SOP applies to all audits of statutory financial statements of insurance enterprises that file financial statements with state insurance de-

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<sup>1</sup> When the codification is complete, certain amendments to SAS No. 62 would be required.

partments, including stock and mutual insurance enterprises. Insurance enterprises that prepare statutory financial statements include life and health insurance enterprises, property and casualty insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools, syndicates, captive insurance companies, financial guaranty insurance enterprises, health maintenance organizations, and hospital, medical and dental service or indemnity corporations.

.09 This SOP supersedes SOP 90-10, *Reports on Audited Financial Statements of Property and Liability Insurance Companies*. It also amends the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* and the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*.<sup>2</sup>

## Conclusions

### **Superseding Statement of Position 90-10, Reports on Audited Financial Statements of Property and Liability Insurance Companies**

.10 Auditors should *not* issue reports on statutory financial statements as to fair presentation in conformity with the statutory basis of accounting that include a disclaimer of opinion as to fair presentation in conformity with GAAP.

## General Distribution Reports

.11 Under SAS No. 62, if an insurance enterprise's statutory financial statements are intended for distribution other than for filing with the insurance departments to whose jurisdiction the insurance enterprise is subject, the auditor of those statements should use the general distribution form of report for financial statements that lack conformity with GAAP. Paragraph 4 in SAS No. 1, section 544, *Lack of Conformity With Generally Accepted Accounting Principles*, requires the auditor to use the standard form of report described in SAS No. 58, *Reports on Audited Financial Statements*, modified as appropriate because of departures from GAAP.

.12 Although it may not be practicable to determine the amount of difference between GAAP and the statutory basis of accounting, the nature of the differences is known. The differences generally exist in significant financial statement items, and are believed to be material and pervasive to most insurance enterprises' financial statements. Therefore, there is a rebuttable presumption that the differences between GAAP and the statutory basis of accounting are material and pervasive. Therefore, auditors should express an adverse opinion with respect to conformity with GAAP (refer to SAS No. 58 paragraph 67), unless the auditor determines the differences between GAAP and the statutory basis of accounting are not material and pervasive.

.13 Paragraph 68 and 69 in SAS No. 58 requires an auditor, when expressing an adverse opinion, to disclose in a separate explanatory paragraph(s) preceding the opinion paragraph in his or her report (a) all of the substantive reasons for the adverse opinion, and (b) the principal effects of the subject matter of the adverse opinion on financial position, results of opera-

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<sup>2</sup> The AICPA is revising the Audit and Accounting Guide *Audits of Life and Health Insurance Entities*, which will incorporate this SOP.

tions, and cash flows, if practicable.<sup>3</sup> If the effects are not reasonably determinable, the report should so state, and also should state that the differences are presumed to be material. Furthermore, the notes to the statutory financial statements should discuss the statutory basis of accounting and describe how that basis differs from GAAP.

.14 After expressing an adverse or qualified opinion on the statutory financial statements as to conformity with GAAP, auditors may express an opinion on whether the statutory financial statements are presented in conformity with the statutory basis of accounting under SAS No. 1, section 544. If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, an accounting practice that departs from that basis of accounting, regardless of whether required by state law or permitted by state regulators, would be considered an exception to the statutory basis of accounting. Accordingly, if such departures are material, the auditors should express a qualified or adverse opinion on the statutory financial statements just as they would under SAS No. 58 regarding conformity with GAAP.<sup>4</sup>

.15 Following is an illustration of an independent auditor's report on the general distribution statutory financial statements of an insurance enterprise prepared in conformity with prescribed-or-permitted statutory accounting practices, which contains an adverse opinion as to conformity with GAAP, and an unqualified opinion as to conformity with the statutory basis of accounting. In this illustrative report, it is assumed that the effects on the statutory financial statements of the differences between GAAP and the statutory basis of accounting are not reasonably determinable.

#### Independent Auditor's Report

To the Board of Directors  
ABC Insurance Company

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

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

As described more fully in Note X to the financial statements, the Company prepared these financial statements using accounting practices prescribed or

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<sup>3</sup> SAS 32, *Adequacy of Disclosure in the Financial Statements*, defines *practicable* as "the information is reasonably obtainable from management's accounts and records and that providing the information in his report does not require the auditor to assume the position of a preparer of financial information." For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in the auditor's report.

<sup>4</sup> See footnote 1.



permitted by the Insurance Department of the State of [state of domicile],<sup>5</sup> which practices differ from generally accepted accounting principles. The effects on the financial statements of the variances between the statutory basis of accounting and generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

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

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

### Limited Distribution Reports

.16 Prescribed-or-permitted statutory accounting for insurance enterprises currently is considered an OCBOA as described in SAS No. 62. If an insurance enterprise's statutory financial statements are intended solely for filing with state insurance departments to whose jurisdiction the insurance enterprise is subject, the auditor may use the form of report for financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP. Paragraph 5f of SAS No. 62 recognizes that such reporting is appropriate even though the auditor's report may be made a matter of public record. However, that paragraph further states that limited distribution reports may be used only if the financial statements and report are intended solely for filing with the regulatory agencies to whose jurisdiction the insurance enterprise is subject. The auditor's report should contain a statement that there is a restriction on distribution of the statutory financial statements to those within the insurance enterprise and for filing with the state insurance departments to whose jurisdiction the insurance enterprise is subject.

.17 Although auditing standards do not prohibit an auditor from issuing limited distribution and general distribution reports on the same statutory financial statements of an insurance enterprise, it is preferable to issue only one of those types of reports. Few, if any, insurance enterprises that do not prepare financial statements in accordance with GAAP will be able to fulfill all of their reporting obligations with limited distribution statutory financial statements.

.18 Following is an illustration, adapted from paragraph 8 of SAS No. 62, of an unqualified auditor's report on limited distribution statutory financial statements prepared in conformity with prescribed-or-permitted statutory accounting practices.

#### Independent Auditor's Report

To the Board of Directors  
XYZ Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 19X2

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<sup>5</sup> If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, this paragraph should be modified to state that the company prepared the financial statements using accounting practices "prescribed by the NAIC's *Accounting Practices and Procedures Manual*," or other appropriate language.

and 19X1, and the related statutory statements of income and changes in surplus, and cash flow, for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As described more fully in Note X to the financial statements, these financial statements were prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of [state of domicile],<sup>6</sup> which is a comprehensive basis of accounting other than generally accepted accounting principles.

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

This report is intended solely for the information and use of the board of directors and the management of XYZ Insurance Company and state insurance departments to whose jurisdiction the company is subject and is not intended to be and should not be used by anyone other than these specified parties.

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.19 In accordance with paragraph 10 of SAS No. 62, the notes accompanying an insurance enterprise's statutory financial statements should contain a summary of significant accounting policies that discusses the statutory basis of accounting and describes how the basis differs from GAAP. However, the effects of the differences need not be quantified.

## General and Limited Distribution Reports

.20 The auditor should consider the need for an explanatory paragraph (or other explanatory language) under the circumstances described in paragraph 11 of SAS No. 58 and paragraph 31 of SAS No. 62 regardless of any of the following:

- a. The type of report—general or limited distribution
- b. The opinion expressed—unqualified, qualified, or adverse
- c. Whether the auditor is reporting as to conformity with GAAP or conformity with the statutory basis of accounting

For example, in a general distribution report, an auditor may express an adverse opinion as to conformity with GAAP and an unqualified opinion as to

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<sup>6</sup> If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, this paragraph should be modified to state that the company prepared the financial statements using accounting practices "prescribed by the NAIC's *Accounting Practices and Procedures Manual*," or other appropriate language.

conformity with the statutory basis of accounting, and also conclude there is a need to add an explanatory paragraph regarding substantial doubt about the insurance enterprise's ability to continue as a going concern; such paragraph should follow both opinion paragraphs.

.21 As discussed in paragraph 37 of SAS No. 58 and paragraph 31 of SAS No. 62, in a separate paragraph of the auditor's report, the auditor may wish to emphasize a matter. When an insurance enterprise prepares its financial statements using accounting practices prescribed or permitted by the insurance department of the state of domicile and has significant transactions that it reports using permitted accounting practices that materially affect the insurance enterprise's statutory capital,<sup>7</sup> the auditor is strongly encouraged to include an emphasis-of-a-matter paragraph in the report describing the permitted practices and their effects on statutory capital.

.22 An example of an emphasis-of-a-matter paragraph follows:

As discussed in Note X to the financial statements, the Company received permission from the Insurance Department of the [state of domicile] in 19XX to write up its property to appraised value; under prescribed statutory accounting practices property is carried at depreciated cost. As of December 31, 19X5, that permitted accounting practice increased statutory surplus by \$XX million over what it would have been had the prescribed accounting practices been followed.

## Mutual Life Insurance Enterprises

.23 In April 1993, the Financial Accounting Standards Board (FASB) issued Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, which concludes that mutual life insurance enterprises can no longer issue statutory financial statements that are described as "in conformity with generally accepted accounting principles." Interpretation No. 40, as amended by FASB Statement of Financial Accounting Standards No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, is effective for financial statements issued for fiscal years beginning after December 15, 1995. (FASB Statement No. 120 does not change the disclosure and other transition provisions of Interpretation No. 40.) For statutory financial statements of mutual life insurance enterprises issued before that effective date, auditors may report on the statutory financial statements as being in conformity with generally accepted accounting principles.

## Effective Date

.24 This SOP should be applied to audits of statutory financial statements for years ended on or after December 31, 1996.

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<sup>7</sup> If, as anticipated, NAIC-codified statutory accounting replaces the prescribed or permitted statutory basis of accounting, such permitted practices would be considered departures from the statutory basis of accounting.

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The AICPA gratefully acknowledges the contributions to this SOP by Gary W. Roubinek, the former chair of the Insurance Companies Committee, and Dionne D. McNamee, former staff aide to the Insurance Companies Committee.

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[The next page is 31,025.]

## Section 11,320

### **Statement of Position 98-3 Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards**

March 17, 1998

#### **NOTE,**

This Statement of Position presents the recommendations of the AICPA Single Audit Working Group regarding the performance of audits in accordance with the Single Audit Act Amendments of 1996 and Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (June 1997 revision). This edition incorporates guidance contained in *Government Auditing Standards* (1994 revision) and Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.,

#### **Summary**

This Statement of Position (SOP) provides guidance on the auditor's responsibilities when conducting a single audit or program-specific audit in accordance with the Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (June 1997 revision). This SOP supersedes SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, and part VII, "Audits of Federal Financial Assistance," of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*.

In addition to providing an overview of the auditor's responsibilities in an audit of federal awards, this SOP—

- Describes the applicability of the Single Audit Act Amendments of 1996 and Circular A-133.
- Describes the auditor's responsibility for testing and reporting on the schedule of expenditures of federal awards.
- Describes the auditor's responsibility for considering internal control and for performing tests of compliance with applicable laws, regulations, and program compliance requirements under generally accepted auditing standards, *Government Auditing Standards*, and Circular A-133.

- Describes the auditor's responsibility for reporting and provides examples of the reports required by *Government Auditing Standards* and Circular A-133.
- Describes the auditor's responsibility for testing and reporting in a program-specific audit.

Further, this SOP incorporates guidance from the following documents:

- The Single Audit Act Amendments of 1996 and Circular A-133
- AICPA Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*
- *Government Auditing Standards* (1994 revision)
- The OMB Circular A-133 *Compliance Supplement* (June 1997 revision)

## Chapter 1

# INTRODUCTION AND OVERVIEW

## Introduction

### Purpose and Applicability

1.1 The purpose of this Statement of Position (SOP) is to provide auditors of states, local governments, and not-for-profit organizations (NPOs) that receive federal awards with a basic understanding of the procedures they should perform and of the reports they should issue for single audits and program-specific audits under—

- a. The Single Audit Act Amendments of 1996 (hereinafter referred to as the Single Audit Act or the Act).<sup>1</sup>
- b. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*,<sup>2</sup> and the related *OMB Circular A-133 Compliance Supplement*.
- c. The standards applicable to financial audits contained in the 1994 revision of *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States of the U.S. General Accounting Office (GAO).<sup>3</sup> These standards incorporate the fieldwork and reporting standards of generally accepted auditing standards (GAAS)<sup>4</sup> issued by the American Institute of Certified Public Accountants (AICPA).

1.2 This SOP provides guidance about financial and compliance auditing standards and requirements related to single audits (chapters 1 through 10) and program-specific audits (chapter 11) for entities (also referred to as auditees) subject to the Single Audit Act and Circular A-133. Applicable standards and requirements are promulgated by the OMB, GAO, and AICPA. This SOP also provides guidance on applicable auditing standards and requirements established by those organizations to assist auditors in planning, performing, and reporting on single audits and program-specific audits in ac-

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<sup>1</sup> The Single Audit Act Amendments of 1996 (Public Law 104-156) was enacted into law in July 1996 and replaced the Single Audit Act of 1984. A reprint of the Single Audit Act Amendments of 1996 is included in appendix A of this SOP.

<sup>2</sup> Circular A-133 (as revised on June 30, 1997), is reprinted in appendix B of this SOP.

<sup>3</sup> The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

<sup>4</sup> GAAS requirements are discussed in this SOP to the extent necessary to explain the related requirements of *Government Auditing Standards*. Auditors should refer to relevant AICPA Statements on Auditing Standards and also related Audit and Accounting Guides such as *Not-for-Profit Organizations*, *Health Care Organizations*, and *Audits of State and Local Governmental Units* for additional information on GAAS requirements.

cordance with those standards and requirements, and includes illustrative audit reports. Since Circular A-133 is the federal policy guidance to which auditors are held in performing single audits, this SOP will primarily focus on its requirements.

1.3 This SOP is organized by chapters in which the important considerations in performing single audits and program-specific audits are discussed (see table of contents).

1.4 This SOP is not a complete manual of procedures, nor should it supplant the auditor's judgment about the audit work required in particular situations. Because of the variety of federal, state, and local financial assistance programs and the complexity of the regulations that govern them, the procedures included in this SOP cannot cover all the circumstances or conditions that would be encountered in the audits of every entity. The auditor should use professional judgment to tailor his or her procedures to meet the conditions of the particular engagement, so that the audit objectives may be achieved.

1.5 Auditors should be aware that certain states have imposed additional audit requirements related to state or local financial assistance. The guidance in this SOP does not extend to individual state requirements (except for the guidance in paragraphs 3.47, 3.48, and 6.71). Furthermore, pass-through entities may impose additional audit requirements on their subrecipients related to the financial assistance passed through. The guidance in this SOP also does not extend to those requirements.

## Definitions

1.6 The terms used in this SOP are intended to be consistent with the definitions in the Single Audit Act and Circular A-133. Similarly, the term *not-for-profit organization* as used in this SOP is consistent with the definition of the term *non-profit organization* in Circular A-133 (see appendix B) and includes not-for-profit institutions of higher education, hospitals, and other health care providers.

## Effective Dates

1.7 The requirements of the Single Audit Act and Circular A-133 are effective for audits of fiscal years beginning after June 30, 1996. This SOP also includes auditing guidance through AICPA Statement on Auditing Standards (SAS) No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333). The effective dates of this auditing guidance should be applied as provided for in the related literature. This SOP does not change the effective dates of the auditing standards, the act, and Circular A-133. The remaining provisions of this SOP are applicable to audits of fiscal years beginning after June 30, 1996, in which the related fieldwork commences on or after March 1, 1998. Earlier application is encouraged.

## Objectives of a Single Audit

1.8 A single audit has two main objectives: (a) an audit of the entity's financial statements and the reporting on the schedule of expenditures of federal awards in relation to those financial statements and (b) a compliance audit of federal awards expended during the fiscal year. Each of these results in the preparation and issuance of certain audit reports (see paragraph 2.7 for a more detailed description of the audit objectives).



## ***Audit of Entity's Financial Statements and Reporting on the Schedule of Expenditures of Federal Awards***

1.9 The financial statement audit required by Circular A-133 is performed in accordance with the standards applicable to financial audits contained in *Government Auditing Standards* and GAAS, and it results in the auditor reporting on the entity's financial statements and on the scope of the auditor's testing of compliance and internal control over financial reporting and presents the results of those tests. The primary sources of guidance and standards regarding financial statement audits are the AICPA Statements on Auditing Standards (SASs), particularly SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801); *Government Auditing Standards*; and the following AICPA Audit and Accounting Guides, as applicable: *Not-for-Profit Organizations*, *Audits of State and Local Governmental Units*, *Health Care Organizations*, and *Audits of Colleges and Universities*.<sup>5</sup> Refer to chapter 4 for a more detailed discussion of financial statement audit considerations under Circular A-133. Guidance on reporting on the schedule of expenditures of federal awards is provided in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551). Refer to chapter 5 for a more detailed discussion of the schedule of expenditures of federal awards.

### ***Compliance Audit of Federal Awards***

1.10 Under Circular A-133, the auditor has additional testing and reporting responsibilities for compliance, as well as internal control over compliance, beyond a financial statement audit performed in accordance with *Government Auditing Standards* and GAAS. The compliance audit of federal awards expended during the fiscal year provides a basis for issuing an additional report on compliance related to major programs and on internal control over compliance.<sup>6</sup> The various types of federal awards and payment methods are described in paragraphs 1.17 through 1.23. Compliance auditing considerations applicable to major programs and internal control over compliance are discussed in chapters 6 and 8. Reporting is discussed in chapter 10.

### ***Adherence to Professional Standards and Requirements***

1.11 The auditor should be aware that AICPA Ethics Interpretation 501-3, *Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits*, states that when an auditor undertakes an audit of government grants or recipients of government monies and agrees to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, he or she is obligated to follow these standards or guidelines in addition to GAAS. Failure to do so is an act discreditable to the profession and a violation of rule 501 of the AICPA Code of Professional Conduct, unless it is disclosed in the auditor's report that these rules were not followed and the reasons for doing so are given.

<sup>5</sup> Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

<sup>6</sup> A major program is defined in Circular A-133. See the discussion of the determination of major programs in chapter 7.

## Relationship of the Single Audit Act, Circular A-133, Government Auditing Standards, and GAAS

1.12 The Single Audit Act Amendments of 1996 were enacted to streamline and improve the effectiveness of audits of federal awards and to reduce the audit burden on states, local governments, and NPOs. Those goals were achieved, in part, by increasing the dollar threshold for requiring a single audit to \$300,000 in federal awards expended from \$25,000 in federal awards received and introducing a risk-based approach for determining which federal programs are to be considered major programs (see paragraph 2.2 for a further discussion of the audit threshold). The Single Audit Act requires single audits and program-specific audits of federal awards to be performed in accordance with *Government Auditing Standards*,<sup>7</sup> and gives the Director of OMB the authority to develop government-wide guidelines and policy on performing audits to comply with the Act. The OMB established audit guidelines and policy in Circular A-133, which was revised and issued June 30, 1997,<sup>8</sup> and establishes a uniform system of auditing states, local governments, and NPOs that expend federal awards. (Chapter 2 provides an overview of Single Audit Act and Circular A-133 requirements.) Circular A-133 has been adopted in regulation by individual federal departments and agencies.

1.13 In performing audits in accordance with the standards applicable to financial audits contained in *Government Auditing Standards*, the auditor assumes certain responsibilities beyond those of audits performed in accordance with GAAS.<sup>9</sup> *Government Auditing Standards* includes general standards, incorporates the fieldwork and reporting standards under GAAS, and includes additional fieldwork and reporting standards. *Government Auditing Standards* includes additional standards in such areas as quality control reviews, continuing professional education, working papers, and audit follow-up (see paragraphs 3.8 through 3.21 for a detailed discussion of the additional standards). The reporting responsibilities in *Government Auditing Standards* require additional reporting on compliance and on internal control over financial reporting (see paragraphs 3.19 through 3.21, 10.15, and 10.16 for a detailed discussion of the reporting requirements).

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<sup>7</sup> *Government Auditing Standards* includes standards for financial audits as well as for performance audits. The references to *Government Auditing Standards* in this SOP encompass only the standards applicable to financial audits and not the performance audit standards (see footnote 3). However, *Government Auditing Standards* states that auditors should follow, as appropriate, the report contents standards for objectives, scope, and methodology; audit results; the view of responsible officials; and its report presentation standards. A discussion of these standards is contained in the performance auditing standards in chapter 7 of *Government Auditing Standards* (see paragraph 10.21).

<sup>8</sup> The June 30, 1997, revision to Circular A-133 superseded OMB Circular A-128, *Audits of State and Local Governments*, and all previous versions of Circular A-133.

<sup>9</sup> Paragraphs 21 through 23 of SAS No. 74 describe the auditor's responsibility when he or she has been engaged to perform an audit in accordance with GAAS and becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement. In such a situation, SAS No. 74 requires that the auditor communicate to management and the audit committee, or to others with equivalent authority or responsibility, that an audit in accordance with GAAS alone may not satisfy the relevant legal, regulatory, or contractual requirements. That communication may be oral or written. However, if the communication is oral, the auditor should document the communication in the working papers. The auditor should consider how the client's actions in response to such a communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions in relation to the guidance in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), and SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316).

**Compliance Testing**

1.14 Table 1.1 presents the relationship among the compliance testing requirements of GAAS, Government Auditing Standards, the Single Audit Act, and Circular A-133. Compliance testing requirements are discussed in detail in chapter 6. SAS No. 74 provides general guidance on the auditor's responsibility for compliance auditing under GAAS, *Government Auditing Standards*, and federal audit requirements. In SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit is described. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), as amended by SAS No. 82, describe the auditor's responsibility in a GAAS audit for the consideration of fraud and errors.

**Internal Control Consideration**

1.15 Table 1.2 presents the relationship among the requirements to consider internal control under GAAS, *Government Auditing Standards*, the Single Audit Act, and Circular A-133. Internal control requirements are discussed in detail in chapters 4 and 8.

Table 1.1

Compliance Testing		
	<i>Fieldwork Responsibilities</i>	<i>Reporting Responsibilities</i>
Generally accepted auditing standards	Design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts in accordance with SAS No. 54, <i>Illegal Acts by Clients</i> , as described in SAS No. 74, <i>Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance</i> , and to provide reasonable assurance about whether the financial statements are free of material misstatements (whether caused by error or fraud), as described in SAS No. 82, <i>Consideration of Fraud in a Financial Statement Audit</i> , and SAS No. 47, <i>Audit Risk and Materiality in Conducting an Audit</i> .	Requires the auditor to adequately inform the audit committee or others with equivalent authority and responsibility about any illegal acts that the auditor becomes aware of during the audit unless they are clearly inconsequential. Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. Fraud involving senior management and fraud that causes a material misstatement of the financial statements should be reported directly to the audit committee. When the auditor identifies fraud risk factors that have continuing control implications, the auditor should communicate those factors that are considered reportable conditions to senior management and the audit committee. See SAS No. 82, paragraphs 38 through 40, for an additional discussion of the reporting requirements of SAS No. 82.
<i>Government Auditing Standards</i>	Same responsibilities as required by GAAS, but <i>Government Auditing Standards</i> specifically states that auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts.	Requires a written report describing the scope of the auditor's testing of compliance with laws and regulations and presenting the results of those tests (additional details on the reporting responsibilities are included in paragraphs 10.15, 10.16, and 10.21 through 10.25).
Single Audit Act and Circular A-133	Determine whether the entity complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that have a direct and material effect on each major program.	Requires the auditor to express an opinion on whether the entity complied with laws, regulations, and with the provisions of contracts or grant agreements which could have a direct and material effect on each major program and, where applicable, refer to a separate schedule of findings and questioned costs.

Table 1.2

**Internal Control Responsibilities**

	<i>Fieldwork Responsibilities</i>	<i>Reporting Responsibilities</i>
Generally accepted auditing standards	Obtain an understanding of internal control over financial reporting sufficient to plan the audit by performing procedures to understand both the design of controls relevant to an audit of financial statements and whether they have been placed in operation, and assess control risk, in accordance with SAS No. 55, <i>Consideration of Internal Control in a Financial Statement Audit</i> , as amended by SAS No. 78, <i>Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55</i> .	Requires the auditor to communicate, either orally or in writing, any reportable conditions as described in SAS No. 60, <i>Communication of Internal Control Related Matters Noted in an Audit</i> .
<i>Government Auditing Standards</i>	Same responsibilities as GAAS. <i>Government Auditing Standards</i> provides additional guidance on the control environment, safeguarding controls, controls over compliance with laws and regulations, and control risk assessments.	Requires a written report describing the scope of the auditor's testing of internal control and presenting the results of those tests. Also requires separate identification and written communication of all reportable conditions, including those reportable conditions that are individually or cumulatively material weaknesses.
Single Audit Act and Circular A-133	With regard to internal control over compliance, the auditor is required to do the following (in addition to the requirements of <i>Government Auditing Standards</i> ): (1) perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs, (2) plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program, and (3) perform tests of internal control (unless the internal control is likely to be ineffective in preventing or detecting noncompliance).	Requires a written report on internal control over major programs describing the scope of testing internal control and the results of the tests, and, where applicable, referring to a separate schedule of findings and questioned costs.

\* Circular A-133 requires the auditor to plan the audit to support a low assessed level of control risk for major programs; however, it does not actually require the achievement of a low assessed level of control risk. See paragraphs 8.16 through 8.22.

Reporting

1.16 A matrix depicting the recommended auditor's reports in a single audit required by GAAS, *Government Auditing Standards*, and Circular A-133 appears in table 1.3. Reporting is discussed in detail in chapter 10.

Table 1.3

Report	Required by—		
	GAAS	Government Auditing Standards	Circular A-133
Opinion (or disclaimer of opinion) on financial statements and supplementary schedule of expenditures of federal awards	X	X	X
Report on compliance and on internal control over financial reporting based on an audit of financial statements		X	X
Report on compliance and internal control over compliance applicable to each major program (this report must include an opinion [or disclaimer of opinion] on compliance)			X
Schedule of findings and questioned costs			X

Types of Federal Awards and Payment Methods

Definition of Federal Awards

1.17 Circular A-133 defines federal awards as *federal financial assistance* and *federal cost-reimbursement contracts* that auditees receive directly from federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts (under grants or contracts) used to buy goods or services from vendors. See paragraph 2.15 for a discussion of subrecipient and vendor determinations.

Federal Financial Assistance—Classification and Types

1.18 Federal sponsors have classified federal financial assistance into program categories in the *Catalog of Federal Domestic Assistance* (CFDA), published by the Government Printing Office. Circular A-133 defines federal programs as all federal awards under the same CFDA number. Certain clusters of federal programs should be treated as one program for determining major programs. Research and development, student financial aid, and certain other programs are defined as a cluster in the *OMB Circular A-133 Compliance Supplement* because they are closely related and share common compliance requirements (see paragraphs 1.26 through 1.28 and chapters 2 and 6 for additional discussion of the *Compliance Supplement*).

1.19 Sometimes state governments combine funding from different federal awards in providing assistance to their subrecipients when the awards are

closely related programs and share common compliance requirements. In this case, Circular A-133 states that the state may require the subrecipient to treat the combined federal awards as a cluster of programs. See paragraph 2.18 for further information.

**1.20** There are over 1,000 individual grant programs and several distinct types of federal award payment methods. Many of these programs are described in the CFDA; however, certain programs may not be included. For example, contracts may not be listed in the CFDA. Circular A-133 states that when a CFDA number is not assigned, all federal awards from the same agency that are made for the same purpose should be combined and considered one program.

**1.21** Programs in the CFDA are classified into fifteen types of assistance. Benefits and services are provided through seven financial and eight nonfinancial types of assistance. The following list describes the eight principal types of assistance that are available.

- *Formula grants.* For activities of a continuing nature not confined to a specific project, allocations of money to nonfederal entities are made in accordance with a distribution formula prescribed by law or administrative regulation. One example is the Department of Agriculture's award to land-grant universities for cooperative extension services. Another example is the Department of Justice's award to state and local governments for drug control and systems improvement.
- *Project grants.* These involve the funding (for fixed or known periods) of specific projects, or the delivery of specific services or products, without liability for damages resulting from a failure to perform. Project grants include fellowships, scholarships, research grants, training grants, traineeships, experimental and demonstration grants, evaluation grants, planning grants, technical assistance grants, construction grants, and unsolicited contractual agreements.
- *Direct payments for specific use.* Financial assistance is provided by the federal government directly to individuals, private firms, and other private institutions to encourage or subsidize a particular activity by conditioning the receipt of the assistance upon the recipient's performance. These do not include solicited contracts for the procurement of goods and services for the federal government.
- *Direct payments with unrestricted use.* Financial assistance is provided by the federal government directly to beneficiaries who satisfy federal eligibility requirements with no restrictions imposed on how the money is spent. Included are payments under retirement, pension, and compensation programs.
- *Direct loans.* Financial assistance is provided through the lending of federal monies for a specific period of time, with a reasonable expectation of repayment. Such loans may or may not require the payment of interest.
- *Guaranteed insured loans.* For these programs, the federal government makes an arrangement to indemnify a lender against part of any defaults by those responsible for the repayment of loans.
- *Insurance.* Financial assistance is provided to assure reimbursement for losses sustained under specified conditions. Coverage may be provided directly by the federal government or through a private carrier, and may or may not involve the payment of premiums.

- *Sale, exchange, or donation of property and goods.* These programs provide for the sale, exchange, or donation of federal real property, personal property, commodities, and other goods, including land, buildings, equipment, food, and drugs. This does not include the loan of, use of, or access to federal facilities or property.

### **Federal Cost-Reimbursement Contracts**

**1.22** The definition of federal awards also includes federal cost-reimbursement contracts. These are contracts with nonfederal entities to provide goods or services to the federal government. These contracts are generally governed by the Federal Acquisition Regulations (found in part 41 of the *Code of Federal Regulations*) and the terms of the contracts.

**1.23** Awards may be provided to entities through reimbursement arrangements in which recipients bill grantors for costs as incurred. Some programs provide for advance payments. Other programs permit entities to draw cash as grant expenditures are incurred.

### **Determining the Scope of a Single Audit**

**1.24** The scope of the auditor's work in an audit in accordance with Circular A-133 is determined by (a) the level of assessed risk associated with the federal programs and whether they are identified as a major program and (b) the compliance requirements applicable to those programs.

### **Risk-Based Approach**

**1.25** The audit scope depends on whether the federal awards expended are identified as relating to major programs. Circular A-133 places the responsibility for identifying major programs on the auditor, and it provides criteria for the auditor to use in applying a risk-based approach. The auditor's determination of the programs to be audited is based on an overall evaluation of the risk of noncompliance occurring which could be material to the individual federal programs. In evaluating risk, the auditor considers, among other things, the current and prior audit experience with the auditee, oversight by the federal agencies and pass-through entities, and the inherent risk of the federal programs. Chapter 7 includes a detailed discussion of applying the risk-based approach to determining major programs.

### **Compliance Requirements**

**1.26** Circular A-133 requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. The term *compliance requirements* refers to the laws, regulations, and provisions of contracts and grant agreements that an auditor should consider in making this determination (see chapter 6 for a more detailed discussion).

**1.27** The principal compliance requirements and suggested audit procedures for the largest federal programs are included in the *Compliance Supplement*.<sup>10</sup>

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<sup>10</sup> A copy of the *Compliance Supplement* may be obtained from EOP Publications, Office of Administration, 2200 NEOB, Washington, D.C. 20503; (202) 395-7332. It is also available from the OMB's home page at <http://www.whitehouse.gov/WH/EOP/omb>, under the captions "OMB Documents," and then "Grants Management," and the Office of Inspector General home page at <http://www.ignet.gov>.



**1.28** With regard to federal programs included in the *Compliance Supplement*, the auditor should follow the guidance contained in the *Compliance Supplement* for testing compliance requirements. The auditor should be aware that compliance requirements may change over time. Thus, the auditor should also inquire of the auditee and review the provisions of grant agreements to determine whether compliance requirements reflected in the *Compliance Supplement* have changed. If there have been changes, the auditor should follow the provisions of the *Compliance Supplement* as modified by the changes (see chapters 2 and 6 for a more detailed discussion of the *Compliance Supplement*). For programs not listed in the *Compliance Supplement*, the auditor should follow *Compliance Supplement* part 7 “Guidance for Auditing Programs Not Included in This Compliance Supplement,” which instructs the auditor to use the types of compliance requirements (for example, cash management, reporting, allowable costs/cost principles, activities allowed or unallowed, eligibility, and matching, level of effort, and earmarking) contained in the *Compliance Supplement* as guidance for identifying the types of compliance requirements to test, and to determine the requirements governing the federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.

**1.29** In addition, some agencies have developed audit guides or supplements related to their programs. Auditors should consult with the applicable federal agency to determine the availability of agency-prepared supplements or audit guides. This guidance, where applicable, may be obtained from the Office of Inspector General of the appropriate federal agency.

## **The Auditor’s Responsibilities in Single Audits— An Overview**

### **Compliance With Laws and Regulations**

**1.30** In addition to the requirements of GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to provide an opinion on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. The auditor’s responsibility for compliance auditing is discussed further in chapter 6. The required reporting and the schedule of findings and questioned costs are discussed in chapter 10.

### **Internal Control Over Compliance**

#### **Planning**

**1.31** In a single audit, the auditor must obtain an understanding of the design and operation of internal control over compliance with requirements that could have a direct and material effect on a major program. The auditor’s work in this area is in addition to the consideration of internal control over financial reporting that is part of a financial statement audit. Specifically, the auditor must obtain an understanding of internal control over compliance that is sufficient to plan the audit to support a low assessed level of control risk for major programs.

#### **Testing**

**1.32** Circular A-133 also requires auditors to test internal control over compliance by implementing the planned tests. Evidence gained from the tests

of controls relevant to compliance requirements may be used by the auditor to determine the nature, timing, and extent of the testing required to express an opinion on compliance with requirements applicable to major programs. The requirements and auditor responsibilities associated with internal control over compliance in a single audit are discussed in chapter 8.

## Chapter 2

# OVERVIEW OF THE SINGLE AUDIT ACT, CIRCULAR A-133, AND THE OMB CIRCULAR A-133 COMPLIANCE SUPPLEMENT

**2.1** This chapter provides an overview of the significant requirements and guidance in the Single Audit Act, Circular A-133, and the *OMB Circular A-133 Compliance Supplement*. Because Circular A-133 incorporates the requirements of the Single Audit Act and provides additional guidance, the requirements of the Act and Circular A-133 are discussed together as one in this SOP. Accordingly, references to Circular A-133 also include the requirements of the Single Audit Act. Auditors should refer to the Single Audit Act, Circular A-133, and the *Compliance Supplement* for a complete understanding of the requirements. The Single Audit Act and Circular A-133 are reprinted in appendixes A and B, respectively. See footnote 10 of chapter 1 for instructions on how to obtain a copy of the *Compliance Supplement*.

## Single Audit Act and Circular A-133 Requirements

### General Audit Requirements

#### *Audit Threshold*

**2.2** Entities that expend \$300,000 or more in a fiscal year in federal awards are subject to the Single Audit Act and Circular A-133 and, therefore, must have a single or program-specific audit. Entities expending awards under only one program (excluding research and development [R&D]) may elect to have a program-specific audit if the program's laws, regulations, or grant agreements do not require a financial statement audit. A program-specific audit may not be elected for R&D unless (a) all expenditures are for awards received from the same federal agency or from the same federal agency and the same pass-through entity and (b) advance approval is obtained (see chapter 11 for additional guidance on program-specific audits). Entities that expend less than \$300,000 in a fiscal year in federal awards are exempt from audit requirements in the Single Audit Act and Circular A-133. However, those entities are not exempt from other federal requirements (including those to maintain records) concerning federal awards provided to the entity. Such records must be available for review or audit by appropriate officials of a federal agency, pass-through entity, and the GAO. The Single Audit Act provides that, every two years, the OMB may review the amount for requiring audits and may raise the dollar threshold amount above \$300,000.

#### *Applicable Standards and Covered Entity*

**2.3** Circular A-133 audits must be conducted by an independent auditor<sup>1</sup> in accordance with *Government Auditing Standards*, and they must cover the entire operations of the auditee or, at the option of the auditee, the audit may include a series of audits that cover departments, agencies, and other organizational units that expended or otherwise administered federal awards

<sup>1</sup> The Single Audit Act defines "independent auditor" as (a) an external state or local government auditor who meets the independence standards included in *Government Auditing Standards* or (b) a public accountant who meets such independence standards.

during the fiscal year, provided that each audit encompasses the financial statements and the schedule of expenditures of federal awards for each such department, agency, and organizational unit (see paragraph 3.25 for a more detailed discussion of this requirement).

### ***Relation to Other Audit Requirements***

2.4 A Circular A-133 audit is deemed to be in lieu of any financial audit of federal awards that an entity is required to undergo under any other federal law or regulation. However, notwithstanding a Circular A-133 audit, a federal agency (including its Inspectors General or GAO) may conduct or arrange for additional audits (for example, financial audits, performance audits, evaluations, inspections, or reviews) that are necessary to carry out their responsibilities under federal law or regulation. Any additional audits should be planned and performed in such a way as to build upon work performed by auditors. A federal agency that conducts or contracts for additional audits must arrange for funding the full cost of such additional audits. See paragraph 2.19 for a discussion of the federal agency option to request certain programs to be audited as major programs.

### ***Frequency of Audits***

2.5 Circular A-133 audits must be performed annually unless an auditee meets one of the following criteria that would allow it to have biennial audits (biennial audits should cover both years within the biennial period):

- State or local governments that are required by constitution or statute (in effect on January 1, 1987) to undergo audits less frequently than annually are permitted to have Circular A-133 audits performed biennially. This requirement must still be in effect for the biennial period under audit.
- NPOs that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, are permitted to have Circular A-133 audits performed biennially.

### ***Non-U.S.-Based Entities***

2.6 Circular A-133 does not apply to non-U.S.-based entities expending federal awards received either directly as a recipient or indirectly as a subrecipient. For example, if a federal agency provides financial assistance to an orphanage operated by a foreign government, Circular A-133 would not apply. However, the circular does apply to expenditures made by U.S.-based entities outside of the United States and by foreign branches of U.S.-based entities. For example, if a university based in the United States receives a federal award for travel and a three-month residence in a foreign country to conduct research, Circular A-133 would apply to the travel and the related research costs incurred in the foreign country. Another example would be a hospital that receives a federal award to perform medical research in a foreign country. If the research is conducted in the hospital's research laboratory based in the foreign country, the federal award would be subject to an audit under Circular A-133.

## **Audit Objectives and Reporting Matters**

### ***Audit Objectives***

2.7 In a single audit, the auditor's objectives are to—

- Determine whether the financial statements of the auditee are presented fairly in all material respects in conformity with generally ac-

cepted accounting principles. (Note that Circular A-133 does not prescribe the basis of accounting that must be used by auditees to prepare their financial statements. See paragraphs 4.2 and 4.3 for a further discussion.)

- Determine whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole.
- Obtain an understanding of the internal control over compliance for each major program, assess the control risk, and perform tests of those controls unless the controls are deemed to be ineffective (the auditor must perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk for each major program).
- Determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that may have a direct and material effect on each of its major programs.

### ***Audit Reports***

2.8 Section 505 of Circular A-133 includes specific auditor reporting requirements. Those requirements are summarized in paragraph 10.3. See paragraphs 10.8 through 10.10 for a description of the reports illustrated in this SOP to meet the reporting requirements of Circular A-133.

### ***Timing of the Submission of the Report***

2.9 The audit should be completed and the data collection form and the reporting package (described in paragraphs 2.24, 2.25, 10.6, and 10.7), including the auditor's reports, should be submitted by the auditee (to the federal clearinghouse designated by the OMB) within the earlier of thirty days after receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit (see paragraphs 10.74 through 10.79 for a further discussion).<sup>2</sup>

### ***Audit Follow-Up***

2.10 Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. (See paragraphs 3.24 and 6.61 through 6.67 for a further discussion of the auditor's responsibility for audit follow-up.)

## **Auditor Selection and Audit Costs**

### ***Procurement of Audit Services and Restriction on Auditors Who Prepare Indirect Cost Proposals***

2.11 Circular A-133 also establishes guidance on the procurement of audit services, as well as guidance on the restrictions on the selection of audi-

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<sup>2</sup> Auditors should note that there is a delayed implementation for this requirement. Therefore, for fiscal years beginning on or before June 30, 1998, the audit must be completed and the data collection form and the reporting package should be submitted (to the federal clearinghouse designated by the OMB) within the earlier of thirty days after receipt of the auditor's report or thirteen months after the end of the audit period.

tors who also prepare the indirect cost proposal or cost allocation plan. Auditors who prepare the indirect cost proposal or cost allocation plan may not also be selected to perform the Circular A-133 audit if the indirect costs recovered by the auditee during the prior year exceeded \$1 million.<sup>3</sup> See paragraph 3.52 for additional information on this restriction.

### **Audit Costs**

**2.12** Circular A-133 provides guidance on whether the charging of audit costs to federal awards may be allowed. Unless prohibited by law, the costs of Circular A-133 audits are allowable charges to federal awards. The charges may be considered a direct cost or an allocated indirect cost, as determined in accordance with the provisions of applicable OMB Cost Principles Circulars, the Federal Acquisition Regulation, or other applicable cost principles or regulations. The costs of single audits that are not conducted in accordance with Circular A-133 are unallowable. Furthermore, audit costs associated with Circular A-133 audits of entities that expend less than \$300,000 per year in federal awards are unallowable. However, this provision does not prohibit pass-through entities from charging federal awards for the costs of limited-scope audits to monitor its subrecipients. See paragraph 9.32 for further information on the allowability of audit costs associated with limited-scope audits. With regard to the amount of audit cost that can be charged to a federal award, the Single Audit Act states that in the absence of documentation demonstrating a higher actual cost, the percentage of the cost of single audits charged to federal awards by an entity may not exceed the ratio of total federal awards expended to the entity's total expenditures for the fiscal year.

### **Basis for Determining When Federal Awards Are Expended**

**2.13** The determination of when an award is expended is based on when the activity related to the award occurs. In general, the activity pertains to events that require the auditee to comply with laws, regulations, and the provisions of contracts or grant agreements. Such events include the following:

- Expenditure/expense transactions associated with grants, cost reimbursement contracts, cooperative agreements, and direct appropriations
- The disbursement of funds passed through to subrecipients
- The use of loan proceeds under loan and loan-guarantee programs
- The receipt of property
- The receipt of surplus property
- The receipt or use of program income
- The distribution or consumption of food commodities
- The disbursement of amounts entitling the auditee to an interest subsidy
- The period when insurance is in force

**2.14** Circular A-133 provides specific guidance on the basis of determining federal awards expended for the following noncash items (see paragraphs 5.13 through 5.15 for additional discussion):

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<sup>3</sup> The implementation date for this provision is for audits of fiscal years beginning after June 30, 1998.

- Loans and loan guarantees, including those at institutions of higher education
- Prior loans and loan guarantees
- Endowment funds
- Free rent
- Noncash assistance, such as free rent, food stamps, food commodities, donated property, or donated surplus property
- Medicare payments to a nonfederal entity for providing patient care services
- Medicaid payments to a subrecipient for providing patient care services

## **Subrecipient and Vendor Determinations**

2.15 An auditee may be a recipient, a subrecipient, and a vendor. Federal awards expended as a recipient or a subrecipient are subject to audit under Circular A-133. The payments received for goods or services provided as a vendor would not be considered federal awards. Circular A-133 provides specific guidance on determining whether payments constitute a federal award or a payment for goods and services. This guidance is discussed further in chapter 9.

## **Major Program Determination**

### ***Risk-Based Approach***

2.16 Circular A-133 requires the auditor to use a risk-based approach to determine which federal programs are major programs. The risk-based approach includes consideration of current and prior audit experience, oversight by federal agencies and pass-through entities, and the inherent risk of the federal programs. This risk-based approach and the determination of major programs are discussed in chapter 7.

### ***Low-Risk Auditee***

2.17 Circular A-133 contains certain criteria for considering an auditee to be a low-risk auditee. A low risk-auditee is eligible for reduced audit coverage. It should be noted that *low-risk auditee* is a term defined in Circular A-133 for the purpose of applying the percentage-of-coverage rule (see paragraphs 7.24 and 7.25) in the risk-based approach. It does not imply or require the auditor to assess audit risk or any of its components as low for an entity that meets the Circular A-133 definition of a low-risk auditee.

### ***Cluster of Programs***

2.18 OMB Circular A-133 defines a cluster of programs as a grouping of closely related federal programs that share common compliance requirements. The types of clusters of programs are R&D, student financial aid (SFA), and other clusters. "Other clusters" are defined by the OMB in the *Compliance Supplement* or are designated as such by a state for the federal awards the state provides to its subrecipients that meet the definition of a cluster of programs. When a state designates federal awards as an "other cluster," it must also identify the federal awards included in the cluster and advise the

subrecipients of the compliance requirements applicable to the cluster. A cluster of programs should be considered as one program for determining major programs and (with the exception of R&D), whether a program-specific audit may be elected.

### ***Federal Agency Selection of Additional Major Programs***

**2.19** A federal agency may request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. After consultation with its auditor, the auditee should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach (described in chapter 7) and, if not, the estimated incremental cost. The federal agency must then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based upon the federal agency request, and the federal agency agrees to pay the full incremental costs, then the auditee must have the program audited as a major program. This approach may also be used by pass-through entities for a subrecipient.

## **Auditee Responsibilities**

### ***Preparation of Appropriate Financial Statements***

**2.20** Circular A-133 requires auditees to prepare financial statements that reflect their financial position, the results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements must be for the same organizational unit and fiscal year that is chosen to meet the requirements of Circular A-133. However, organization-wide financial statements may also include departments, agencies, and other organizational units that have separate audits in accordance with Circular A-133 and prepare separate financial statements (see paragraph 3.25 for a further discussion). Circular A-133 also requires auditees to prepare a schedule of expenditures of federal awards for the period covered by the financial statements. (The schedule of expenditures of federal awards is discussed in chapter 5.)

### ***Summary Schedule of Prior Audit Findings***

**2.21** The auditee is also required to prepare a summary schedule of prior audit findings. The schedule should report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to federal awards. It should also include audit findings reported in the prior audit's summary schedule of prior audit findings, except audit findings that have been corrected or are no longer valid. See paragraphs 10.68 through 10.70 for a further discussion of this schedule.

### ***Other Responsibilities***

**2.22** In addition to the responsibilities described in paragraphs 2.20 and 2.21, Circular A-133 establishes certain other responsibilities for auditees, including the following:

- Identifying in its accounts all federal awards received and expended and the federal programs under which they were received, including, as applicable, the CFDA title and number, the award number and



year, the name of the federal agency, and the name of the pass-through entity

- Establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs
- Complying with laws, regulations, and the provisions of contract or grants agreements related to each of its federal programs
- Ensuring that the audits required by Circular A-133 are properly performed and submitted when due
- Following up and taking corrective action on audit findings (including the preparation of a summary schedule of prior audit findings (see paragraph 2.21) and a corrective action plan (see paragraph 2.26); corrective action should be initiated within six months after the receipt of the audit report and proceed as rapidly as possible

### ***Responsibility for Compliance at the Financial Statement Level and for Internal Control Over Financial Reporting***

**2.23** Although not specifically stated in Circular A-133, the auditee is also responsible for complying with the requirements of laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on the financial statements and for establishing and maintaining effective internal control over financial reporting. These responsibilities support the requirements of *Government Auditing Standards*.

### ***Reporting Package***

**2.24** The auditee is also required to submit a reporting package that includes financial statements and a schedule of expenditures of federal awards (see paragraph 2.20 and chapters 4 and 5), the summary schedule of prior audit findings (see paragraph 2.21), the auditor's reports (see paragraph 2.8), and a corrective action plan (see paragraph 2.26). Although not part of the reporting package, the submission of the report must also include the data collection form described in paragraph 2.25. The report submission requirements of Circular A-133 are described in paragraphs 2.9 and 10.74 through 10.79. Auditees must keep one copy of the data collection form and the reporting package on file for three years from the date of submission to the federal clearinghouse. Furthermore, unless restricted by law or regulation, the auditee is required to make copies of the data collection form and the reporting package available for public inspection.

### ***Data Collection Form***

**2.25** The auditee is required to complete and sign certain sections of a data collection form which states whether the audit was completed in accordance with Circular A-133 and provides information about the auditee, its federal programs, and the results of the audit. The auditor is also required to complete and sign certain sections of this form. See paragraphs 10.71 through 10.73 for a further discussion of the data collection form.

### ***Corrective Action Plan***

**2.26** At the completion of the audit, the auditee should prepare a corrective action plan to address each audit finding included in the current year's

auditor's reports. See paragraphs 10.68 through 10.70 for a further discussion of the corrective action plan.

## Federal Awarding Agency Responsibilities

**2.27** For federal agencies that provide federal awards to recipients, Circular A-133 establishes certain responsibilities including the following:

- Identifying the federal awards made by informing each recipient of the CFDA title and number, the award name and number, the award year, and if the award is for R&D. When some of this information is not available, the federal agency must provide information necessary to clearly describe the federal award
- Advising recipients of the requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements
- Ensuring that audits are completed and reports are received in a timely manner and in accordance with the requirements of Circular A-133
- Providing technical advice and counsel to auditees and auditors as requested
- Issuing a management decision on audit findings within six months after receipt of the audit report and ensuring that the recipient takes appropriate and timely corrective action
- Assigning a person to provide annual updates of the *Compliance Supplement* to the OMB

## Pass-Through Entity Responsibilities

**2.28** Pass-through entities have many responsibilities that are similar to those of federal awarding agencies. See chapter 9 for a detailed description of the responsibilities of pass-through entities.

## Cognizant Agency for Audit

### Definition

**2.29** Circular A-133 defines the cognizant agency for audit as a federal agency designated to carry out the federal responsibilities with regard to a single audit. For recipients expending more than \$25 million a year in federal awards, the cognizant agency for audit will be the federal awarding agency that provides the predominant amount of direct funding to the recipient unless the OMB makes a specific cognizant agency for audit assignment. The determination of the predominant amount of direct funding is based on the direct federal awards expended by a recipient during its fiscal year ending in 1995, 2000, 2005, and every fifth year thereafter. For example, the audit cognizance for periods ending in 1997 through 2000 will be determined based on the federal awards expended in 1995.<sup>4</sup> Audit cognizance can be reassigned if both the old and the new federal agencies notify the auditee (and, if known, the auditor), of

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<sup>4</sup> It should be noted that for states and local governments that expend more than \$25 million a year in federal awards and have previously assigned cognizant agencies for audit, the requirements in this paragraph are not effective until fiscal years beginning after June 30, 2000.

the change within thirty days of the reassignment. A recipient may have one federal agency responsible for audit cognizance and another federal agency responsible for the negotiation of indirect costs.

### **Responsibilities**

**2.30** Circular A-133 states that a cognizant agency for audit is responsible for—

- Providing technical audit advice and liaison to auditees and auditors.
- Considering auditee requests for extensions to the report submission due date. The cognizant agency for audit may grant extensions for good cause.
- Obtaining or conducting quality control reviews of selected audits made by nonfederal auditors and providing the results, when appropriate, to other interested organizations.
- Promptly informing other affected federal agencies and appropriate federal law enforcement officials of any direct reporting by the auditee or its auditor of irregularities or illegal acts, as required by *Government Auditing Standards* or laws and regulations.
- Advising the auditor and, where appropriate, the auditee of any deficiencies found in the audits when the deficiencies require corrective action by the auditor. When advised of deficiencies, the auditee should work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency for audit must notify the auditor, the auditee, and the applicable federal awarding agencies and pass-through entities of the facts and make recommendations for follow-up action. Major inadequacies or repeated substandard performance by auditors will be referred to appropriate state licensing agencies and professional bodies for disciplinary action.
- Coordinating, to the extent practicable, the audits or reviews made by or for federal agencies that are in addition to audits under Circular A-133, so that the additional audits or reviews build upon the Circular A-133 audits performed.
- Coordinating a management decision for audit findings that affect the federal programs of more than one federal agency.
- Coordinating the audit work and reporting responsibilities among auditors, to achieve the most cost-effective audit.

For biennial audits, the cognizant agency for audit is also responsible for considering auditee requests to qualify as a low-risk auditee.

## **Oversight Agency for Audit**

### **Definition**

**2.31** An auditee that does not have a designated cognizant agency for audit that (that is, one that expends \$25 million or less in federal awards) will have an oversight agency for audit. Circular A-133 defines the oversight agency for audit as a federal awarding agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency for audit (see paragraphs 2.29 and 2.30). When there is no direct funding, the federal agency

with the predominant indirect funding is required to assume the oversight responsibilities.

### **Responsibilities**

**2.32** Circular A-133 describes the duties of oversight agencies for audit. The responsibilities of an oversight agency for audit are not as broad as those of a cognizant agency for audit. However, an oversight agency's primary responsibility is to provide technical advice to auditees and auditors when it is requested. An oversight agency may assume all or some of the responsibilities normally performed by a cognizant agency for audit.

### **Program-Specific Audits**

**2.33** Circular A-133 provides general guidance on performing program-specific audits. In many cases, a program-specific audit guide will be available from the federal agency's Office of Inspector General. The audit guide will provide specific guidance to the auditor with respect to internal control, compliance requirements, suggested audit procedures, and audit reporting requirements. When a program-specific audit guide is not available, the auditee and auditor have basically the same responsibilities for the federal program as they would have for an audit of a major program in a single audit. Program-specific audits are discussed further in chapter 11.

## **OMB Circular A-133 Compliance Supplement**

**2.34** The *Compliance Supplement* is based on the requirements of the Single Audit Act and Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits. The *Compliance Supplement* serves to identify existing compliance requirements that the federal government expects to be considered as part of an audit in accordance with the Single Audit Act and Circular A-133. For the programs included in the *Compliance Supplement*, it provides a source of information for auditors to understand the federal program's objectives, procedures, and compliance requirements relevant to the audit, as well as the audit objectives and suggested audit procedures for determining compliance with these requirements. It also provides guidance to assist auditors in determining compliance requirements relevant to the audit, audit objectives, and suggested audit procedures for programs not included in the *Compliance Supplement*. For single audits, the *Compliance Supplement* replaces agency audit guides and other audit requirement documents for individual federal programs.

**2.35** The *Compliance Supplement* is effective for audits of fiscal years beginning after June 30, 1996, and supersedes the compliance supplements, *Audits of States and Local Governments* (issued in 1990), and *Audits of Institutions of Higher Education and Other Non-Profit Organizations* (issued in 1991). The *Compliance Supplement* is discussed in greater detail in paragraphs 1.27, 1.28, and 6.21 through 6.30.

## Chapter 3

### PLANNING AND OTHER SPECIAL AUDIT CONSIDERATIONS OF CIRCULAR A-133

**3.1** In planning an audit to meet the requirements of Circular A-133, the auditor needs to consider several matters in addition to those ordinarily associated with an audit of financial statements in accordance with GAAS and *Government Auditing Standards*.<sup>1</sup> In this chapter the overall planning considerations in a single audit conducted in accordance with Circular A-133 are discussed. Many of these planning considerations are also applicable in a program-specific audit. Program-specific audits are discussed in detail in chapter 11.

**3.2** The following matters are relevant to the planning of a single audit:

- Satisfying Circular A-133 requirements and other relevant legal, regulatory, or contractual requirements (see paragraphs 3.3 through 3.5)
- Establishing an understanding with the auditee (see paragraphs 3.6 and 3.7)
- Satisfying the additional requirements of *Government Auditing Standards* (see paragraphs 3.8 through 3.21)
- Satisfying the additional requirements of the Single Audit Act and Circular A-133 regarding working papers and audit follow-up (see paragraphs 3.22 through 3.24)
- Defining the entity to be audited (see paragraph 3.25)
- Determining the audit period (see paragraphs 3.26 and 3.27)
- Initial-year audit considerations (see paragraphs 3.28 and 3.29)
- The timing of the completion of the audit and reporting submission deadlines (see paragraph 3.30)
- Determining the major programs to be audited (see paragraph 3.31)
- The preliminary assessment of audit risk (see paragraph 3.32)
- Audit materiality considerations (see paragraphs 3.33 through 3.38)
- Determining compliance requirements (see paragraph 3.39)
- Developing an efficient audit approach (see paragraph 3.40)
- Joint audits and reliance on others (see paragraphs 3.41 through 3.44)
- Existence of internal audit function (see paragraph 3.45)
- Communications with the cognizant agency for audit and others (see paragraph 3.46)

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<sup>1</sup> In *AICPA Professional Standards*, AU section 311, "Planning and Supervision," the auditor's responsibilities for planning and supervision in an audit of financial statements in accordance with GAAS are described. Paragraphs 4.6 and 4.7 of *Government Auditing Standards* describe its planning requirements.

- Understanding the applicable state and local compliance and reporting requirements (see paragraphs 3.47 through 3.49)
- Desk reviews and on-site reviews (see paragraphs 3.50 and 3.51)
- The restriction on the auditor's preparation of indirect cost proposals (see paragraph 3.52)
- The exit conference (see paragraphs 3.53 and 3.54)

## **Satisfying Circular A-133 Requirements and Other Relevant Legal, Regulatory, or Contractual Requirements**

**3.3** Because of the variety of audit requirements to which entities receiving federal awards are subject, paragraph 21 of SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801.21), states that auditors should exercise due professional care in ensuring that they and management understand the type of engagement to be performed. The auditor should consider including a statement about the type of engagement and whether it is intended to meet specific audit requirements in a proposal, in a contract, or in the communication issued to establish an understanding with the auditee (see paragraphs 3.6 and 3.7 for a further discussion of the establishment of an understanding with the auditee).

**3.4** Management is also responsible for obtaining audits that satisfy relevant legal, regulatory, or contractual requirements. Paragraph 22 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.22) states that GAAS do not require the auditor to perform procedures beyond those he or she considers necessary to obtain sufficient competent evidential matter to form a basis for the opinion on the financial statements. However, if during a GAAS audit of the financial statements, the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements.<sup>2</sup> For example, the auditor will be required to make this communication if he or she is engaged to perform an audit of an entity's financial statements in accordance with GAAS and the auditor becomes aware that by law, regulation, or contractual agreement, the entity is also required to have an audit performed in accordance with one or more of the following:

- *Government Auditing Standards*
- The Single Audit Act and Circular A-133
- Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides

**3.5** Paragraph 23 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.23) states that the required communication may be oral or written.

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<sup>2</sup> For entities that do not have audit committees, "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, the owner in owner-managed entities, the city council, or the legislative standing committee.

If the communication is oral, the auditor should document the communication in the working papers. The auditor should consider how the client's actions in response to such a communication relate to other aspects of the audit, including their potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in SAS No. 54, *Illegal Acts by Clients*, and SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*.

## Establishing an Understanding With the Auditee

3.6 SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310), states that the auditor should establish an understanding with the auditee regarding the services to be performed. Such understanding reduces the risk that either the auditor or the auditee may misinterpret the needs or expectations of the other party. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and the limitations of the engagement. The auditor should document this understanding in the working papers, preferably through a written communication with the auditee. If the auditor believes an understanding with the client has not been established, he or she should decline to accept the engagement.

3.7 SAS No. 83 includes a listing of the matters that should generally be included when the auditor establishes an understanding with the auditee regarding an audit of the financial statements. In addition to those matters, the auditor should also consider including the following information in the communication when he or she is engaged to perform a single audit:

- A description of the financial statements and supplemental schedule(s) to be audited
- The reporting period
- The auditing standards and requirements that will be followed (for example, GAAS, *Government Auditing Standards*, and Circular A-133)
- The objective of an audit in accordance with Circular A-133
- A description of the reports the auditor is expected to prepare and issue, including any limitation on their use
- A description of management's responsibility for (a) the financial statements and the schedule of expenditures of federal awards; (b) internal control over financial reporting and internal control over compliance; (c) compliance with laws, regulations, and the provisions of contracts and grant agreements; (d) following up and taking corrective action on audit findings, including the preparation of a summary schedule of prior audit findings and a corrective action plan; and (e) submitting the reporting package
- A statement that management has made the auditor aware of significant vendor relationships where the vendor is responsible for program compliance (so that the auditor can determine if additional procedures on vendor records will be necessary—see paragraphs 9.16 and 9.17)
- A description of the auditor's responsibility in an audit of financial statements and in a compliance audit of major programs under Circular

A-133, including the determination of major programs, the consideration of internal control, and reporting responsibilities

- Other communications that may arise from the audit
- A description of the working paper retention requirements
- A statement that the working papers will be made available upon request to appropriate federal agencies and the GAO
- The communication with audit committees or other responsible individuals required by *Government Auditing Standards* (see paragraphs 3.19 and 3.20 for a further discussion of this requirement)

SAS No. 83 also states that the establishment of an understanding may be communicated in the form of an engagement letter.

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

## Satisfying the Additional Requirements of *Government Auditing Standards*

3.8 Circular A-133 requires that audits of the financial statements and of the federal awards of the auditee be performed in accordance with *Government Auditing Standards* (see chapter 4 for a further discussion). In an audit in accordance with *Government Auditing Standards*, the auditor has considerations beyond those in a GAAS audit. *Government Auditing Standards* incorporates the fieldwork and reporting standards of GAAS and has general standards (described in chapter 2 of *Government Auditing Standards*) that are similar to those of the AICPA (that is, auditor qualifications, independence, and due professional care). However, *Government Auditing Standards* also contains additional general, fieldwork, and reporting requirements, which are summarized in Table 3.1 and discussed in detail in the three subsequent sections of this chapter.

**Table 3.1**

### **Additional Financial Statement Audit Requirements of *Government Auditing Standards***

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#### *General Requirements*

- Continuing professional education (CPE) in subjects directly related to the government environment and to government auditing or to the specific or unique environment that the audited entity operates in
- Appropriate internal quality control system and external quality control review every three years

#### *Fieldwork Requirements*

- Audit follow-up requirements on known material findings and recommendations from previous audits
- Plan audit to provide reasonable assurance of detecting misstatements resulting from noncompliance with provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts
- Additional working paper requirements

#### *Reporting Requirements*

- Communication with audit committees or other responsible individuals
  - Referring to *Government Auditing Standards* in the auditor's report
  - Reporting on compliance with laws and regulations and on internal controls
  - Consideration of privileged and confidential information
  - Report distribution
-



**3.9** *Government Auditing Standards* also provides additional guidance on audit materiality, on fraud<sup>3</sup> and illegal acts, and on internal controls. Table 3.2 summarizes where this additional guidance is provided in *Government Auditing Standards* and also where it is discussed in this SOP.

**Table 3.2**

<b>Additional Guidance in Government Auditing Standards</b>		
<i>Area of Additional Guidance</i>	<i>Government Auditing Standards Reference</i>	<i>SOP Reference</i>
Materiality	Paragraphs 4.8 and 4.9	Paragraph 3.34
Fraud and illegal acts	Paragraphs 4.14 through 4.17	Paragraphs 10.21 through 10.25
Internal controls	Paragraphs 4.21 through 4.33	Paragraphs 4.17 and 4.18

## **General Requirements**

### ***Continuing Professional Education***

**3.10** Government Auditing Standards requires auditors to participate in a program of continuing professional education (CPE) and training. Every two years, all auditors (whether certified or not) performing audits in accordance with *Government Auditing Standards* should complete at least eighty credit hours of training that contribute directly to their professional proficiency. At least twenty of those hours should be completed in each year of the two-year period. For auditors responsible for planning, directing, or reporting on the audit and for auditors conducting substantial portions of the audit, at least twenty-four hours should be in subjects directly related to the government environment and to government auditing. If the auditee operates in a specific or unique environment, auditors should receive training that is related to that environment. For example, if the auditor performs an audit of a not-for-profit organization, the twenty-four hours should be in topics related to the not-for-profit accounting and auditing environment. These could include compliance and government-related courses or those broadly related to the type of not-for-profit organization being audited.

**3.11** *Interpretation of Continuing Education and Training Requirements*, a detailed interpretation of the foregoing CPE standards, is available from the GPO (stock number 020-000-00250-6). Among other things, this interpretation discusses who is subject to the CPE requirements and what programs, activities, and subjects qualify as acceptable CPE. During engagement planning, auditors and audit organizations should ensure that members of the audit team have met or will meet the appropriate CPE requirements within two years of the start of the first audit in accordance with *Government Auditing Standards*, and every two years thereafter.

### ***Quality Control***

**3.12** *Government Auditing Standards* also states that the audit organization should have in place an appropriate internal quality control system and

<sup>3</sup> The term *fraud* as used in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, is synonymous with the term *irregularities* as used in *Government Auditing Standards*. Therefore, in discussing the requirements of *Government Auditing Standards*, this SOP will use the term *fraud* instead of the term *irregularities*.

undergo an external quality control review (for example, a peer review). An external quality control review should be conducted at least once every three years by an organization not affiliated with the organization being reviewed.

**3.13** *Government Auditing Standards* further requires audit organizations seeking to enter into a contract to perform an audit in accordance with *Government Auditing Standards* to provide their most recent external quality control review report to the party contracting for the audit. Auditors are not required to provide separate letters of comment. Auditors should consider documenting in the working papers the provision of the quality control review report to the party contracting for the audit.

## Fieldwork Requirements

### Audit Follow-Up

**3.14** *Government Auditing Standards* states that the auditee is responsible for resolving audit findings and recommendations. It further requires auditors to follow up on known material findings and recommendations from previous audits that could affect the financial statement audit. The purpose of this follow-up is to determine whether the auditee has taken timely and appropriate corrective actions. *Government Auditing Standards* also requires auditors to report the status of uncorrected material findings and recommendations that are from prior audits and that affect the financial statement audit. (See paragraphs 3.24, 6.61 through 6.67, and 10.62 for a further discussion of the auditor's responsibility for audit follow-up under both *Government Auditing Standards* and Circular A-133 and how these responsibilities correlate.)

### Responsibilities With Regard to the Provisions of Contracts and Grant Agreements

**3.15** Paragraph 4.13 of *Government Auditing Standards* refers to additional responsibilities with regard to detecting material misstatements resulting from noncompliance with the provisions of contract and grant agreements that have a direct and material effect on the determination of financial statement amounts. However, it has generally been interpreted under GAAS that the phrase *laws and regulations* in SAS No. 54 implicitly includes the provisions of contracts and grant agreements. Thus, the auditor's responsibility with regard to detecting material misstatements resulting from noncompliance with the provisions of contracts and grant agreements under *Government Auditing Standards* equates to the auditor's responsibility under GAAS.

### Working Papers

**3.16** SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), provides guidance on the auditor's preparation and maintenance of working papers. *Government Auditing Standards* includes an additional standard that requires working papers to contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments. This additional standard requires working papers to include sufficient documentation of the transactions and records examined that would enable an experienced auditor to examine the same transactions and records. *Government Auditing Standards* also states that auditors should provide for working paper access to other auditors, to facilitate reviews of audit

quality and reliance by other auditors on the auditor's work, and should provide for such access in contractual arrangements for *Government Auditing Standards* audits (see paragraphs 3.22 and 3.23 for a discussion of the working paper access and retention requirements under Circular A-133).

**3.17** Audits done in accordance with *Government Auditing Standards* are subject to review by other auditors and by oversight officials more frequently than are audits done in accordance with GAAS. Thus, whereas GAAS cites two main purposes of working papers (providing the principal support for the audit report and aiding auditors in the conduct and supervision of the audit), working papers serve an additional purpose in audits performed in accordance with *Government Auditing Standards*. Working papers allow for the review of audit quality by providing the reviewer written documentation of the evidence supporting the auditor's significant conclusions and judgments.

**3.18** *Government Auditing Standards* specifically states that working papers should contain—

- The objectives, scope, and methodology, including any sampling criteria used.
- Documentation of the work performed to support significant conclusions and judgments, including descriptions of the transactions and records examined that would enable an experienced auditor to examine the same transactions and records.<sup>4</sup>
- Evidence of supervisory reviews of the work performed.

## Reporting Requirements

### ***Communication With Audit Committees or Other Responsible Individuals***

**3.19** *Government Auditing Standards* includes an additional reporting standard that requires the auditor to communicate certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit. This standard applies in all situations in which there is an audit committee or the audit is performed under contract. In other situations, the auditor may still find it useful to communicate with management or other officials of the auditee, although it is not required. The auditor should communicate the following information to the audit committee or representatives of the contractor:

- a. The auditor's responsibilities in a financial statement audit, including his or her responsibilities for testing and reporting on internal control and compliance with laws and regulations
- b. The nature of any additional testing of internal controls and compliance required by laws and regulations
- c. The responsibilities and the nature of any additional testing described in items a and b should be contrasted with other financial related audits of internal control and compliance (to help responsible parties understand the limitations of the auditor's responsibilities for testing and reporting on internal control and compliance)

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<sup>4</sup> Auditors may meet this requirement by listing voucher numbers, check numbers, or other means of identifying specific documents they examined. Auditors are not required to include in the working papers copies of documents they examined nor are they required to list detailed information from those documents.

**3.20** Professional judgment should be used in determining the form and content of the communication, which may be oral or written. If the communication is oral, the auditor should document the communication in the working papers. If written, the required communication may be issued as a separate communication or as part of the auditor's communication issued to establish an understanding with the auditee (see paragraphs 3.6 and 3.7).

### **Other Additional Reporting Requirements**

**3.21** The other additional reporting requirements of *Government Auditing Standards*—referring to *Government Auditing Standards* in the auditor's report, reporting on compliance with laws and regulations and on internal control, consideration of privileged and confidential information, and report distribution—are addressed in paragraphs 10.15 and 10.16.

## **Satisfying the Additional Requirements of the Single Audit Act and Circular A-133 Regarding Working Papers and Audit Follow-Up**

### **Working Papers**

**3.22** The Single Audit Act states that upon request by a federal agency or the Comptroller General, any independent auditor conducting a single audit should make the auditor's working papers available to the federal agency or the Comptroller General (a) as part of a quality review, (b) to resolve audit findings, or (c) to carry out oversight responsibilities. It also states that access to the auditor's working papers shall include the right to obtain copies. The Single Audit Act intends that federal agencies be judicious in the exercise of this authority and that the release of the working papers should not compromise the confidentiality of proprietary information. The Single Audit Act also intends that any trade secrets and confidential commercial or financial information obtained from the working papers be treated as confidential under the Freedom of Information Act. Auditors should refer to the guidance in the AICPA Auditing Interpretation titled *Providing Access to or Photocopies of Working Papers to a Regulator* (AICPA, *Professional Standards*, vol. 1, AU sec. 9339), when a regulator requests access to the auditor's working papers pursuant to law, regulation, or audit contract.

**3.23** Circular A-133 requires that auditors retain working papers and reports for a minimum of three years after the date of issuance of the auditor's report to the auditee, unless the auditor is notified in writing by the cognizant agency for audit, oversight agency for audit, or pass-through entity to extend the retention period. When the auditor is aware that the federal awarding agency, pass-through entity, or auditee is contesting an audit finding, the auditor is required to contact the parties contesting the audit finding for guidance prior to the destruction of the working papers and reports.

### **Audit Follow-Up**

**3.24** In addition to the requirements of *Government Auditing Standards*, Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current-year au-

dit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. (See paragraphs 6.61 through 6.67 and 10.62 for a further discussion of the responsibility for audit follow-up under both Circular A-133 and *Government Auditing Standards* and how these responsibilities correlate.)

## Defining the Entity to Be Audited

**3.25** One of the initial tasks during the planning process of a single audit is determining whether management has properly defined the entity to be audited. Circular A-133 requires that single audits must cover the entire operations of the auditee. However, Circular A-133 provides auditees the option to meet the audit requirements of the circular through a series of audits that cover an auditee's departments, agencies, and other organizational units which expended or otherwise administered federal awards during a fiscal year. If an auditee elects this option, then separate financial statements and a schedule of expenditures of federal awards must be prepared for each such department, agency, or other organizational unit. In these circumstances, an auditee's organization-wide financial statements may also include departments, agencies, or other organizational units that have separate audits and prepare separate financial statements. For example, if a local government has its school districts audited separately, it would be acceptable for the local government's financial statements to include the school districts, even though the school districts were not included in the local government's Circular A-133 audit, because a separate Circular A-133 audit was conducted of the school districts. However, if separate financial statements were not prepared for the school districts, it would be unacceptable for a separate Circular A-133 audit to be conducted of the school districts (that is, the local government's organization-wide financial statements could not be used as a substitute for separate financial statements for the school districts). See paragraph 10.34 for a discussion of the situation where the implementation regulations of certain federal agencies define the entity to be audited differently than GAAP.

## Determining the Audit Period

### Fiscal Year and Program Period May Differ

**3.26** An audit performed in accordance with Circular A-133 should cover the auditee's financial transactions (including transactions related to federal awards) for its fiscal year (or a two-year period, if allowed by Circular A-133), which is not necessarily the same as the period of the program being funded (see paragraph 2.5 for further information on biennial audits). Thus, the audit might include only a part of the transactions of a federal award, because some transactions may not occur within the period covered by the audit.

### Stub Periods

**3.27** Stub periods may occur when an auditee converts from a program-specific audit to a single audit or changes audit periods. One example would be a community college with a September 30 year end that previously had a program-specific audit and is now converting to a single audit. The prior program-specific audits were performed based on a June 30 award year. The first single audit will be for the year ending September 30. This would leave the community college with an unaudited stub period of June 30 to September

30. Arrangements should be made to meet the audit requirements for federal expenditures during the stub period. This is usually done either as a separate audit of the stub period or by including expenditures of the stub period with the following period's Circular A-133 audit. The cognizant or oversight agency for audit or the pass-through entity should be contacted for advice on how stub periods should be addressed.

## Initial-Year Audit Considerations

### Preceding Period Audited by Another Auditor

3.28 Whenever an auditor is considering accepting an engagement in which the federal awards of the preceding period were audited by another auditor, he or she should refer to the guidance in SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315). It provides guidance on communications between predecessor and successor auditors when a change in auditors is in process or has taken place, and it includes illustrative letters. SAS No. 84 also provides communications guidance when possible misstatements are discovered in financial statements reported on by a predecessor auditor.

### Factors to Consider Under the Risk-Based Approach

3.29 When the engagement includes the selection of major programs using the risk-based approach, an auditor accepting, or contemplating accepting, an engagement should consider gathering information about the following:

- Federal awards expended by federal program
- Prior-period findings and questioned costs (including the corrective action plan and management decision related to the findings and summary schedule of prior audit findings)
- Whether the predecessor auditor used the exception that allows deviation from the risk-based approach during the last three years (see paragraph 7.20)
- Correspondence from program officials indicating potential problems
- New programs
- Changes to programs
- Amount of funding passed through to subrecipients by individual federal program
- Extent to which computer processing is used to administer federal programs
- Federal programs audited as major programs for the last two years

## Timing of the Completion of the Audit and Reporting Submission Deadlines

3.30 When planning the timing of the audit, auditors should be aware that Circular A-133 requires that the audit be completed and the data collection form and reporting package (described in paragraphs 2.24, 2.25, 10.6, 10.7,

and 10.71 through 10.73) be submitted to the federal clearinghouse within a certain time period. The timing requirements are discussed in detail in paragraphs 10.74 through 10.79.

## Determining the Major Programs to Be Audited

**3.31** As discussed in paragraphs 2.16 through 2.19, Circular A-133 requires the auditor to use a risk-based approach to determine which federal programs are major programs. This determination will affect the scope of the audit and the compliance requirements to be tested. The determination of major programs is discussed further in chapter 7.

## Preliminary Assessment of Audit Risk

**3.32** As required by SAS No. 54, the auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. While not explicitly stated in SAS No. 54, it has generally been interpreted that the phrase “laws and regulations” implicitly includes provisions of contracts and grant agreements. (Auditors should note that *Government Auditing Standards* explicitly states that the auditor should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with the provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statements amounts.) Circular A-133 further requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. In developing an audit plan, the auditor should assess the risk that noncompliance may cause the financial statements to contain a material misstatement or may have a material effect on each major program. Furthermore, the auditor should consider risk factors related to the risk of noncompliance with those laws, regulations, and provisions of contracts and grant agreements and to the related control activities designed to prevent or to detect such noncompliance. As required by SAS No. 82, the auditor should also specifically assess the risk of material misstatement of the financial statements because of error or fraud and should consider that assessment in designing the audit procedures to be performed (see paragraphs 4.32 through 4.37). Audit risk is discussed in greater detail in paragraphs 6.7 through 6.12.

## Audit Materiality Considerations

**3.33** SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, provides guidance on the auditor’s consideration of materiality when he or she plans and performs an audit of financial statements in accordance with GAAS. Materiality, as it relates to the financial statement audit, is further discussed in the following related AICPA Audit and Accounting Guides:

- *Not-for-Profit Organizations*
- *Audits of State and Local Governmental Units*
- *Health Care Organizations*
- *Audits of Colleges and Universities*<sup>5</sup>

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<sup>5</sup> Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

## **Materiality Guidance in Government Auditing Standards**

**3.34** As noted in paragraph 3.9, *Government Auditing Standards* contains guidance on certain areas, including materiality considerations. Paragraphs 4.8 and 4.9 of *Government Auditing Standards* state that “auditors’ consideration of materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. In an audit of the financial statements of a government entity or an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions.”

## **Materiality Differences Between the Financial Statement Audit and the Single Audit**

**3.35** In auditing compliance with requirements governing major programs in accordance with Circular A-133, the auditor’s consideration of materiality differs from that in an audit of financial statements in accordance with GAAS and *Government Auditing Standards*. In an audit of financial statements, materiality is considered in relation to the financial statements being audited. In designing audit tests and developing an opinion on an auditee’s compliance with requirements having a direct and material effect on each major program, however, the auditor considers materiality in relation to each major program (see paragraphs 6.13 through 6.16 for a further discussion of materiality considerations).

## **Materiality for Purposes of Reporting Audit Findings**

**3.36** Circular A-133 requires the auditor to consider a lower level of materiality for purposes of reporting audit findings in the schedule of findings and questioned costs. The auditor should be cautious that this “audit finding” materiality not be confused with (a) the materiality used for planning and performing the single audit, (b) giving an opinion on the financial statements, and (c) giving an opinion on the auditee’s compliance with requirements having a direct and material effect on each major program (see paragraph 3.35 above).

**3.37** Among other findings that must be reported, Circular A-133 requires the auditor to report material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program in the schedule of findings and questioned costs (other findings that are required to be reported are described in paragraph 10.63). The auditor’s determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement (for example, activities allowed or unallowed, cash management, eligibility, or reporting) for a major program or an audit objective identified in the *Compliance Supplement*.

**3.38** For example, when the auditor discovers one or more instances of noncompliance involving the reporting type of compliance requirement for a particular major program, several materiality determinations must be made using professional judgment. First, the auditor must decide whether the noncompliance is material to the reporting type of compliance requirement for the



particular major program. If the auditor determines the noncompliance is material to the reporting type of compliance requirement, the noncompliance would be reported as a finding in the schedule of findings and questioned costs. Second, the auditor must decide whether the discovered noncompliance is material, either individually or when aggregated with other noncompliance findings, in relation to the particular major program taken as a whole. If the auditor determines the noncompliance is material to the major program taken as a whole, the auditor would express a qualified or adverse opinion on compliance with respect to the particular major program.

## Determining Compliance Requirements

**3.39** In planning the consideration of the internal control and compliance aspects of the audit, the auditor should obtain from management the principal compliance requirements at the start of the audit (see paragraph 4.27 for a listing of possible audit procedures to assess management's identification of compliance requirements). The auditee and auditor may also ascertain the principal compliance requirements for the largest federal programs by referring to the *Compliance Supplement*. For programs not included in the *Compliance Supplement*, auditors should refer to part 7 of that document, which provides guidance for auditing programs not included in the *Compliance Supplement*. Among other things, part 7 instructs auditors to review the federal award document and referenced laws and regulations applicable to the program, the CFDA, and previously issued compliance supplements (see paragraph 6.30 for further information).

## Developing an Efficient Audit Approach

**3.40** Auditors should consider planning and performing a single audit to achieve maximum audit efficiency. Examples of ways to achieve audit efficiency follow.

- The financial statement audit and the single audit could be planned at the same time.
- If the auditee's system administers more than one major program using common internal control, the transactions of those programs could be combined into one population for selecting sample sizes. When testing transactions selected from the major programs, the auditor could use the sample to test internal control over financial reporting, internal control over compliance, and compliance requirements.
- Since Circular A-133 requires the planning and performance of internal control work to assess control risk as low (unless weaknesses are found), the auditor could take advantage of the low assessed level of control risk when he or she performs the substantive testing of compliance.
- Helpful quality control materials (such as planning checklists and reporting checklists) could be used.

## Joint Audits and Reliance on Others

**3.41** Circular A-133 encourages auditees, whenever possible, to make positive efforts to utilize small business, minority-owned firms, and women's business enterprises. In keeping with the spirit of this provision, certain audi-

tees may engage such independent accounting firms on a joint-venture or subcontract basis. In these instances it may be necessary to refer to the work of other auditors. Prior to entering into an agreement to perform a joint audit or to subcontract with another firm, the auditor should consider SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*, and Ethics Interpretation 101-10, *The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements*.

**3.42** In some circumstances, each of the auditors participating in the single audit will jointly sign the audit reports. This is appropriate only when each auditor or firm has complied with GAAS and *Government Auditing Standards* and is in a position that would justify being the only signatory of the report.

**3.43** If part of the single audit is performed by governmental auditors, the auditors should be satisfied that the government auditors meet the independence standards in chapter 3 of *Government Auditing Standards* as well as the CPE and quality control standards. These standards require that government auditors be free from organizational, personal, and external impairments to independence and that they maintain an independent attitude and appearance.

**3.44** Another common occurrence, particularly in a governmental environment, is the separation of a single audit between the principal auditor of the reporting entity and a secondary auditor of a component unit included in the financial statements of the reporting entity (see paragraph 3.25). The principal auditor's report on the financial statements of the reporting entity most often refers to the report of the secondary auditor as it relates to the financial statements of the component unit. The principal auditor may also need to refer to the programs audited by other auditors in his or her reports on the schedule of expenditures of federal awards, compliance, and internal control related to federal awards, as they relate to federal awards administered by the component unit. In such cases, the auditor should follow the guidance in SAS No. 1, section 543.

## Existence of Internal Audit Function

**3.45** Another factor the auditor should consider when planning the single audit is whether the addressee has an internal audit function and the extent to which internal auditors are involved in monitoring compliance with specified requirements. The auditor should consider the guidance in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), when addressing the competence and objectivity of internal auditors; the nature, timing, and extent of work to be performed; and other related matters (for example, in obtaining an understanding of the entity's internal control over financial reporting and compliance, assessing audit risk, and performing substantive procedures).

## Communications With the Cognizant Agency for Audit and Others

**3.46** When professional judgment indicates it is appropriate, the auditor may communicate with the cognizant agency for audit, the oversight agency for audit, federal awarding agencies, pass-through entities, state auditors, or state

awarding agencies, to aid in planning the audit. The auditor might want to consider documenting such communications, as well as any decisions rendered as a result. If a planning meeting is held, matters such as the following may be discussed:

- The audit plan
- The scope of the compliance testing of federal programs
- The intended use of the *Compliance Supplement*
- The identification of federal awards, including those that are considered to be major programs
- The form and content of the supplemental schedule of expenditures of federal awards
- The testing of the monitoring of subrecipients
- The scope of the review and testing of internal control
- The testing of compliance requirements
- The status of prior-year findings and questioned costs
- Federal agency or pass-through entity management decisions on prior-year findings
- Compliance requirements and any changes to those requirements

## Understanding the Applicable State and Local Compliance and Reporting Requirements

### Impact on Circular A-133 Audit

3.47 Auditors may be engaged to test and report on compliance with state and local laws and regulations in addition to testing and reporting on the compliance requirements imposed by *Government Auditing Standards* and Circular A-133. For example, there may be state-imposed state award requirements that provide state funds to political subdivisions or NPOs (in this example, the state is not a pass-through entity). Even though such nonfederal awards are not considered part of the total federal awards expended by the auditee and are not subject to audit in accordance with Circular A-133, auditors would still need to consider such laws and regulations under GAAS and *Government Auditing Standards*. Therefore, in connection with the financial statement audit, auditors should obtain an understanding of applicable state and local compliance and reporting requirements that have a direct and material effect on the financial statements being audited.

### Compliance Audits of State or Local Grants

3.48 When engaged to audit one or more grants subject to state or local compliance requirements, the auditor should consider performing the following procedures:

- Determine whether the state or local government has a compliance supplement or other audit guide for the program.
- Inquire of management about the additional compliance auditing requirements applicable to the entity.

- Inquire of the audit divisions of the sponsoring agencies about the audit requirements applicable to the entity.
- Obtain any applicable audit guidance from the grantor agency (including any audit guides, amendments, administrative rulings, and the like) pertaining to the grant.
- Read the grant agreements and any amendments, including referenced laws and regulations.
- Review information about governmental audit requirements that is available from state societies of CPAs or associations of governments.
- When appropriate, discuss with the grantor agency the scope of the testing that is expected to be performed.

### **Compliance Audits Not Involving Governmental Assistance**

**3.49** Guidance for engagements related to management's written assertion about an entity's compliance with specified state or local laws, regulations, rules, or contracts not involving governmental financial assistance is provided in Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500).

### **Desk Reviews and On-Site Reviews**

**3.50** In addition to the quality control requirements set forth in *Government Auditing Standards* (see paragraphs 3.12 and 3.13), cognizant agencies for audit have implemented procedures for evaluating the quality of audits. These procedures include both desk reviews and on-site reviews (note that the oversight agencies for audit may also perform these reviews). As a part of the cognizant agencies' evaluation of the completed reports of such engagements, and, as required by Circular A-133, the supporting audit working papers must be made available upon request of the representative of the federal agency. Audit working papers are typically reviewed at a location agreed upon by the cognizant agency for audit and the independent auditor. (See the additional discussion in paragraphs 3.16 and 3.22 regarding working paper access issues.)

**3.51** Whenever a review of the audit report or the working papers discloses an inadequacy, the audit firm is contacted for corrective action. Where major inadequacies are identified and the representative of the cognizant agency for audit determines that the audit report and the working papers are substandard, cognizant agencies may take further steps. In those instances in which the audit was determined to be substandard by the federal agency, the matter may be submitted to state boards of public accountancy.

### **Restriction on the Auditor's Preparation of Indirect Cost Proposals**

**3.52** Circular A-133 precludes the auditor who prepares the indirect cost proposal or cost allocation plan from performing the single audit when indirect costs recovered during the prior year by the auditee exceed \$1 million. This restriction applies to the base year used in the preparation of the indirect proposal or cost allocation plan and to any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs.

The implementation date for this provision is for audits of fiscal years beginning after June 30, 1998. For example, an auditor who prepares an indirect cost proposal or cost allocation plan that is used as the basis for charging indirect costs in the fiscal year ending June 30, 1999, is not permitted to perform the 1999 single audit (assuming that the indirect costs recovered during the prior year exceeded \$1 million).

## Exit Conference

**3.53** Upon completion of fieldwork, the auditor should consider holding a closing or exit conference with senior officials of the auditee. The exit conference gives the auditor an opportunity to obtain management's comments on the accuracy and completeness of his or her facts and conclusions, including whether or not management concurs with the audit findings. This conference also serves to provide the auditee with advance information so that it may initiate corrective action without waiting for a final audit report. In the case of decentralized operations, as at a university, auditors should consider having preliminary meetings with deans, department heads, and other operating personnel who have direct responsibility for financial management systems and the administration of sponsored projects.

**3.54** The auditor should consider documenting the names of the auditors who conducted the exit conference, the names and positions of the representatives with whom exit conferences were held and any comments that they had, and other details of the discussions.

## Chapter 4

# FINANCIAL STATEMENT AUDIT CONSIDERATIONS UNDER CIRCULAR A-133

### Introduction

4.1 Circular A-133 requires auditees to prepare financial statements that reflect their financial position, their results of operations or changes in net assets, and, where appropriate, their cash flows for the fiscal year. The financial statements must be for the same organizational unit and fiscal year that is chosen to meet the requirements of Circular A-133. However, organization-wide financial statements may also include departments, agencies, and other organizational units that have separate audits and prepare separate financial statements (see paragraph 4.5 below). Circular A-133 also requires auditees to prepare a schedule of expenditures of federal awards for the period covered by the financial statements. (The schedule of expenditures of federal awards is discussed in chapter 5.)

4.2 Circular A-133 does not prescribe the basis of accounting that must be used by auditees to prepare their financial statements. However, auditees are required to disclose the basis of accounting and significant accounting policies used in preparing the financial statements. Auditees must be able to reconcile amounts presented in the financial statements to related amounts in the schedule of expenditures of federal awards.

4.3 Circular A-133 does, however, require the auditor to report whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP). This results in the expression of an opinion or a disclaimer of opinion. (Guidance on reporting on the financial statements of the auditee appears in chapter 10.) If the auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP,<sup>1</sup> the auditor is still required to express or disclaim an opinion and should follow the reporting guidance in SAS No. 62, *Special Reports*.

4.4 The financial statements are also required to be audited in accordance with *Government Auditing Standards* (see paragraphs 3.8 through 3.21, 4.17 through 4.19, and 4.41). Circular A-133 does not impose on the financial statement audit any additional audit requirements beyond *Government Auditing Standards*.

4.5 The audit must cover the entire operations of the auditee, or at the option of the auditee, the audit may include a series of audits that cover departments, agencies, and other organizational units that expended or otherwise administered federal awards during the fiscal year, provided that each audit encompasses the financial statements and schedule of expenditures of federal awards for each such department, agency, and other organizational unit (see paragraph 3.25 for a further discussion).

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<sup>1</sup> A comprehensive basis of accounting other than GAAP is defined in paragraph 4 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.04).

4.6 In performing the financial statement audit, the auditor should refer to the accounting and auditing guidance applicable to specific industries as found in the following AICPA Audit and Accounting Guides: *Not-for-Profit Organizations*, *Audits of State and Local Governmental Units*, *Health Care Organizations*, and *Audits of Colleges and Universities*.<sup>2</sup>

4.7 In this chapter, the requirements of GAAS related to the auditor's consideration of compliance and internal control over financial reporting in a financial statement audit are summarized and the additional requirements of *Government Auditing Standards* in those areas are discussed.

## Consideration of Internal Control Over Financial Reporting

4.8 In the following paragraphs the requirements of GAAS and *Government Auditing Standards* applicable to the auditor's consideration of internal control over financial reporting in a financial statement audit are described.

### Summary of GAAS Requirements

4.9 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent auditor's consideration of an auditee's internal control in an audit of financial statements in accordance with GAAS, defines internal control, describes the objectives and components of internal control, and explains how an auditor should consider internal control in planning and performing an audit.

4.10 When obtaining an understanding of internal control over financial reporting and assessing control risk for the assertions embodied in the financial statements, the auditor should refer to SAS No. 55, as amended by SAS No. 78, and to guidance applicable to specific industries as found in the AICPA Audit and Accounting Guides listed in paragraph 4.6.

### Definition of Internal Control

4.11 The definition of internal control in both SAS No. 55, as amended by SAS No. 78, and Circular A-133 is consistent with the definition and description of internal control contained in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. The definition is as follows:

*Internal control* means a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations;
- Reliability of financial reporting; and
- Compliance with applicable laws and regulations.

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<sup>2</sup> Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

### **Control Objectives**

4.12 The three categories of control objectives described previously are what an auditee strives to achieve. These distinct but somewhat overlapping categories have differing purposes and allow a directed focus to meet the needs of the auditee and others regarding each separate purpose. In general, controls that are relevant to an audit of financial statements pertain to the auditee's objective of the reliability of financial reporting and involve the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP or a comprehensive basis of accounting other than GAAP (see footnote 1 of this chapter). However, controls pertaining to the operations and compliance objectives may also be relevant to a financial statement audit to the extent that they pertain to data the auditor evaluates or uses in applying auditing procedures to the financial statements. Controls relevant to an audit of the financial statements are referred to collectively in this SOP as "internal control over financial reporting" and are encompassed in the reporting on internal control required by *Government Auditing Standards* (see paragraphs 10.38 through 10.40). Controls relevant to an audit of compliance with requirements applicable to major federal programs are referred to collectively in this SOP as "internal control over compliance" and are encompassed in the report on internal control required by Circular A-133 (see paragraphs 10.46 through 10.49). In a particular single audit engagement, some controls may be relevant to both the audit of the financial statements and the audit of compliance. When this occurs, those controls would be encompassed in both internal control reports. Section 505 of Circular A-133 provides guidance on reporting findings involving reportable conditions in internal control in such a circumstance (see paragraph 10.56).

### **Components of Internal Control**

4.13 The five components of internal control are the control environment, risk assessment, control activities, information and communication, and monitoring. SAS No. 55, as amended by SAS No. 78, requires the auditor to obtain an understanding of each of those components that is sufficient to plan the audit by performing procedures to understand (a) the design of controls relevant to an audit of financial statements, and (b) whether they have been placed in operation. In all audits of financial statements, including those audited as part of a single audit, this understanding incorporates knowledge about the design of controls relevant to compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts, as well as knowledge about whether they have been placed in operation. After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.

### **Relationship Between Objectives and Components**

4.14 There is a direct relationship between the three categories of control objectives (what an auditee strives to achieve) and the control components (what is needed to achieve the objectives). Although an auditee's internal control addresses objectives in each of the categories referred to in the definition of internal control in paragraph 4.11, not all of these objectives and related controls are relevant to an audit of the auditee's financial statements.

### **Documentation Requirements**

4.15 SAS No. 55, as amended by SAS No. 78, requires the auditor to document the understanding of the auditee's internal control components that



was obtained to plan the audit. In addition, the auditor should document the basis for his or her conclusions about the assessed level of control risk. The form and extent of this documentation is influenced by the size and complexity of the auditee, as well as by the nature of the auditee's internal control (see paragraphs 3.16 through 3.18 for a discussion of the working paper requirements of *Government Auditing Standards*). Auditors should refer to SAS No. 55, as amended by SAS No. 78, for more detail on the documentation requirements related to internal control over financial reporting.

### **Communication Requirements**

**4.16** The auditor should consult the guidance in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), for guidance on identifying and reporting conditions that relate to an entity's internal control over financial reporting observed during an audit of financial statements (see also paragraphs 4.19 and 10.26 through 10.30). The auditor should also consult the guidance in SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), for required communications to persons who have responsibility for the oversight of the financial reporting process (see also paragraph 10.14).

## **Responsibilities Under Government Auditing Standards**

### **Fieldwork**

**4.17** *Government Auditing Standards* does not prescribe any additional fieldwork standards with respect to the auditor's consideration of internal control over financial reporting beyond those required in an audit conducted in accordance with GAAS. However, paragraphs 4.22 through 4.33 of *Government Auditing Standards* provide guidance on four aspects of internal control over financial reporting that are important to the judgments auditors make about audit risk and about the evidence needed to support their opinion on the financial statements. These aspects are summarized as follows:

- **Control environment.** Auditors' judgments about the control environment may influence (either positively or negatively) judgments about specific control procedures.
- **Safeguarding controls.** These are the controls that prevent or timely detect unauthorized transactions and unauthorized access to assets resulting in possible losses that are material to the financial statements. Therefore, the understanding of safeguarding controls assists auditors in planning the audit to detect material misappropriations as well as to assess other risks that the financial statements could be materially misstated.
- **Controls over compliance with laws and regulations.** These are important to auditors in identifying the types of potential misstatements that could occur and the factors that could affect the risk of material misstatement. Such information can help provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.
- **Control risk assessments.** These are important in determining the nature, timing, and extent of the audit tests to be performed. *Government Auditing Standards* reminds auditors that when control risk is

assessed below the maximum for a given financial statement assertion, the need for evidence from substantive tests of that assertion is reduced. Auditors are not required to assess control risk below the maximum and to rely on controls. However, auditors may find it efficient to do so for larger entities or those with complex operations. The auditors' ability to rely on controls is directly related to the evidence obtained to show that the controls work. Auditors may find it necessary to reconsider assessments of control risk when substantive tests detect misstatements.

**4.18** The auditor should consider this guidance as it relates to the consideration of the auditee's internal control over financial reporting in the audit of the financial statements.

### **Reporting**

**4.19** Reporting on the internal control over financial reporting under *Government Auditing Standards* differs from such reporting under SAS No. 60. *Government Auditing Standards* requires written reporting on internal control over financial reporting in all audits. SAS No. 60 requires communication (either written or oral) only when the auditor has noted reportable conditions. *Government Auditing Standards* requires a description of any reportable conditions noted, including the identification of those that are individually or cumulatively material weaknesses. SAS No. 60 permits, but does not require, the auditor to identify and communicate separately, as material weaknesses, those reportable conditions that, in the auditor's judgment, are considered to be material weaknesses. Finally, *Government Auditing Standards* requires communication of the following matters, which are not addressed by SAS No. 60: (a) a description of the scope of the auditor's testing of internal control and the results of those tests and (b) deficiencies in internal control that are not considered reportable conditions (see the discussion in paragraph 10.29). See paragraphs 3.19 through 3.20 and 10.26 through 10.30 for a more detailed discussion of the reporting requirements related to internal control over financial reporting.

## **Compliance Considerations**

**4.20** The auditor should be aware of the unique characteristics of the compliance auditing environment. States, local governments, and not-for-profit organizations differ from commercial enterprises in that they may be subject to diverse compliance requirements. Management is responsible for ensuring compliance with relevant laws and regulations. That responsibility encompasses the identification of applicable laws and regulations and the establishment of internal control designed to provide reasonable assurance that the auditee complies with those laws and regulations.

**4.21** In the following paragraphs, the requirements of GAAS that are applicable to the auditor's consideration of compliance in a financial statement audit are summarized and the additional requirements of *Government Auditing Standards* are discussed.

## **Summary of GAAS Requirements**

### **General Guidance**

**4.22** SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, pro-

vides general guidance when the auditor is engaged to audit an entity that receives federal awards, including audits performed under GAAS, *Government Auditing Standards*, and Circular A-133. SAS No. 74 describes the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit and also discusses the auditor's responsibility for compliance auditing related to federal awards in an audit performed under Circular A-133. The auditor's responsibility for compliance auditing related to federal awards is discussed in chapter 6 of this SOP.

**4.23** The auditor is required to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations, error, or fraud. SAS No. 54, *Illegal Acts by Clients*, describes the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended by SAS No. 82, describe the auditor's responsibility in a GAAS audit for the consideration of fraud and errors. The requirements of SAS Nos. 54, 82, and 47 are described in paragraphs 4.24 through 4.38.

### **SAS No. 54 Requirements**

**4.24** SAS No. 54 requires the auditor to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. This involves identifying laws and regulations that may have a direct and material effect on the determination of financial statement amounts, and then assessing the risk that noncompliance with these laws and regulations may cause the financial statements to contain a material misstatement. The auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality per se.

**4.25** Although it has not been explicitly stated in SAS No. 54, the phrase "laws and regulations" has generally been interpreted to implicitly include the provisions of contract and grant agreements (see paragraph 3.15). Laws, regulations, and provisions of contracts and grant agreements are referred to in this SOP as "compliance requirements." Violations of laws, regulations, and provisions of contracts and grant agreements are referred to in this SOP as "instances of noncompliance."

**4.26** In considering whether the financial statements may be materially misstated because of instances of noncompliance, the auditor should—

- Assess whether management has identified compliance requirements that have a direct and material effect on the determination of amounts in the financial statements.
- Obtain an understanding of the possible effects of these compliance requirements on the determination of financial statement amounts.
- Assess the risk that a material misstatement of the financial statements has occurred because of instances of noncompliance.
- Design and conduct the audit to provide reasonable assurance of detecting such material noncompliance.

**4.27** The auditor may consider performing the following procedures in assessing management's identification of these compliance requirements and in obtaining an understanding of their possible effects on the determination of financial statement amounts:

- a. Consider knowledge about these compliance requirements that has been obtained from prior years' audits.
- b. Discuss these compliance requirements with the auditee's chief financial officer, legal counsel, or grant administrators.
- c. Obtain written representation from management regarding the completeness of management's identification of compliance requirements (see paragraph 4.40).
- d. Review the relevant portions of any directly related agreements, such as those related to grants and loans.
- e. Identify sources of revenue, review any related agreements (for example, loan agreements or grant agreements) and inquire about the applicability of any overall governmental regulations to the accounting for the revenue.
- f. Obtain publications pertaining to compliance requirements. These publications often address federal tax and other reporting requirements, such as the Department of the Treasury and the Internal Revenue Service requirements pertaining to information returns and regulations concerning the calculation of arbitrage rebates and refunds.
- g. Obtain copies of, and review pertinent sections of, the state constitution, laws, and regulations concerning the auditee. The sections of these documents pertaining to financial reporting, debt, taxation, budget, and appropriation and procurement matters may be especially relevant.
- h. Review the minutes of meetings of the governing body of the auditee for the enactment of laws and regulations or information about contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.
- i. Inquire of the office of the federal, state, or local auditor or other appropriate audit oversight organization about the compliance requirements applicable to entities within their jurisdiction, including statutes and uniform reporting requirements.
- j. Review information about applicable federal and state program compliance requirements, such as the information included in the *Compliance Supplement*, the CFDA, and state and local policies and procedures.
- k. Review the guidance contained in the applicable AICPA Audit and Accounting Guides referred to in paragraph 4.6 and review the materials available from other professional organizations, such as state societies of CPAs or industry associations.
- l. Inquire of the audit, finance, or program administrators from which grants are received about the restrictions, limitations, terms, and conditions under which such grants were provided. These administrators can usually be helpful in identifying compliance requirements, which they may identify separately or publish in an audit guide.

**4.28** In obtaining an understanding of the possible effects on financial statements of compliance requirements that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts, the auditor may consider—

- The materiality of the effect on financial statement amounts.
- The level of management or employee involvement in the compliance-assurance process.
- The opportunity for concealment of instances of noncompliance.

**4.29** As part of assessing the risk of material misstatement, the auditor should assess the risk that instances of noncompliance may cause such a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting instances of noncompliance that are material to the financial statements. Therefore, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from instances of noncompliance that have a direct and material effect on the determination of financial statement amounts (see paragraph 6.53 for a discussion of the impact on the financial statements of actual and projected errors noted in a single audit, and see paragraph 10.42 for a discussion of situations that could occur when the auditor reports on the results of compliance testing).

**4.30** Auditees may be affected by many other laws and regulations, including those related to occupational safety and health, environmental protection, equal employment, food and drug, and price fixing. These laws and regulations generally concern an auditee's operations more than financial reporting and accounting. Their effect on an auditee's financial statements is indirect and normally takes the form of the disclosure of a contingent liability that follows from the allegation or determination of illegality. The auditor would not ordinarily have sufficient basis to recognize possible violations of these laws and regulations. Even when violations of such laws and regulations can have consequences that are material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he or she is informed by the auditee, or unless there is evidence of an investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.<sup>3</sup>

**4.31** If specific information comes to the auditor's attention that provides evidence concerning the existence of possible instances of noncompliance that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an instance of noncompliance occurred. However, because of the characteristics of such noncompliance, an audit made in accordance with GAAS provides no assurance that indirect-effect instances of noncompliance will be detected or that any contingent liabilities that may result will be disclosed.

### **SAS No. 82 Requirements**

**4.32** SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110), states

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<sup>3</sup> In addition, for compliance with laws and regulations that have an indirect effect on the determination of financial statement amounts, SAS No. 54 notes that, where applicable, the auditor should also inquire of management concerning (a) the client's policies relative to the prevention of illegal acts and (b) the use of directives issued by the client, as well as periodic representations obtained by the client, from management at appropriate levels of authority, concerning compliance with laws and regulations.

that the auditor also has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. SAS No. 82 provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.

**4.33** Although fraud is a broad legal concept, the auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of financial statements is intentional or unintentional. Two types of misstatements are relevant to the auditor's consideration of fraud in a financial statement audit: misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets. These two types of misstatements, as well as the characteristics of fraud, are discussed further in paragraphs 3 through 10 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.03 through 316.10).

**4.34** The risk of material misstatement of the financial statements due to fraud is part of audit risk. Therefore, the auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets in each of the following categories:

***Misstatements Arising From Fraudulent Financial Reporting***

- Management's characteristics and influence over the control environment
- Industry conditions
- Operating characteristics and financial stability

***Misstatements Arising From the Misappropriation of Assets***

- Susceptibility of assets to misappropriation
- Controls

The auditor should exercise professional judgment when considering (a) risk factors individually or in combination and (b) whether there are specific controls that mitigate the risk. Risk factors are discussed in greater detail in paragraphs 16 through 25 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU secs. 316.16 through 316.25).

**4.35** As noted previously, an auditor's interest specifically relates to fraudulent acts that cause a material misstatement in the financial statements. When the auditor is identifying risk factors and other conditions in an audit of financial statements performed in conjunction with a single audit, the auditor's responsibilities under SAS No. 82 are expanded to include (in addition to the risk factors normally associated with financial statements) the consideration of risk factors associated with the receipt of federal awards that could present a material misstatement of the financial statements. Auditors may wish to refer to the AICPA practice aid titled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, which

includes specific nonauthoritative guidance on applying the concepts of SAS No. 82 to several industries, including government, health care, and not-for-profit organizations. Among other things, it identifies example risk factors for those industries, including risk factors that relate to recipients of federal awards.

**4.36** In planning the audit, the auditor should document in the working papers evidence of the performance of the assessment of the risk of material misstatement due to fraud. Where risk factors are identified as being present, the documentation should include (a) those risk factors identified and (b) the auditor's response to those risk factors, individually or in combination. In addition, if, during the performance of the audit, fraud risk factors or other conditions are identified that cause the auditor to believe that an additional response is required, these risk factors or other conditions, as well as any further response that the auditor concluded was appropriate, should also be documented.

**4.37** SAS No. 82 also contains requirements on the auditor's response to the results of the assessment of risk, the evaluation of audit test results, and communications about fraud to management, the audit committee, and others. Auditors should refer to SAS No. 82 for a description of the specific requirements in those areas (see also paragraphs 10.18 through 10.20).

### **SAS No. 47 Requirements**

**4.38** SAS No. 47, as amended by SAS No. 82, provides guidance to auditors in fulfilling the responsibility described in paragraph 4.32, as it relates to errors, in an audit of financial statements conducted in accordance with GAAS. Errors are described as unintentional misstatements, or as omissions of amounts or disclosures, in financial statements. Errors may involve (a) mistakes in gathering or processing data from which financial statements are prepared, (b) unreasonable accounting estimates arising from oversight or the misinterpretation of facts, and (c) mistakes in the application of accounting principles relating to amounts, classification, the manner of presentation, or disclosure. When the auditor is considering his or her responsibility to obtain reasonable assurance that the financial statements are free of material misstatement, there is no important distinction between error and fraud. There is a distinction, however, in the auditor's response to detected misstatements. An isolated, immaterial error in processing accounting data or in applying accounting principles is generally not significant to the audit. In contrast, when fraud is detected, the auditor should consider its implications for the integrity of management or employees and its possible effect on other aspects of the audit. Auditors should refer to SAS No. 47 for more detailed guidance.

### **Working Paper Documentation**

**4.39** The auditor should document the procedures performed to evaluate compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts in accordance with SAS No. 41, *Working Papers*. (See paragraphs 3.16 through 3.18 of this SOP for a discussion of the *Government Auditing Standards* requirements related to working papers.) The fraud risk factors identified and the auditor's response to those risk factors should be documented in accordance with SAS No. 82 (see paragraph 4.36). The auditor's understanding of internal control over financial reporting as it pertains to compliance with such laws and regulations, as well as the related assessment of control risk, should be documented in accordance with SAS No. 55, as amended by SAS No. 78 (see paragraph 4.15).

### **Written Representations From Management**

**4.40** SAS No. 85, *Management Representations*, requires the auditor to obtain written representations from management as part of an audit conducted in accordance with GAAS. It also includes an illustrative management representation letter and an appendix containing additional representations that may be appropriate to be included in a management representation letter in certain circumstances. With respect to compliance requirements affecting the financial statement audit, auditors should consider obtaining additional representations from management acknowledging that management (see paragraphs 6.68 and 6.69 for a discussion of additional management representations in a single audit)—

- a. Is responsible for compliance with the laws, regulations, and provisions of contracts and grant agreements applicable to the auditee.
- b. Is responsible for establishing and maintaining effective internal control over financial reporting.
- c. Has identified and disclosed to the auditor all laws, regulations, and provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.
- d. Has identified and disclosed to the auditor violations (or possible violations) of laws, regulations, and provisions of contracts and grant agreements whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

### **Additional Responsibilities Under Government Auditing Standards**

**4.41** *Government Auditing Standards* prescribes as part of the financial statement audit additional fieldwork and reporting requirements beyond those in GAAS that are related to compliance. The additional fieldwork responsibilities are related to audit follow-up on known material findings and recommendations from previous audits, as well as to working paper access and documentation. (See paragraphs 3.14 through 3.18 of this SOP for a further discussion of these requirements.) With regard to reporting, *Government Auditing Standards* requires, among other things, that the auditor report on the scope of his or her testing of compliance and present the results of those tests. See paragraphs 10.15 and 10.16 for a more detailed discussion of the *Government Auditing Standards* reporting requirements related to compliance.

### **Reasonable Assurance**

**4.42** SAS No. 1, section 230, “Due Professional Care in the Performance of Work” (AICPA, *Professional Standards*, vol. 1, AU sec. 230), states that since the auditor’s opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her audit report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with GAAS.



## Chapter 5

# SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

## Overview of Schedule Requirements

5.1 Circular A-133 requires the auditor to determine whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole. This schedule, prepared by the auditee, reports the total expenditures for each federal program (see paragraph 1.18 for the Circular A-133 definition of federal programs). In this chapter the identification of federal awards, the general presentation requirements governing the schedule, pass-through awards, non-cash awards, and endowment funds are described. The auditor's reporting on the schedule is discussed in paragraphs 10.36 and 10.37.

## Identification of Federal Awards

### Federal Agency and Pass-Through Entity Requirements

5.2 Circular A-133 requires federal agencies and pass-through entities to identify the federal awards made by informing each recipient or subrecipient of the CFDA title and number, the award's name and number, the award year, and whether the award is for R&D. When some of this information is not available, the federal agency or pass-through entity is required to provide the information necessary to describe the federal award clearly.

### Auditee Requirements

5.3 Circular A-133 also requires the auditee to identify in its accounts all federal awards received and expended, as well as the federal programs under which they were received. Federal program and award identification includes, as applicable, the CFDA title and number, the award number and year, the name of the federal granting agency, and the name of the pass-through entity.

### Auditor Assessment of Auditee Identification of Federal Programs

5.4 In assessing the appropriateness and completeness of the auditee's identification of federal programs in the schedule, the auditor should consider, among other matters, evidence obtained from audit procedures performed to evaluate the completeness and classification of recorded revenues and expenditures. This may include sending confirmations to granting federal agencies or pass-through entities in an audit of a subrecipient. When the auditee is unable to identify federally funded expenditures separately, the auditor should consider whether a reportable condition exists. If it does, a finding should be reported in the schedule of findings and questioned costs (see chapter 10 for a further discussion of reporting findings and the schedule of findings and questioned costs).

## General Presentation Requirements

### Basis of Accounting

5.5 Circular A-133 does not prescribe the basis of accounting that must be used by the auditee to prepare the schedule of expenditures of federal awards. Some auditees may choose to prepare the schedule on a basis of accounting that is different from that in the financial statements. In any case, the auditee is required to disclose the basis of accounting and the significant accounting policies used in preparing the schedule. The auditee must also be able to reconcile amounts presented in the financial statements to related amounts in the schedule of expenditures of federal awards.

### Required Schedule Contents

5.6 Circular A-133 requires the auditee to prepare a schedule of expenditures of federal awards for the period covered by the auditee's financial statements. At a minimum, the schedule should—

- List individual federal programs by federal agency. For federal programs included in a cluster of programs (see paragraphs 1.18, 1.19, and 2.18), list individual federal programs within a cluster of programs. For R&D, the total federal awards expended must be shown either by individual award or by federal agency and major subdivision within the federal agency. For example, the National Institutes of Health is a major subdivision in the Department of Health and Human Services (the federal agency).
- Include, for federal awards received as a subrecipient, the name of the pass-through entity and the identifying number assigned by the pass-through entity.
- Provide the total federal awards expended for each individual federal program and the CFDA number or other identifying number when the CFDA information is not available.
- Include notes that describe the significant accounting policies used in preparing the schedule.
- Identify, to the extent practical, the total amount provided to subrecipients by pass-through entities from each federal program (see chapter 9 for a further discussion of the audit considerations of federal pass-through awards).
- Include, in either the schedule or a note to the schedule, the value of federal awards expended in the form of noncash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end (see paragraph 5.13).

Example schedules of expenditures of federal awards appear in appendix C.

### Providing Additional Information

5.7 Although not required, the auditee may choose to provide other information (in addition to the foregoing requirements) that is requested by federal awarding agencies and pass-through entities to make the schedule easier to

use. For example, when a federal program has multiple award years, the auditee may choose to list the amount of federal awards expended for each award year separately, if so requested by a federal agency.

## **Schedule Not in Agreement With Other Federal Award Reporting**

5.8 Auditors should note that the information included in the schedule may not fully agree with other federal award reports that the auditee submits directly to federal granting agencies because, among other reasons, the award reports (a) may be prepared for a different fiscal period and (b) may include cumulative (from prior years) data rather than data for the current year only.

## **Inclusion of Nonfederal Awards**

5.9 Circular A-133 does not require nonfederal awards (for example, state awards) to be presented in the schedule. However, to meet state or other requirements, auditees may decide to include such awards in the schedule. If such nonfederal data are presented, they should be segregated and clearly designated as nonfederal. The title of the schedule should also be modified to indicate that nonfederal awards are included.

## **CFDA Number Not Available**

5.10 The auditee may be unable to obtain the CFDA number, which is sometimes the case for new federal programs and R&D programs. In addition, cost-type contracts will normally not have a CFDA number. When the CFDA number is not available, the auditee should indicate that fact and should include in the schedule the program's name and, if available, other identifying number.

## **Pass-Through Awards**

### **Treatment of Pass-Through Awards**

5.11 Circular A-133 defines a subrecipient as an entity that expends federal awards that are received from a pass-through entity to carry out a federal program. State or local government redistributions of federal awards to subrecipients, known as "pass-through awards," should be treated by the subrecipient as though they were received directly from the federal government. Accordingly, pass-through awards should be included in the scope of the single audit on the same basis as that of federal awards that are received directly. The audit considerations of federal pass-through awards are discussed further in chapter 9. As noted in paragraph 5.6, in addition to the other general presentation requirements, Circular A-133 requires the schedule to include the name of the pass-through entity and the identifying number assigned by the pass-through entity for federal awards received as a subrecipient.

## **Commingled Assistance**

5.12 The individual sources (that is, federal, state, and local) of federal awards may not be separately identifiable because of commingled assistance

from different levels of government. If the commingled portion cannot be separated to specifically identify the individual funding sources, the total amount should be included in the schedule, with a footnote describing the commingled nature of the funds.

## Noncash Awards

### Treatment of Noncash Awards

5.13 Most federal awards are in the form of cash awards. However, there are a number of federal programs that do not involve cash transactions. These programs may include food stamps, commodities, loan guarantees, loans, surplus property, interest rate subsidies, or insurance. Circular A-133 requires the value of federal awards expended in the form of noncash assistance (such as loan guarantees, loans, insurance programs, surplus property, food stamps issued, or commodities distributed) to be reported either on the face of the schedule or disclosed in the notes to the schedule. The OMB states in Circular A-133 that although it is not required, it is preferable to present this information in the schedule rather than in the notes to the schedule. See paragraphs 2.13 and 2.14 for a discussion on determining when awards, including noncash awards, are considered to be expended.

### Determining the Value of the Noncash Awards Expended

5.14 Table 5.1 shows the bases generally used to determine the value of noncash awards expended (see section 205 of Circular A-133 for additional details).

### Loan and Loan Guarantee Continuing Compliance Requirements

5.15 As noted previously, in determining the value of total noncash awards expended for loans and loan guarantees, the balances of loans from previous years must be included if the federal government imposes continuing compliance requirements. Circular A-133 does not specifically define the term *continuing compliance requirements*. Therefore, it is a matter of judgment as to whether continuing compliance requirements are significant enough to require inclusion of prior-year loan or loan guarantee balances. For example, if in a prior year an auditee expended the proceeds of a federal loan to construct a building, and the current-year activity consists only of loan repayments and a requirement by the federal lender for the auditee to submit a report that only details loan payment information, it may not be necessary to include the prior year's loan balance in determining the total amount of loans expended. However, if the federal lender requires the auditee to ensure on an ongoing basis that a certain percentage of the building is rented to low-income residents, it would likely be necessary to include the prior year's loan balance in determining the total amount of loans expended. The auditor should consider contacting the federal agency Office of Inspector General for assistance in determining whether continuing compliance requirements are significant enough to require inclusion of the balances of prior loans or loan guarantees.

Table 5.1

**Determining the Value of Noncash Awards Expended**

<i>Types of Noncash Awards</i>	<i>Basis Used to Determine the Value of Noncash Awards Expended</i>
Loans and loan guarantees	Value of new loans made or received during the fiscal year plus the balance of loans from previous years for which the federal government imposes continuing compliance requirements (see paragraph 5.15), plus any interest subsidy, cash, or administrative cost allowance received.
Loans and loan guarantees (loans) at institutions of higher education	When loans are made to students but the institution of higher education does not make the loans, only the value of loans made during the year are considered federal awards expended. The balance of loans for previous years is not included because the lender accounts for the prior balances.
Insurance	Fair market value of insurance contract at the time of receipt, or the assessed value provided by the federal agency.
Food stamps	Fair market value of food stamps at the time of receipt, or the assessed value provided by the federal agency.
Commodities	Fair market value of commodities at the time of receipt, or the assessed value provided by the federal agency.
Donated property or donated surplus property	Fair market value of donated property or donated surplus property at the time of receipt, or the assessed value provided by the federal agency.
Free rent	Fair market value of free rent at the time of receipt, or the assessed value provided by the federal agency. Free rent is not considered an award expended unless it is received as part of an award to carry out a federal program.

\* The proceeds of loans that were received and expended in prior years are not considered federal awards expended when the laws, regulations, and the provisions of contracts or grant agreements pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

**Endowment Funds**

**5.16** Circular A-133 states that the cumulative balance of federal awards for endowment funds which are federally restricted are considered awards expended in each year in which the funds are still restricted.

## Chapter 6

### COMPLIANCE AUDITING APPLICABLE TO MAJOR PROGRAMS

**6.1** In this chapter the auditor's consideration of compliance requirements applicable to major programs in a single audit under Circular A-133 is discussed (as noted in paragraph 11.5, much of the guidance in this chapter would also be applicable to a program-specific audit when a program-specific audit guide is not available). The consideration of internal control over compliance for major programs is discussed in chapter 8. The related reporting requirements are discussed in chapter 10. The auditor's consideration of the auditee's compliance with laws, regulations, and the provisions of contracts or grant agreements in a financial statement audit is discussed in chapter 4.

#### Single Audit Compliance Objectives

**6.2** In addition to a financial statement audit in accordance with GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs (these are hereinafter referred to as "compliance requirements"). A single audit results in the auditor expressing an opinion on the auditee's compliance with these compliance requirements for each of its major programs. To express such an opinion, the auditor accumulates sufficient evidence by planning and performing tests of transactions and such other auditing procedures as are necessary in support of the entity's compliance with applicable compliance requirements, thereby limiting audit risk to an appropriately low level.

#### Responsibilities of Auditee

**6.3** The auditee is responsible (a) for complying with the compliance requirements related to each of its federal programs and (b) for establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs. The auditor should obtain management's written representations regarding its compliance and internal control responsibilities as discussed in paragraphs 6.68 and 6.69.

**6.4** The form and extent of the documentation of management's compliance will vary depending on the nature of the compliance requirements and the size and complexity of the entity. The auditee may have documentation in the form of accounting or statistical data, case files, entity policy manuals, accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, or internal auditors' reports.

#### Use of Professional Judgment

**6.5** The planning, conduct, and evaluation of the results of compliance testing in a single audit require the auditor to exercise professional judgment.

The following factors may be considered by the auditor in applying his or her professional judgment:

- The assessment of inherent risk, control risk, and fraud risk
- The assessment of materiality
- The evidence obtained from other auditing procedures
- The amount of expenditures for the program
- The diversity or homogeneity of expenditures for the program
- The length of time that the program has operated, or changes in its conditions
- The current and prior auditing experience with the program, particularly findings in previous audits and other evaluations (that is, inspections, program reviews, or system reviews required by the federal acquisition regulations)
- The extent to which the program is carried out through subrecipients, as well as the related monitoring activities
- The extent to which the program contracts for goods or services
- The level to which the program is already subject to program reviews or other forms of independent oversight
- The expectation of noncompliance or compliance with the applicable compliance requirements
- The extent to which computer processing is used to administer the program, as well as the complexity of the processing
- Whether the program has been identified as being high-risk by the OMB in the *Compliance Supplement*

## Audit Risk Considerations

**6.6** To express an opinion on compliance, the auditor accumulates sufficient evidence in support of compliance, thereby limiting audit risk to an appropriately low level. The auditor's consideration of audit risk and materiality when he or she plans and performs a single audit is similar to the consideration in a financial statement audit in accordance with SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*. Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

## Components of Audit Risk

**6.7** Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on compliance. It is composed of inherent risk, control risk, fraud risk, and detection risk. For the purposes of a single audit, these components are defined as follows:

- *Inherent risk*—the risk that material noncompliance with a major program's compliance requirements could occur, assuming there is no related internal control

- *Control risk*—the risk that material noncompliance that could occur in a major program will not be prevented or detected on a timely basis by the entity's internal control
- *Fraud risk*—the risk that intentional material noncompliance with a major program's compliance requirements could occur
- *Detection risk*—the risk that the auditor's procedures will lead him or her to conclude that noncompliance that could be material to a major program does not exist when, in fact, such noncompliance does exist

In paragraphs 6.8 through 6.12, each of these components of audit risk is discussed and an explanation of how the components of audit risk interrelate in providing a basis for the auditor's opinion on compliance is given.

## Inherent Risk

6.8 In assessing inherent risk, the auditor should consider factors that are relevant to compliance engagements. Such factors include the following (the factors listed in paragraph 6.5 should also be considered):

- The complexity of the compliance requirements
- The length of time the entity has been subject to the compliance requirements
- Prior experience with the entity's compliance
- The potential impact of noncompliance, both qualitatively and quantitatively

6.9 The auditor's assessment of inherent risk over major programs may be performed in part when the auditor is determining major programs using the risk-based approach (see paragraph 7.36). The nature of some programs may indicate higher inherent risk. Programs with higher inherent risk may be of a higher risk for the purpose of determining major programs. Circular A-133 provides the following examples for program characteristics with potentially higher inherent risks:

- Complex programs and the extent to which a program contracts for goods and services have the potential for higher risk. For example, federal programs that disburse funds through third-party contracts or have eligibility criteria may be of higher risk. Federal programs primarily involving staff payroll costs may have a high risk for time-and-effort reporting but may otherwise be at low risk.
- The phase of a federal program's life cycle at the federal agency may indicate risk. For example, a new program with new or interim regulations may have a higher risk than an established program with time-tested regulations. In addition, significant changes in federal programs, laws, or regulations or in the provisions of contracts or grant agreements may increase risk.
- The phase of a program's life cycle at the auditee may indicate risk. For example, during the first and last years in which an auditee participates in a program, the risk may be higher because of the start-up or closeout of the program's activities and staff.
- Type B programs with larger federal awards expended would be of higher risk than would programs with substantially smaller federal awards expended.



## Control Risk

**6.10** Circular A-133 requires the auditor to plan the testing of internal control over compliance for major programs, to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. The circular does not, however, actually require the achievement of a low assessed level of control risk. The assessment of control risk contributes to the auditor's evaluation of the risk that material noncompliance exists in a major program. The process of assessing control risk (together with assessing inherent risk and fraud risk) provides evidential matter about the risk that such noncompliance may exist. The auditor uses this evidential matter as part of the reasonable basis for his or her opinion on compliance. The auditor's consideration of internal control over compliance for major programs, including the assessment of control risk, is discussed in chapter 8.

## Fraud Risk

**6.11** SAS No. 82 provides guidance to the auditor on his or her responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to fraud (see paragraphs 4.32 through 4.37). Because SAS No. 82 only applies to an audit of financial statements, its requirements do not apply to an audit of an auditee's compliance with specified requirements applicable to its major programs. However, as part of assessing audit risk in a single or program-specific audit, the auditor should specifically assess the risk of material noncompliance with a major program's compliance requirements occurring due to fraud. The auditor should consider that assessment in designing the audit procedures to be performed. Auditors may wish to refer to the AICPA practice aid titled, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, which identifies example risk factors that relate to recipients of federal awards. When the auditor has assessed fraud risk and has deemed that a further response is necessary, the guidance in paragraphs 26 through 32 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.26–32) may be helpful.

## Detection Risk

**6.12** In determining an acceptable level of detection risk, the auditor considers his or her assessments of inherent risk, control risk, and fraud risk, and the extent to which he or she seeks to restrict the audit risk related to the major program. As assessed inherent risk, control risk, or fraud risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of the compliance tests performed based on the assessments of inherent risk, control risk, and fraud risk. Circular A-133 states that compliance testing must include tests of transactions and such other auditing procedures necessary to provide the auditor with sufficient evidence to support an opinion on compliance. Such compliance testing serves to limit detection risk.

## Materiality Considerations

**6.13** In a compliance audit, the auditor's consideration of materiality differs from that in an audit of financial statements (see paragraphs 3.33 through 3.38). Materiality is affected by (a) the nature of the compliance requirements, which may or may not be quantifiable in monetary terms, (b) the

nature and frequency of noncompliance identified with an appropriate consideration of sampling risk, and (c) qualitative considerations, such as the needs and expectations of federal agencies and pass-through entities. Qualitative factors that indicate that an identified instance of noncompliance may be immaterial include (a) a low risk of public or political sensitivity, (b) a single exception that has a low risk of being pervasive, or (c) an indication, based on the auditor's judgment and experience, that the affected federal agency or pass-through entity would normally not need to resolve the finding or take follow-up action.

## **Materiality Judgments About Compliance Applied to Each Major Program Taken as a Whole**

**6.14** In designing audit tests and developing an opinion on the auditee's compliance with compliance requirements, the auditor should apply the concept of materiality to each major program taken as a whole, rather than to all major programs combined.

**6.15** For purposes of evaluating the results of compliance testing, a material instance of noncompliance is defined as a failure to follow requirements, or a violation of prohibitions, established by law, regulation, contract, or grant that results in an aggregation of noncompliance (that is, the auditor's best estimate of the overall noncompliance) that is material to the affected federal program. It should be noted that several instances of noncompliance that may not be individually material should be assessed to determine if, in the aggregate, they could have a material effect. Because the auditor expresses an opinion on each major program and not on all the major programs combined, reaching a conclusion about whether the instances of noncompliance (either individually or in the aggregate) are material to a major program requires consideration of the type and nature of the noncompliance, as well as the actual and projected effect on each major program in which the noncompliance was noted. Instances of noncompliance that are material to one major program may not be material to a major program of a different size or nature. In addition, the level of materiality relative to a particular major program can change from one audit to the next.

## **Effect of Material Noncompliance on the Financial Statements**

**6.16** If the tests of compliance reveal material noncompliance at the major program level, the auditor should consider its effect on the financial statements. The auditor should also consider the cumulative effect of all instances of noncompliance on the financial statements. (See also paragraphs 6.53 and 10.42.)

## **Performing a Compliance Audit**

**6.17** The auditor should exercise (a) due care in planning and performing the audit and in evaluating the results of his or her audit procedures, and (b) the proper degree of professional skepticism to achieve reasonable assurance that material noncompliance will be detected.

**6.18** In performing compliance tests, the auditor should—

- a. Identify the auditee's major programs to be tested and reported on for compliance (paragraph 6.19 and chapter 7).
- b. Identify the applicable compliance requirements (paragraphs 6.20 through 6.30).

- c. Plan the engagement (paragraphs 6.31 through 6.34 and chapter 3).
- d. Consider relevant portions of the entity's internal control over compliance for major programs (paragraph 6.35 and chapter 8).
- e. Obtain sufficient evidence, which involves testing compliance with applicable compliance requirements (paragraphs 6.36 through 6.47).
- f. Consider subsequent events (paragraphs 6.48 through 6.50).
- g. Form an opinion about whether the auditee complied with the applicable compliance requirements (paragraphs 6.51 through 6.60).
- h. Perform follow-up procedures on previously identified findings (paragraph 6.61 through 6.67).

## Identifying Major Programs to Be Tested

**6.19** Circular A-133 requires the auditor to determine the major programs to be tested in a single audit using a risk-based approach. The application of the risk-based approach to determine major programs is discussed in chapter 7.

## Identifying Applicable Compliance Requirements

**6.20** The auditor must determine the applicable compliance requirements to be tested and reported on in a single audit (that is, those laws, regulations, and provisions of contracts or grant agreements that may have a direct and material effect on each major federal program). The auditor should use professional judgment in making this determination.

### **Compliance Supplement**

**6.21** The *Compliance Supplement* is based on the requirements of the Single Audit Act and Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits (see paragraphs 1.27 through 1.29, 2.34, and 2.35 for additional discussion of the *Compliance Supplement* and for instructions on how to obtain a copy). The *Compliance Supplement* identifies the fourteen types of compliance requirements applicable to most federal programs. It also includes the compliance requirements specific to certain of the largest federal programs. Part 7 of the *Compliance Supplement* provides guidance to assist the auditor in identifying the compliance requirements for federal programs not included in the *Compliance Supplement* (see also paragraph 6.30).

### **Fourteen Types of Compliance Requirements**

**6.22** Part 3 of the *Compliance Supplement* lists and describes the fourteen types of compliance requirements and the related audit objectives that the auditor should consider in every audit conducted under Circular A-133, with the exception of program-specific audits performed in accordance with a federal agency's program specific audit guide (see paragraph 11.4). Suggested audit procedures are also provided to assist the auditor in planning and performing tests of the auditee's compliance with the requirements of federal programs. The auditor's judgment will be necessary to determine whether the suggested audit procedures are sufficient to achieve the stated audit objectives and whether additional or alternative audit procedures are needed (see paragraph 6.44). The fourteen types of compliance requirements are as follows:

- A—activities allowed or unallowed
- B—allowable costs/cost principles

- C—cash management
- D—Davis-Bacon Act
- E—eligibility
- F—equipment and real property management
- G—matching, level of effort, earmarking
- H—period of availability of federal funds
- I—procurement and suspension and debarment
- J—program income
- K—real property acquisition and relocation assistance
- L—reporting
- M—subrecipient monitoring
- N—special tests and provisions

The auditor should consider the applicability of these compliance requirements to the auditee's major programs. Part 2 of the *Compliance Supplement* provides a matrix that is useful to the auditor for this purpose by identifying whether particular compliance requirements apply to the federal programs included in the *Compliance Supplement*. In making a determination not to test a compliance requirement identified as applicable to a particular program, the auditor must conclude either that the requirement does not apply to the particular auditee or that noncompliance with the requirements could not have a material effect on a major program.

### **Keeping Abreast of Changes in Compliance Requirements**

**6.23** Circular A-133 states that an audit of the compliance requirements related to federal programs contained in the *Compliance Supplement* will meet the requirements of the circular. However, it also states that when there have been changes to the compliance requirements and the changes are not reflected in the *Compliance Supplement*, the auditor must determine the current compliance requirements and modify the audit procedures accordingly.

**6.24** Although Circular A-133 provides that federal agencies are responsible to inform the OMB annually of any updates needed to the *Compliance Supplement*, the auditor should recognize that laws and regulations change periodically and that delays will occur between such changes and revisions to the *Compliance Supplement*. Accordingly, the auditor should perform reasonable procedures to ensure that compliance requirements are current. Besides describing the compliance requirements, the *Compliance Supplement* includes references to the Code of Federal Regulations and other sources of information about the requirements. The auditor may refer to those other sources of information to identify significant changes to the requirements or perform other procedures, including the following:

- Discussions with appropriate individuals within the auditee organization (that is, the chief financial officer, internal auditors, legal counsel, the compliance officer, or grant or contract administrators)
- A review of contracts or grant agreements, new guidance material issued by the granting agency or pass-through entity (for example, handbooks and operating procedures), and correspondence from the granting agency or pass-through entity

- An inquiry of granting agency personnel (appendix III of the *Compliance Supplement* includes a listing of federal agency contacts, including addresses, phone numbers, and E-mail or Web page addresses that could be useful if the auditor decides to make such an inquiry)

### **Considering Additional Provisions of Contracts or Grant Agreements**

6.25 The *Compliance Supplement* states that in addition to the compliance requirements identified in the supplement, auditors need to consider whether there are any provisions of contracts or grant agreements that are unique to a particular entity (for example, the grant agreement may specify the matching percentage, or an entity may have agreed to additional requirements that are not required by law or regulation, perhaps as part of a resolution of prior audit findings).

6.26 Therefore, in using the *Compliance Supplement* to identify applicable compliance requirements, the auditor needs to consider—

- a. The applicability to the federal program of the fourteen types of compliance requirements identified in part 3 of the *Compliance Supplement*.
- b. Additional compliance requirements specific to the federal program as identified in part 4 of the *Compliance Supplement*.
- c. Any provisions of contracts or grants that are unique to the particular entity.

### **Compliance Requirements Specific to Certain Federal Programs**

6.27 Part 4 of the *Compliance Supplement* discusses program objectives, program procedures, and compliance requirements that are specific to each federal program included. With the exception of special tests and provisions, the auditor should refer to part 3 of the *Compliance Supplement* for the audit objectives and suggested audit procedures that pertain to the compliance requirements associated with each program. Since special tests and provisions are unique to each program, the audit objectives and suggested audit procedures for each program are included in part 4.

### **Compliance Requirements Specific to a Cluster of Programs**

6.28 As noted in paragraph 2.18, a cluster of programs is a grouping of closely related programs that have similar compliance requirements (for example, SFA, R&D, and other clusters). Part 5 of the *Compliance Supplement* identifies those programs that are considered to be clusters of programs. It also provides compliance requirements, audit objectives, and suggested audit procedures for the clusters.

### **Relationship of the Compliance Supplement to Federal Program Audit Guides**

6.29 The *Compliance Supplement* states that for single audits, the supplement replaces federal agency audit guides and other audit requirement documents for individual federal programs.<sup>1</sup> Accordingly, for a federal program

<sup>1</sup> Auditors should note that two federal agencies, the Department of Housing and Urban Development and the Department of Education have issued interim supplements to address the requirements of certain agency programs. Those supplements provide guidance similar to that provided in part 4 of the *Compliance Supplement*. A description of the supplements and the authoritative status of each are discussed in part 1 of the *Compliance Supplement*. Auditors should refer to the *Compliance Supplement* to determine whether to use the interim supplements or the *Compliance Supplement* for the federal programs included in the supplements. As of the date of this SOP, the OMB has indicated that the federal programs included in the Department of Education interim supplement will be included in the next revision of the *Compliance Supplement*.

included in the *Compliance Supplement* and having a separate federal program audit guide or other federal program audit requirement documents, the auditor needs to consider only those compliance requirements in the *Compliance Supplement* when performing a single audit (versus a program-specific audit).

### **Federal Programs Not Included in the Compliance Supplement**

**6.30** The *Compliance Supplement* does not include all federal programs from which an auditee may receive federal awards. Circular A-133 states that for those federal programs not covered in the *Compliance Supplement*, the auditor should use the fourteen types of compliance requirements (see paragraph 6.22) contained in the supplement as guidance for identifying the types of compliance requirements to test, and should determine the requirements governing the federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements. The auditor should follow the guidance in part 7 of the *Compliance Supplement* for identifying the applicable compliance requirements to test and report on in a single audit. That guidance outlines the following steps to determine which compliance requirements to test:

- a. Identify the applicable compliance requirements for the federal program.
- b. Determine which of the compliance requirements identified in step a could have a direct and material effect on the major program.
- c. Determine which of the compliance requirements identified in step b are susceptible to testing by the auditor.
- d. Determine which of the fourteen types of compliance requirements would the compliance requirements identified in step c fall into.
- e. For special tests and provisions, determine the applicable audit objectives and audit procedures.

Part 7 of the *Compliance Supplement* provides more detailed guidance on the steps to perform to identify applicable compliance requirements.

## **Planning the Engagement**

### **General Considerations**

**6.31** Planning a compliance audit involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, auditors need to have sufficient knowledge to enable them to understand adequately the events, transactions, and practices that, in their judgment, have a significant effect on compliance. Proper planning and supervision contribute to the effectiveness of audit procedures. Proper planning directly influences the selection of appropriate procedures and the timeliness of their application, and proper supervision helps ensure that planned procedures are appropriately applied.

**6.32** Factors to be considered by the auditor in planning a compliance audit include (a) the anticipated level of audit risk related to the compliance requirements on which the auditor will report (see paragraphs 6.6 through 6.12), (b) preliminary judgments about materiality levels for audit purposes (see paragraphs 6.13 through 6.16), and (c) conditions that may require extension or modification of audit procedures.

**6.33** The nature, timing, and extent of planning will vary with the nature and complexity of the compliance requirements and the auditor's prior experience with the auditee. As part of the planning process, the auditor should consider the nature, timing, and extent of the work to be performed to accomplish the objectives of the compliance audit. Nevertheless, as the compliance audit progresses, changed conditions may make it necessary to modify planned procedures. For discussion of additional planning considerations, see chapter 3.

### **Multiple Components**

**6.34** In a compliance audit in which the auditee has operations in several components (for example, locations or branches), the auditor may determine that it is not necessary to test compliance with requirements at every component. In making such a determination and in selecting the components to be tested, the auditor should consider such factors as the following: (a) the degree to which the specified compliance requirements apply at the component level, (b) judgments about materiality, (c) the degree of centralization of the records, (d) the effectiveness of controls, particularly those that affect management's direct control over the exercise of authority delegated to others, as well as its ability to supervise activities at various locations effectively, (e) the nature and extent of operations conducted at the various components, and (f) the similarity of operations and controls over compliance for different components. See paragraph 8.13 for a discussion of internal control considerations for multiple components.

## **Consideration of Internal Control Over Compliance for Major Programs**

**6.35** The auditor should obtain an understanding of relevant portions of internal control over compliance sufficient to plan the audit and to assess control risk for compliance with specified requirements. In planning the audit, the auditor should use this knowledge to identify types of potential noncompliance, to consider factors that affect the risk of material noncompliance, and to design appropriate tests of compliance. Circular A-133 specifically requires the auditor to perform procedures to obtain an understanding of internal control over compliance for federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs. Circular A-133 also requires the auditor to perform testing of controls as planned. In some instances, the auditor may be able to perform compliance testing for major programs concurrently with tests of controls (see paragraph 3.40). Any reportable conditions in internal control over compliance for major programs that are noted are required to be reported as an audit finding (see paragraph 10.63). Control risk is discussed further in paragraph 6.10, and the auditor's consideration of internal control over compliance for major programs (including the final control risk assessment and the performance of tests of controls) is discussed in more detail in chapter 8.

## **Performing Compliance Testing**

**6.36** Circular A-133 requires that compliance testing include tests of transactions and such other auditing procedures as are necessary to provide the auditor with sufficient evidence to support an opinion on compliance for each major program. Such compliance testing may be performed (a) concurrently with tests of controls, (b) as substantive testing, or (c) as a combination

of the two. In performing compliance testing, the auditor attempts to obtain reasonable assurance that the auditee complied, in all material respects, with the compliance requirements. This includes designing the compliance audit to detect both intentional and unintentional noncompliance. Absolute assurance is not attainable because of factors such as the need for judgment, the use of sampling, and the inherent limitations of internal control over compliance and because much of the evidence available to the auditor is persuasive rather than conclusive in nature. Furthermore, procedures that are effective for detecting unintentional noncompliance may be ineffective for detecting noncompliance that is intentional and is concealed through a collusion between the client's personnel and third parties or among the management or employees of the client. Therefore, the subsequent discovery that material noncompliance exists does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the auditor.

**6.37** In determining the nature, timing, and extent of tests to perform, the auditor's professional judgment regarding the appropriate level of detection risk should be used. In applying his or her judgment, the auditor should be aware that small sample sizes for tests of details with a low dollar value and from a large population generally do not, by themselves, provide sufficient evidence. In determining the nature, timing, and extent of the testing of an auditee's compliance with compliance requirements, the auditor should consider audit risk and materiality related to each major program. The auditor plans compliance tests to reduce detection risk to an acceptable level. The evidence provided by these tests, along with evidence regarding inherent risk and control risk, provides the basis for expressing an opinion on whether the auditee complied, in all material respects, with the compliance requirements for each major program.

**6.38** In determining the nature of his or her tests of compliance with requirements governing major programs, the auditor should consider the nature of those requirements. For example, to test compliance with requirements applicable to the allowability of expenditures using program funds, audit procedures should be designed to provide the auditor with sufficient evidential matter to evaluate how management expended the funds.

### ***Sufficient Evidence***

**6.39** The auditor should apply procedures to provide reasonable assurance of detecting material noncompliance. The selection and application of procedures that will accumulate evidence that is sufficient in the circumstances to provide a reasonable basis for expressing an opinion on compliance require the careful exercise of professional judgment. A broad array of available procedures may be applied in a compliance audit. In establishing a proper combination of procedures to restrict audit risk appropriately, the auditor should consider the following presumptions, bearing in mind that they are not mutually exclusive and may be subject to important exceptions:

- a. Evidence obtained from independent sources outside an entity provides greater assurance of an entity's compliance than evidence secured solely from within the entity.
- b. Information obtained from the auditor's direct personal knowledge (such as through physical examination, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.



- c. The more effective the internal control, the greater the assurance it provides about the entity's compliance.

**6.40** Thus, in the hierarchy of available audit procedures, those that involve search and verification (for example, inspection, confirmation, or observation)—particularly when independent sources outside the entity are used—are generally more effective in reducing audit risk than are those involving internal inquiries and comparisons of internal information (for example, analytical procedures and discussions with the individuals responsible for compliance).

**6.41** In a compliance audit, the auditor's objective is to accumulate sufficient evidence to limit audit risk to a level that is, in the auditor's professional judgment, appropriately low for the high level of assurance being provided. An auditor should select from all available procedures (that is, procedures that assess inherent, control, and fraud risk and restrict detection risk)—any combination that can limit audit risk to such an appropriately low level.

**6.42** For regulatory requirements, the auditor's procedures may include reviewing reports of significant examinations and related communications between regulatory agencies and the entity and, when appropriate, making inquiries of the regulatory agencies, including inquiries about examinations in progress.

### **Audit Objectives**

**6.43** As noted in paragraph 6.22, the *Compliance Supplement* contains the audit objectives for each type of compliance requirement that the auditor should consider in planning and performing tests of compliance requirements. The audit objectives are useful in understanding the specific objectives to be satisfied when the auditor performs audit tests and determines whether the noncompliance that is identified is material.

### **Suggested Audit Procedures**

**6.44** The *Compliance Supplement* contains suggested audit procedures for testing federal programs for compliance. These suggested audit procedures represent procedures that may be used by the auditor in developing an audit program. The suggested audit procedures may also be useful in testing the same types of compliance requirements for programs that are not included in the *Compliance Supplement*. These suggested audit procedures represent a tool available to the auditor; however, the auditor is neither required to follow these audit procedures nor restricted to using only these procedures. The auditor should use professional judgment in determining the appropriate audit procedures to be performed to allow him or her to obtain sufficient evidence to form an opinion on the auditee's compliance with the compliance requirements that could have a direct and material effect on each major program.

### **Audit Sampling**

**6.45** The auditor generally uses audit sampling to obtain evidential matter. There are two approaches to audit sampling: nonstatistical and statistical. Circular A-133 does not require any particular sampling approach in a single audit. The factors to be considered in planning, designing, and evaluating audit samples (including planning a particular sample for a test of controls) are discussed in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350). When planning to test a particular sample of transactions,

the auditor should consider the specific audit objective to be achieved and should determine that the audit procedure, or combination of procedures, to be applied will achieve that objective. The size of a sample necessary to provide sufficient evidential matter depends on both the objectives and the efficiency of the sample. Auditors should note that SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, and Circular A-133 require the auditor to determine both the known questioned costs and likely questioned costs associated with audit findings. The determination of likely questioned costs may require the projection of sample results to determine whether a finding is required to be reported in the schedule of findings and questioned costs. Circular A-133 does not require the auditor to report an exact amount or a statistical projection of likely questioned costs, but rather to include an audit finding when the auditor's estimate of likely questioned costs is greater than \$10,000. See paragraph 6.59 for a further discussion of likely questioned costs.

**6.46** The AICPA Audit and Accounting Guide *Audit Sampling* provides guidance to help auditors apply audit sampling in accordance with SAS No. 39. In the Audit Guide, sampling in compliance tests of internal controls and in substantive tests of details, as well as dual-purpose testing is discussed.

### **Using Separate Samples for Each Major Program**

**6.47** Although the auditor must obtain sufficient evidence to support an opinion on compliance for each major federal program, separate samples for each major program are not required. Experience has shown, however, that it is preferable to select separate samples from each major program because the separate sample provides clear evidence of the tests performed, the results of those tests, and the conclusions reached. If the auditor chooses to select audit samples from the entire universe of major program transactions, the working papers should be presented in such a fashion that they clearly indicate that the results of such samples, together with other audit evidence, are sufficient to support the opinion on each major program's compliance. As noted in paragraph 6.37, the auditor should be aware that a sample of a few items with a low dollar value and from a large population, generally does not, by itself, provide sufficient evidence.

### **Consideration of Subsequent Events**

**6.48** The auditor's consideration of subsequent events in a compliance audit is similar to the auditor's consideration of subsequent events in a financial statement audit, as outlined in SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560). The auditor should consider information about events relating to the applicable compliance requirements that comes to his or her attention after the end of the audit period and prior to the issuance of his or her report.

**6.49** Two types of subsequent events require consideration by management and evaluation by the auditor. The first type consists of events that provide additional information about the entity's compliance during the audit period. For the period from the end of the audit period to the date of the auditor's report, the auditor should perform procedures to identify such events. These procedures should include, but may not be limited to, inquiries about and consideration of the following information:

- Relevant internal auditors' reports issued during the subsequent period

- Other auditors' reports identifying noncompliance that were issued during the subsequent period
- Regulatory agencies' reports on the entity's noncompliance that were issued during the subsequent period
- Information about the entity's noncompliance, obtained through other professional engagements for that entity

**6.50** The second type of subsequent events consists of noncompliance that occurs subsequent to the audit period but before the date of the auditor's report. The auditor has no responsibility to detect such noncompliance. However, should such noncompliance come to the auditor's attention, it may be of such a nature and significance that the auditor should consider whether the matter is adequately disclosed in the notes to the schedule of expenditures of federal awards.

## **Evaluation and Reporting of Noncompliance**

### ***Instances of Noncompliance (Findings)***

**6.51** The auditor's tests of compliance with compliance requirements may disclose instances of noncompliance. Circular A-133 refers to these instances of noncompliance as "findings." Such findings may be of a monetary nature and involve questioned costs or may be nonmonetary and not result in questioned costs. Both *Government Auditing Standards* and Circular A-133 specify how certain findings should be reported. The auditor's opinion on compliance and his or her responsibilities for reporting findings are discussed in greater detail in chapter 10.

### ***Compliance Opinion***

**6.52** Circular A-133 requires the auditor to report on compliance, which includes an opinion or disclaimer of opinion (on each major program) on whether the auditee complied with the applicable compliance requirements, and to prepare a schedule of findings and questioned costs (see paragraphs 10.41 through 10.46 and 10.55 through 10.67 for a further discussion). In evaluating whether the auditee complied with the compliance requirements in all material respects, the auditor should consider (a) the nature and frequency of the noncompliance identified, and (b) whether such noncompliance is material relative to the nature of the compliance requirements. Assessing materiality at the appropriate level is critical to the proper evaluation of findings. Materiality as it relates to giving an opinion on the auditee's compliance is discussed in paragraphs 6.13 through 6.16. The auditor's evaluation of the effect of questioned costs on the compliance opinion is discussed in paragraph 6.55.

### ***Financial Statement Impact***

**6.53** The auditor also has the responsibility of assessing the impact of the actual and projected error noted in the single audit against the materiality level established for the basic financial statements (see paragraph 6.16). The auditor should consider the effect of (a) any contingent liability that may arise from the noncompliance in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and (b) for nongovernmental entities, any uncertainty regarding the resolution of instances of noncompliance in accordance with SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

### ***Questioned Costs***

**6.54** Questioned costs are defined by Circular A-133 to include costs that are questioned by the auditor because of an audit finding (a) that resulted from a violation or possible violation of a provision of a law, regulation contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds, (b) for which the costs, at the time of the audit, are not supported by adequate documentation, or (c) for which the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

### ***Evaluating the Effect of Questioned Costs on the Compliance Opinion***

**6.55** In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of the total costs questioned for each major program (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). There may be instances in which the known questioned costs are not considered material but the likely questioned costs are considered material. In this situation, the auditor should consider the noncompliance to be material or may expand the scope of the audit and apply additional audit procedures to further establish the likely questioned costs. For example, if an auditor's sample results in known questioned costs related to three sample items out of thirty selected, the three errors may not be considered material. However, the auditor's projection of those errors to the entire population may suggest that there are likely questioned costs that are material. In this example, the auditor should consider the noncompliance to be material and should report a finding or expand the scope of the audit and apply additional audit procedures.

### ***Federal Agency Consideration of Findings and Questioned Costs***

**6.56** The auditor's designation of a cost as questioned does not necessarily mean that a federal grantor agency will disallow the cost. In most instances, the auditor is unable to determine whether a federal awarding agency or pass-through entity will ultimately disallow a questioned cost, because the agency or entity has considerable discretion in these matters.

**6.57** Circular A-133 defines a management decision as the evaluation by the federal awarding agency or pass-through entity of the audit findings and corrective action plan (see paragraphs 2.26 and 10.68 through 10.70 for a further discussion of the corrective action plan) and the issuance of a written decision as to what corrective action is necessary. Circular A-133 allows a federal awarding agency or pass-through entity receiving an auditor's report indicating findings and questioned costs six months after receipt of the audit report to issue such a decision. The nature of the questioned costs, as well as the amounts involved, are considered by the awarding agency or pass-through entity in issuing a management decision and deciding whether to disallow them. In addition, most federal awarding agencies have established appeal and adjudication procedures for questioned costs. Because of the discretion allowed in resolving these matters, all questioned costs are subject to uncertainty regarding their resolution.

### ***Reporting the Findings***

**6.58** Circular A-133 requires the auditor to consider a different level of materiality for the purposes of reporting audit findings (see paragraphs 3.36

through 3.38 for a further discussion). Circular A-133 requires the auditor, in addition to providing an opinion on compliance, to include the following items, among other things, in the schedule of findings and questioned costs (see paragraph 10.56 for a complete listing of the items that are required to be included):

- Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the *Compliance Supplement*.
- Known questioned costs that are greater than \$10,000 for a type of compliance requirement for a major program (see paragraph 6.22 for a listing of the fourteen types of compliance requirements). Known questioned costs are those specifically identified by the auditor.
- Known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement.
- Known questioned costs that are greater than \$10,000 for a federal program that is not audited as a major program (see paragraph 10.63 for a further discussion).

The reporting of findings is discussed in greater detail in paragraphs 10.63 and 10.64.

### ***Reporting the Likely Questioned Costs***

**6.59** As noted before, in evaluating the effect of questioned costs on the opinion on compliance, the auditor considers both known questioned costs and the best estimate of the total costs questioned (likely questioned costs) for each major program. Known and likely questioned costs also need to be considered when audit findings are reported. In addition to reporting known questioned costs greater than \$10,000 in the schedule of findings and questioned costs, the auditor is also required to report known questioned costs when likely questioned costs are greater than \$10,000. For example, if the auditor specifically identifies \$7,000 in questioned costs but, based on his or her evaluation of the effect of questioned costs on the opinion on compliance, the auditor estimates that the total questioned costs are in the \$50,000–\$60,000 range, the auditor would report a finding that indicates the known questioned costs of \$7,000. See paragraph 10.63 for a further discussion.

### ***Findings That Cannot Be Quantified***

**6.60** The auditor may discover instances of noncompliance that cannot be quantified. The auditor's responsibility for reporting such findings can best be described through an example. Assume that the auditor encounters a pass-through entity that consistently fails to provide its subrecipients with federal award information. Circular A-133 requires the auditor to consider all findings in relation to a type of compliance requirement (in the example provided, subrecipient monitoring is the relevant type of compliance requirement) or an audit objective identified in the *Compliance Supplement*. The pertinent audit objective included in the *Compliance Supplement* and relating to the example provided here is for the auditor to "determine whether the pass-through entity identifies federal award information and compliance requirements to the sub-

recipient.” Because the pass-through entity failed to provide federal award information to its subrecipients, this noncompliance would be material in relation to the audit objective and, therefore, should be reported as an audit finding. In addition, the auditor should also consider whether reportable conditions exist and require reporting with respect to subrecipient monitoring.

## **Performing Follow-Up Procedures**

### ***Auditee Responsibilities for Audit Follow-Up and for the Summary Schedule of Prior Audit Findings***

**6.61** Circular A-133 states that the auditee is responsible for follow-up and corrective action on all audit findings. The follow-up required by Circular A-133 is facilitated by the requirement that the auditee prepare a summary schedule of prior audit findings (see paragraphs 2.21 and 10.68). This schedule reports the status of all audit findings included in the prior audit’s schedule of findings and questioned costs relative to federal awards. It also includes audit findings reported in the prior audit’s summary schedule of prior audit findings that were not identified as either (1) fully corrected, (2) no longer valid, or (3) not warranting further actions. Circular A-133 states that a valid reason for considering an audit finding as not warranting further action is that *all* of the following have occurred:

- Two years have passed since the audit report in which the finding occurred was submitted to the federal clearinghouse.
- The federal agency or pass-through entity is not currently following up with the auditee on the audit finding.
- A management decision was not issued.

**6.62** Circular A-133 also states the following with regard to the auditee’s schedule of prior audit findings:

- When audit findings were fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.
- When audit findings were not fully corrected or were only partially corrected, the summary schedule must describe the planned corrective action as well as any partial corrective action taken.
- When the corrective action taken is significantly different from the corrective action previously reported in a corrective action plan or in the federal agency’s or pass-through entity’s management decision, the summary schedule must provide an explanation.
- When the auditee believes the audit findings are no longer valid or do not warrant further actions, the reasons for this position must be described in the summary schedule (see paragraph 6.61).

### ***Auditor Responsibilities for Follow-Up on Previously Reported Findings***

**6.63** Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. The auditor should also perform audit follow-up procedures regardless of whether a prior audit finding relates to a major program in the current year. The auditor’s reporting responsibilities are further discussed in chapter 10.

### **Auditor Follow-Up Procedures**

**6.64** To follow up on previous audit findings, the auditor should obtain the auditee's summary schedule of prior audit findings and should review its contents with appropriate members of management. Although in many cases the procedures performed in the current audit will provide a basis for the auditor to assess the schedule, the auditor may find it necessary to perform procedures directed specifically at the status of prior audit findings. In these cases, the following procedures are to be considered:

- Inquiry of auditee management and program personnel
- Review of management decisions issued by federal awarding agencies or pass-through entities to the auditee (see paragraph 6.57)
- Observation of an activity that has been redesigned to address a prior-year finding
- Testing of similar current-year transactions

### **Audit Follow-Up for Findings Reported, as Required by Government Auditing Standards**

**6.65** As noted in paragraph 3.14, *Government Auditing Standards* establishes an additional fieldwork standard, which requires the auditor to follow up on known material findings and recommendations from previous audits that could affect the financial statement audit to determine whether the auditee has taken timely and appropriate corrective actions. The auditee's schedule of prior audit findings is only required to include the status of prior-year findings relative to federal awards. However, there may be certain financial statement audit findings required to be reported under *Government Auditing Standards* that are included in the summary schedule of prior audit findings (because they also relate to federal awards). Also, although not required, some auditees may decide to include the status of other financial statement audit findings (that is, those that are not related to federal awards) in the schedule. For those financial statement audit findings included in the summary schedule of prior audit findings, the auditor's assessment of the reasonableness of the schedule (described in paragraphs 6.63 and 6.64) would meet the audit follow-up requirements of *Government Auditing Standards*. For financial statement audit findings that are not included in the schedule, the auditor should follow up on the findings to determine their status. See paragraph 10.62 for a discussion of the auditor's responsibility to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit.

### **Corrective Action Plan**

**6.66** Circular A-133 also requires that upon completion of the audit, the auditee prepare a corrective action plan that identifies the contact person responsible for corrective action, indicates the corrective action planned, the anticipated completion date or, if the auditee does not agree with the finding, an explanation and specific reasons why the auditee disagrees. The auditor may find the auditee's corrective action plan useful in performing audit follow-up (in addition to the auditee's summary schedule of prior audit findings) because it may provide a preliminary indication of the corrective steps planned by the auditee.

### **Disputes or Unresolved Findings**

**6.67** There may be times when, as part of the follow-up on prior findings, the auditor determines that (a) a previous finding is the subject of a dispute

between the auditee and the federal awarding agency or pass-through entity or (b) the federal awarding agency or pass-through entity has not addressed the finding by issuing a management decision. In these situations, if the finding relates to a current-year major program, the auditor should report similar transactions of the current year as findings and questioned costs until either the dispute is resolved or the initial finding no longer warrants further action under Circular A-133 as described in paragraph 6.61. However, if the auditor no longer believes that there is noncompliance because of additional evidence obtained in the current year, similar transactions need not be reported as findings.

## Management Representations Related to Federal Awards

**6.68** As part of an audit under Circular A-133, the auditor should obtain written representations from management about matters related to federal awards. Therefore, in addition to the management representations obtained in connection with an audit of the financial statements as discussed in paragraph 4.40, the auditor should obtain written representations from management concerning the identification and completeness of federal award programs, representations concerning compliance with compliance requirements, and identification of known instances of noncompliance.

### Suggested Representations

**6.69** The auditor should consider obtaining the following written representations in a single audit:<sup>2</sup>

- Management is responsible for complying, and has complied, with the requirements of Circular A-133.
- Management has prepared the schedule of expenditures of federal awards in accordance with Circular A-133 and has included expenditures made during the period being audited for all awards provided by federal agencies in the form of grants, federal cost-reimbursement contracts, loans, loan guarantees, property (including donated surplus property), cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, and other assistance.
- Management is responsible for complying with the requirements of laws, regulations, and the provisions of contracts and grant agreements related to each of its federal programs.
- Management is responsible for establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on its federal programs.
- Management has identified and disclosed to the auditor the requirements of laws, regulations and the provisions of contracts and grant agreements that are considered to have a direct and material effect on each federal program.

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<sup>2</sup> These representations may be added to a representation letter obtained in connection with an audit of the financial statements instead of a separate letter.



- Management has made available all contracts and grant agreements (including amendments, if any) and any other correspondence that have taken place with federal agencies or pass-through entities and are related to federal programs.
- Management has complied, in all material respects, with the compliance requirements in connection with federal awards except as disclosed to the auditor.
- Management has identified and disclosed to the auditor all amounts questioned and any known noncompliance with the requirements of federal awards, including the results of other audits or program reviews.
- Management's interpretations of any compliance requirements that have varying interpretations have been provided.
- Management has made available all documentation related to the compliance requirements, including information related to federal program financial reports and claims for advances and reimbursements.
- Federal program financial reports and claims for advances and reimbursements are supported by the books and records from which the basic financial statements have been prepared, and are prepared on a basis consistent with that presented in the schedule of expenditures of federal awards.
- The copies of federal program financial reports provided to the auditor are true copies of the reports submitted, or electronically transmitted, to the federal agency or pass-through entity, as applicable.
- If applicable, management has monitored subrecipients to determine that they have expended pass-through assistance in accordance with applicable laws and regulations and has met the requirements of Circular A-133.
- If applicable, management has issued management decisions on a timely basis after their receipt of subrecipients' auditor's reports that identified noncompliance with laws, regulations, or the provisions of contracts or grant agreements, and has ensured that subrecipients have taken the appropriate and timely corrective action on findings.
- If applicable, management has considered the results of subrecipient audits and has made any necessary adjustments to their own books and records.
- Management is responsible for and has accurately prepared the summary schedule of prior audit findings to include all findings required to be included by Circular A-133.
- Management has provided the auditor with all information on the status of the follow-up on prior audit findings by federal awarding agencies and pass-through entities, including all management decisions.
- Management has accurately completed the appropriate sections of the data collection form.
- If applicable, management has disclosed all contracts or other agreements with the service organizations.

- If applicable, management has disclosed to the auditor all communications from the service organization relating to noncompliance at the service organization.
- Management has disclosed any known noncompliance occurring subsequent to the period for which compliance is audited.
- Management has disclosed whether any changes in internal control over compliance or other factors that might significantly affect internal control, including any corrective action taken by management with regard to reportable conditions (including material weaknesses), have occurred subsequent to the date as of which compliance is audited.

## **Refusal to Furnish Written Representation**

6.70 Management's refusal to furnish all written representations that the auditor considers necessary in the circumstances constitutes a limitation on the scope of the audit sufficient to require a qualified opinion or disclaimer of opinion on the auditee's compliance with major program requirements. The auditor should also consider the effects of management's refusal on his or her ability to rely on other management representations.

## **State and Local Government Compliance Auditing Considerations**

6.71 An auditor may also be engaged to test and report on compliance with state and local laws and regulations in addition to the testing and reporting requirements imposed by *Government Auditing Standards* and Circular A-133. Although such auditing is outside the scope of this SOP, such a requirement may specify compliance tests, similar to those in a single audit. When this is the case, auditors should consult state or local government officials or other sources concerning the nature and scope of the required testing. However, state or local government funds should be distinguished from pass-through federal funds. When a single audit is conducted, pass-through federal funds are considered part of the federal awards received. See paragraphs 3.47 through 3.49 for a brief discussion of state and local compliance requirements.

## Chapter 7

### DETERMINATION OF MAJOR PROGRAMS

**7.1** As noted in paragraph 2.22, Circular A-133 requires the auditee to identify in its accounts all federal awards received and expended and the federal programs under which they were received. The auditee is also required to prepare a schedule of expenditures of federal awards for the period covered by its financial statements (see chapter 5 for a further discussion of the requirements related to this schedule). However, Circular A-133 places the responsibility for identifying major programs on the auditor, and it provides the criteria to be used in applying a risk-based approach to determining major programs. The risk-based approach is designed to focus the single audit on higher-risk programs. See paragraph 7.20 for a description of when the auditor can deviate from the use of risk criteria.

**7.2** The auditor's determination of the programs to be audited is based on an evaluation of the risk of noncompliance occurring that could be material to an individual major federal program. In evaluating such risk, the auditor considers, among other things, the current and prior audit experience with the auditee, the oversight exercised by federal agencies and pass-through entities, and the inherent risk of the federal programs. The auditor should use professional judgment and the guidance in sections 520, 525, and 530 of Circular A-133 in the risk assessment process. In addition, the auditor should consider the need to discuss the nature of federal programs with the management of the auditee and of the federal or state agency that provided the funds to the auditee.

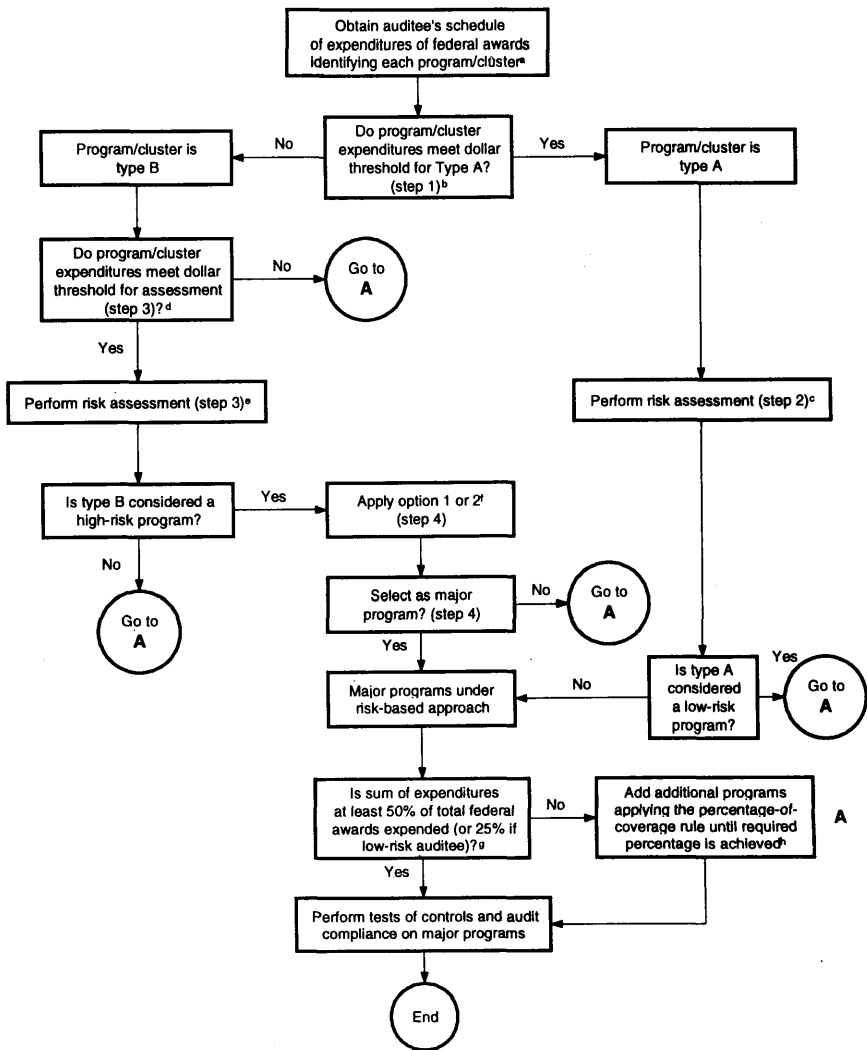
### Applying the Risk-Based Approach

**7.3** The guidance on the risk-based approach is organized here as provided in Circular A-133 and consists of the following steps (see table 7.1 for a flowchart illustration of applying the risk-based approach for determining major programs):

- Step 1—determination of type A and type B programs (paragraphs 7.4 through 7.9)
- Step 2—identification of low-risk type A programs (paragraphs 7.10 through 7.13)
- Step 3—identification of high-risk type B programs (paragraphs 7.14 through 7.16)
- Step 4—determination of programs to be audited as major (paragraphs 7.17 through 7.20)

Exhibit 7.1

Flowchart Illustration of Applying the Risk-Based Approach for Determining Major Programs



- a. See paragraph 1.18 for the definition of federal programs, including clusters.
- b. See paragraphs 7.4 through 7.9 for a detailed discussion of step 1.
- c. See paragraphs 7.10 through 7.13 for a detailed discussion of step 2.
- d. See paragraphs 7.14 through 7.16 for a detailed discussion of step 3.
- e. Before performing the risk assessment, the auditor should consider whether option 1 or option 2 will be selected under step 4 because it will affect whether risk assessments need to be performed on all type B programs or only some type B programs. See paragraph 7.15.
- f. The number of type B high-risk programs identified as major programs is either—
  - *Option 1:* one-half of the number of type B high-risk programs, unless this number exceeds the number of low-risk type A programs identified in step 2. In this case, the auditor would be required to audit as major the same number of high-risk type B programs as low-risk type A programs. Under this option, the auditor is expected to perform risk assessments on all type B programs that exceed the threshold for type B.
  - *Option 2:* one high-risk program for each low-risk type A program. This option does not require the auditor to perform risk assessments on all type B programs. See paragraphs 7.17 through 7.20 for a detailed discussion of step 4, including option 1 and option 2.
- g. There may be instances when the auditee includes certain noncash assistance (such as loan guarantees or loans) in the notes to the schedule of expenditures of federal awards (see paragraph 5.13). The auditor should be sure to include such noncash assistance as part of total federal awards expended when performing this calculation.
- h. The additional programs/clusters selected (marked “A” on the flow-chart) to meet the percentage-of-coverage rule are audited as major programs in addition to type A and type B programs identified in steps 1 through 4. See paragraph 7.24 for a further discussion of the percentage-of-coverage rule.

## Step 1—Determination of Type A and Type B Programs

7.4 To determine which federal programs are to be audited as major (see step 4), the auditor must first identify federal programs as being either type A or type B as defined in Circular A-133. In general, type A programs are larger federal programs and type B programs are smaller federal programs. The auditor should obtain the schedule of expenditures of federal awards from the auditee to assist in the identification of type A and type B programs. The schedule of expenditures of federal awards, prepared by the auditee, includes all cash and noncash awards either on the face of the schedule or in the notes to the schedule. Auditors should note that for purposes of determining major programs, a cluster of programs should be considered as one program (see paragraphs 1.18, 1.19, 2.18, 5.6, and 8.30 for a further discussion of a cluster of programs).

**Type A Program Criteria**

7.5 The larger federal programs are labeled as type A. The criteria that Circular A-133 establishes for identifying Type A programs are presented in table 7.1.

**Table 7.1**

**Criteria for Identifying Type A Programs**

<i>When Total Federal Awards Expended* Are—</i>	<i>A Type A Program Is Any Program With Federal Awards Expended That Exceed the Larger of—</i>
More than or equal to \$300,000 and less than or equal to, \$100 million	\$300,000 or 3% (0.03) of federal awards expended
More than \$100 million and less than or equal to \$10 billion	\$3 million or 0.3% (0.003) of federal awards expended
More than \$10 billion	\$30 million or 0.15% (0.0015) of federal awards expended

\* Includes both cash and noncash awards.

**Type B Program Criteria**

7.6 Federal programs that do not meet the type A criteria are considered type B programs.

**Effect of Large Loans and Loan Guarantees on Identification of Type A Programs**

7.7 The various types of noncash awards, including loans and loan guarantees, and how they are valued are discussed in chapter 5. Circular A-133 states that when the auditor applies the dollar criteria shown in table 7.1 to identify type A programs, the inclusion of large loans and loan guarantees should not result in the exclusion of other federal programs as type A programs. Auditors should note that this requirement relates only to loans and loan guarantees and not to any other large noncash awards. When a federal program providing loans or loan guarantees *significantly affects* the number or size of type A programs, the auditor should consider the loan or loan guarantee program a type A program and exclude its values in determining other type A programs. The auditor should use professional judgment in determining whether type A programs would be *significantly* affected in this situation.

7.8 The example in table 7.2 demonstrates this concept by showing the identification of type A programs as well as the effect of loans and loan guarantees on that identification process.

Table 7.2

**Identification of Type A Programs and the Effect  
of Loans and Loan Guarantees**

<i>Program / Federal Grantor</i>	<i>Federal Awards Expended (\$000)</i>
Cash program A—U.S. Department of Labor	\$ 1,335
Cash program B—U.S. Department of Health and Human Services	3,000
Cash program C-1—U.S. Department of Education	175
Cash program C-2—U.S. Department of Education	280
Cash program D—U.S. Department of Housing and Urban Development (a pass-through grant from a local government)	310
Subtotal—cash federal awards expended	\$ 5,100
Commodities program E—U.S. Department of Agriculture (a pass- through grant from a state)	2,000
Subtotal—cash and commodities federal awards expended	\$ 7,100
Loan program F—U.S. Department of Housing and Urban Development	33,500*
Loan guarantee program G—U.S. Department of Agriculture	57,000*
Total federal awards expended	\$97,600

\* In accordance with Circular A-133, loans and loan guarantees include new loans made during the year, plus prior-year loans for which the federal government imposes continuing compliance requirements, plus any interest subsidy, cash, or administrative cost allowance received. See paragraphs 5.14 and 5.15 for additional information.

7.9 In table 7.2 the auditee has \$97,600,000 in total federal awards expended. Therefore, an application of the criteria in table 7.1 would indicate that type A programs would be those that expended federal awards equal to or greater than \$2,928,000 (3 percent of \$97,600,000), or programs B, F, and G. However, when large loan and loan guarantee programs F and G are excluded from the base amount of the total federal awards expended in the calculation, the type A programs would be those programs that expended federal awards equal to or greater than \$300,000 (the larger of \$213,000 [3 percent of \$7,100,000], or \$300,000). Therefore, under the second calculation programs A, B, D, E, F, and G would be type A programs. If the auditor, in his or her professional judgment, concludes that the difference in the number or size of type A programs is significantly affected by the inclusion of the loans and loan guarantees (which in this example would be likely due to the significant increase in type A programs), the auditor would identify programs A, B, D, E, F, and G as type A programs. The auditor should consider contacting the cognizant or oversight agency for audit if the auditor is unsure about whether to exclude loan or loan guarantees when determining type A programs.

## Step 2—Identification of Low-Risk Type A Programs

7.10 After completing step 1, the auditor should perform a risk assessment of each type A program to identify those that are low-risk. Circular A-133 includes certain conditions that, when met, indicate that a type A program may be low-risk.

### General Conditions for Low-Risk Type A Programs

7.11 Type A programs may generally be considered low-risk if both of the following conditions are met: (a) the program has been audited as a major program

in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and (b) in the most recent audit period, the *program* had no audit findings (see paragraph 10.63 for a description of audit findings).

### ***Auditor Judgment in Determination of Low-Risk Type A Programs***

7.12 Circular A-133 permits the auditor to conclude, based on professional judgment, that a type A program is low-risk even though (a) in the prior audit period it may have had known or likely questioned costs greater than \$10,000 for a type of compliance requirement, (b) known fraud has been identified, or (c) the summary schedule of prior audit findings materially misrepresents the status of a prior audit finding. For example, consider a situation in which the funds expended under a federal program in the prior year totaled \$10 million, there were known questioned costs of \$11,000 that related to one isolated instance, and there were no additional likely questioned costs. In this example, the auditor, based on professional judgment, could decide that the program is low-risk in the current year. In making the final determination of whether a type A program is low-risk, the auditor should also consider the risk criteria in paragraphs 7.26 through 7.36, the results of audit follow-up, and whether any changes in the personnel or systems affecting a type A program have significantly increased its risk. Based on all of this information, the auditor would apply professional judgment in determining whether a type A program is low-risk.

### ***Type A Program Not Considered Low-Risk at Request of Federal Awarding Agency***

7.13 A federal awarding agency may request that a type A program for certain recipients not be considered low-risk so that it would be audited as a major program. For example, it may be necessary for a large type A program to be audited as major each year for particular recipients, to allow the federal agency to comply with the Government Management Reform Act of 1994. In this instance, Circular A-133 requires the federal awarding agency to obtain approval from the OMB. Furthermore, the federal awarding agency must notify the recipient and, if known, the auditor at least 180 days prior to the end of the fiscal year end to be audited. (See also paragraph 7.35 for a discussion of the federal agency or pass-through entity option to identify federal programs as higher risk in the *Compliance Supplement*.)

## **Step 3—Identification of High-Risk Type B Programs**

7.14 After completing steps 1 and 2, the auditor should identify type B programs that are high-risk, using professional judgment and the risk criteria discussed in paragraphs 7.26 through 7.36. Except for known reportable conditions in internal control or instances of noncompliance, a single risk criteria would, in general, seldom cause a type B program to be considered high-risk.

7.15 Before beginning step 3, the auditor should—

- a. Consider whether there are low-risk type A programs. When there are no type A programs identified as low-risk (either because there are no type A programs or because none of the type A programs are low-risk), the auditor is not required to perform step 3. Instead, the auditor would audit as major enough type B programs to meet the



percentage-of-coverage rule (see paragraph 7.24). When there are type A programs, but none are low-risk, the auditor would audit as major all type A programs plus any additional type B programs needed to meet the percentage-of-coverage rule. In either case, any programs requested to be audited by a federal agency or pass-through entity must be audited as a major program and would be included in determining whether the percentage-of-coverage rule has been met (see paragraph 7.21).

- b. Consider whether option 1 or option 2 will be used in step 4 (see paragraphs 7.18 through 7.19 for a detailed description of each option). The auditor's decision of which option to choose will likely be based on audit efficiency and will affect how many type B programs are subject to risk assessment. The auditor should consider the following discussion before deciding whether to use option 1 or option 2.
  - Under option 1, the auditor is required to perform a risk assessment on all type B programs (excluding small type B programs as discussed in paragraph 7.16). In comparison with option 2, option 1 will likely require the auditor to perform more type B program risk assessments, but may also result in the auditor having to audit fewer major programs. For example, assume that an auditee has four low-risk type A programs and ten type B programs that exceed the amount specified in table 7.3. Also assume that the auditor chooses option 1. In this scenario, the auditor would be required to perform a risk assessment on all type B programs. If the auditor finds that only four type B programs are high-risk, the auditor would only be required to audit two of the four high-risk type B programs as major (one-half of the number of high-risk type B programs).
  - Under option 2, the auditor is only required to identify high-risk type B programs up to the number of low-risk type A programs. In comparison with option 1, option 2 will likely require the auditor to perform fewer type B risk assessments, but may also result in the auditor having to audit more major programs. For example, assume that an auditee has four low-risk type A programs and ten type B programs that exceed the amount specified in table 7.3. Assume also that the first four type B programs subject to risk assessment are determined by the auditor to be high-risk. In this scenario, the auditor may choose option 2, identify the four high-risk type B programs as major, and not perform risk assessments on the remaining six type B programs. Using the same example but assuming that the auditee only has one low-risk type A program (instead of four), the auditor would be required to audit one type B program as major under either option 1 or 2. In this scenario, option 2 would likely be the most efficient choice for the auditor since the auditor would only need to perform type B program risk assessments until one high-risk type B program was identified (under option 1 the auditor would be required to perform a risk assessment on all type B programs).

### ***Criteria for Performing Risk Assessments on Type B Programs***

**7.16** An auditor is not expected to perform risk assessments on relatively small federal programs. Therefore, Circular A-133 only requires the auditor to

perform risk assessments on type B programs that exceed the larger of the criteria shown in table 7.3.

Table 7.3

Criteria for Performing Risk Assessments on Type B Programs

<i>When Total Federal Awards Expended* Are—</i>	<i>Perform Risk Assessment for Type B Programs That Exceed the Larger of—</i>
More than or equal to \$300,000 and less than or equal to \$100 million	\$100,000 or 0.3% (0.003) of federal awards expended
More than \$100 million	\$300,000 or 0.03% (0.0003) of federal awards expended

\* Includes both cash and noncash awards.

Step 4—Determination of Programs to Be Audited as Major

Criteria for Major Programs

7.17 After completing steps 1 through 3, the auditor identifies the major programs. At a minimum, Circular A-133 requires the auditor to audit all of the following as major programs:

- All type A programs, except those identified as low-risk under step 2 (see paragraphs 7.10 through 7.13)
- High-risk type B programs as identified under either of the two options described in paragraph 7.18
- Programs to be audited as major based on a federal agency request (in lieu of the federal agency conducting or arranging for additional audits; see paragraph 7.21 for further information)
- Additional programs, if any, that are necessary to meet the percentage-of-coverage rule described in paragraph 7.24

Two Options Available for Identifying High-Risk Type B Programs

7.18 Section 520(e)(2) of Circular A-133 provides two options for identifying high-risk type B programs:

- *Option 1.* Under option 1, the auditor is expected to perform risk assessments of all type B programs that exceed the amount specified in table 7.3, and to audit at least one-half of the high-risk type B programs as major, unless this number exceeds the number of low-risk type A programs identified in step 2 (that is, the cap). In this case, the auditor would be required to audit as major the same number of high-risk type B programs as the cap. For example, consider an auditee that has ten low-risk type A programs, and fifty type B programs above the amount specified in table 7.3. Under this option, the auditor would be required to perform risk assessments of the fifty type B programs. Assume that based on that assessment, the auditor determines that there are twenty-five high-risk type B programs. One-half of the twenty-five high-risk type B programs is 12.5, which rounds up to thirteen programs. Under this option, the auditor would audit thirteen of the high-risk type B programs as major; however, since the cap in this example is ten (that is, the number of low-risk type

A programs), the auditor is only required to audit ten high-risk type B programs as major.

- **Option 2.** Under option 2, the auditor is only required to audit as major one high-risk type B program for each type A program identified as low-risk in step 2. Under this option the auditor would not be required to perform risk assessments for any type B program when there are no low-risk type A programs (that is, the cap is zero). Continuing with the previous example, under option 2 the auditor would perform risk assessments of type B programs until ten high-risk programs are identified (that is, ten is the number of low-risk type A programs). The auditor would then audit as major the ten type B programs identified as high-risk. Depending on the order in which risk assessments on type B programs are performed, the auditor might only need to perform risk assessments of ten type B programs determined to be high-risk, or the auditor may need to perform risk assessments on additional Type B programs until ten high-risk programs are identified.

**7.19** The auditor may choose option 1 or option 2. There is no requirement to justify the reasons for selecting either option. The results under options 1 and 2 may vary significantly, depending on the number of low-risk type A programs and high-risk type B programs (see paragraph 7.15). Circular A-133 encourages the auditor to use an approach that provides an opportunity for different high-risk type B programs to be audited as major over a period of time.

### ***Deviation From Use of Risk Criteria***

**7.20** For first-year audits, Circular A-133 allows auditors to deviate from the above-described risk assessment process. A first-year audit is defined as the first year an entity is audited under the June 30, 1997, revision to Circular A-133 or as the first year of a change in auditors. This exception allows the auditor to elect to determine major programs as all type A programs plus any type B programs as are necessary to meet the percentage-of-coverage rule described in paragraph 7.24. Under this option, the auditor is not required to perform steps 2, 3, and 4. However, to ensure that a frequent change of auditors would not preclude the audit of high-risk type B programs, this election for first-year audits may not be used more than once every three years. Auditors should consider whether this exception is an option during the planning phase of the single audit (see also paragraphs 3.28 and 3.29 for a discussion of initial-year audit considerations).

## **Other Considerations Regarding the Risk-Based Approach**

### **Federal Agency Requests for Additional Major Programs**

**7.21** A federal agency may request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. The auditee, after consultation with its auditor, should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach and, if it would not, in-

forming the agency of the estimated incremental cost. The federal agency must then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based on the federal agency's request, and the federal agency agrees to pay the full incremental costs, then the auditee must have the program audited as a major program. This approach may also be used by pass-through entities for a subrecipient.

## **Documentation of Risk Assessment in the Working Papers**

**7.22** Circular A-133 requires the auditor to document in the working papers the risk assessment process used in determining major programs. It is therefore necessary for the auditor to document adequately, as required by GAAS and *Government Auditing Standards*, the determination of major programs (see the discussion of working paper requirements in paragraphs 3.16 through 3.18 and 3.22 through 3.23).

## **Auditor Judgment in the Risk Assessment Process**

**7.23** Circular A-133 states that when the determination of major programs is performed and documented by the auditor in accordance with the circular, the auditor's judgment in applying the risk-based approach to determine major programs is presumed correct. Challenges by federal agencies and pass-through entities should only be made for clearly improper use of the guidance in Circular A-133. It should be noted, however, that federal agencies and pass-through entities may provide the auditor with guidance about the risk of a particular federal program, which the auditor should consider when determining major programs.

## **Percentage-of-Coverage Rule**

**7.24** Circular A-133 requires the auditor to audit, as major programs, federal programs with federal awards expended that, in the aggregate, encompass at least 50 percent of the total federal awards expended. However, if the auditee meets the criteria for a low-risk auditee (see paragraph 7.25), the auditor is only required to audit as major programs federal programs with federal awards expended that, in the aggregate, encompass at least 25 percent of the total federal awards expended. To comply with this requirement, the auditor should compute the total federal awards expended for the major programs, determined under step 4, as a percentage of the total federal awards expended. If the total does not equal 50 percent (or 25 percent in the case of a low-risk auditee) of the total federal awards expended, the auditor should select additional programs (either type A or type B) to equal 50 percent (or 25 percent in the case of a low-risk auditee) and test them as major programs. The selection of additional programs to meet the percentage of coverage is based on the auditor's professional judgment. When selecting additional programs to meet the percentage-of-coverage rule, the auditor may select programs without regard to risk assessment. If loans or loan guarantees are major programs, these programs may be used for purposes of meeting the percentage-of-coverage rule. Furthermore, when a federal agency or pass-through entity requests and pays for a program to be audited as major (see paragraph 7.21), that program may also be used for purposes of meeting the percentage-of-coverage rule.

## **Low-Risk Auditee Criteria**

**7.25** Circular A-133 establishes certain conditions for determining whether an auditee is low-risk. An auditee that meets all of the following con-

ditions for each of the preceding two years (or in the case of biennial audits, the preceding two audit periods) qualifies as a low-risk auditee and is eligible for the reduced audit coverage discussed in paragraph 7.24:

- a. Single audits were performed on an annual basis in accordance with Circular A-133. An auditee that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.
- b. The auditor's opinions on the financial statements and the schedule of expenditures of federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of federal awards and may provide a waiver.
- c. There were no deficiencies in internal control over financial reporting that were identified as material weaknesses under the requirements of *Government Auditing Standards*. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of federal awards and may provide a waiver.
- d. None of the federal programs had audit findings from any of the following in either of the preceding two years (or in the case of biennial audits, the preceding two audit periods) in which they were classified as type A programs:
  - Material weaknesses in the internal control over compliance
  - Noncompliance with the provisions of laws, regulations, contracts, or grant agreements that have a material effect on the type A program
  - Known or likely questioned costs that exceed 5 percent of the total federal awards expended for a type A program during the year

## Criteria for Federal Program Risk

**7.26** The auditor's risk assessment should be based on an overall evaluation of the risk of noncompliance occurring which could be material to the federal program being evaluated. Circular A-133 indicates that the auditor should use professional judgment and consider certain criteria to identify risk in federal programs. As a part of the risk assessment, the auditor may also wish to discuss a particular federal program with auditee management and with the federal agency or pass-through entity. The criteria for federal program risk that are identified in Circular A-133 are discussed in the following sections.

### Current and Prior Audit Experience

**7.27** The auditor should consider his or her prior experience with the auditee and the results of audits performed in the past. The following specific factors that should be considered:

- Weaknesses in the internal control over compliance for federal programs (paragraph 7.28)
- Federal programs administered under multiple internal control structures (paragraph 7.29)

- A weak system for monitoring subrecipients when significant parts of federal programs are passed through to subrecipients (paragraph 7.30)
- The extent to which computer processing is used (paragraph 7.31)
- Prior audit findings (paragraph 7.32)
- Federal programs not recently audited as major (paragraph 7.33)

### ***Weaknesses in Internal Control Over Federal Programs***

**7.28** In assessing program risk, the auditor should consider internal control over compliance for federal programs (see chapter 8 for detailed guidance on internal control over compliance for federal programs). Weak internal control over compliance for federal programs is an indication of higher risk. Consideration should also be given to the control environment over federal programs and to such factors as the expectation of management's adherence to applicable laws and regulations and the provisions of contracts and grant agreements. The auditor may also consider the competence and experience of the personnel who administer federal programs. In instances in which the staff are new or do not have experience with a program, consideration should be given to assessing the program at a higher level of risk.

### ***Federal Programs Administered Under Multiple Internal Control Structures***

**7.29** Federal programs administered by multiple internal control structures may have a higher risk. This often occurs when multiple operating units are involved in the administration of federal programs. An example of this would be a university that has several campuses administering a federal program. When assessing risk, the auditor should consider whether any internal control weaknesses are isolated in a single operating unit (that is, one college campus) or are pervasive throughout the entity. If the identified weaknesses are isolated, and absent other weaknesses, the auditor could still potentially reach the conclusion that the program is low-risk. The final determination would be based on the auditor's judgment.

### ***Weak System for Monitoring Subrecipients***

**7.30** Consideration should be given to the extent that federal programs are passed through to subrecipients. If the auditee passes a significant portion of a federal program to subrecipients and the auditor has identified that the auditee has a weak system for monitoring subrecipients, the auditor should consider assigning a higher risk to the program. Alternatively, if the auditee passes a significant portion of programs to subrecipients and the auditee has an effective system in place to monitor the subrecipients, the auditor should consider assigning a lower level of risk to the program.

### ***Extent to Which Computer Processing Is Used***

**7.31** When assessing risk, the auditor should consider the extent to which computer processing is used to administer federal programs, as well as the complexity of that processing. A complex system does not always indicate higher risk. On the other hand, a newly installed system that has not been tested in the past, or a recently modified system, may indicate higher risk. Auditors should refer to SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to SAS No. 31, Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec.

326), for guidance when significant auditee information is transmitted, processed, maintained, or accessed electronically.

### ***Prior Audit Findings***

**7.32** As a part of the risk assessment, the auditor should consider prior audit findings. These findings may be the result of previous single audits by independent auditors or of compliance or financial audits performed by internal auditors or government auditors in conjunction with the federal awarding agency's monitoring activities. The auditor should consider assessing a higher risk for programs for which prior audit findings have a significant impact on a federal program or for which no corrective action has been implemented since the findings were identified.

### ***Federal Programs Not Recently Audited as Major***

**7.33** Federal programs that have not recently been audited as major programs may be of higher risk than federal programs recently audited as major. For example, many type B programs may never have been audited as major programs in the past. A higher level of risk would likely be assessed on such programs than on those programs that have been consistently audited as major programs without audit findings.

## **Oversight Exercised by Federal Agencies and Pass-Through Entities**

**7.34** The oversight exercised by federal agencies or pass-through entities could indicate risk. An important factor in assessing risk is the results of recent audits performed by federal agencies or pass-through entities. For example, recent monitoring or other reviews that were performed by an oversight entity and that disclosed no audit findings may indicate lower risk, whereas monitoring that disclosed significant findings could indicate higher risk. However, the auditor should understand the scope of the review that was performed. Reviews performed by federal agencies or pass-through entities vary widely as to coverage and intensity.

**7.35** Circular A-133 states that federal agencies, with the concurrence of the OMB, may identify federal programs that are high-risk. This identification will be provided by the OMB in the *Compliance Supplement*. For example, the U.S. Department of Health and Human Services has identified the Medicaid Assistance Program as a program of higher risk in the *Compliance Supplement*. Although such an identification by a federal agency does not preclude an auditor from determining that a program is low-risk (for example, because prior audits have shown strong internal control and compliance), the auditor should consider it as part of the risk assessment process.

## **Inherent Risk of the Federal Programs**

**7.36** As part of the risk assessment, the auditor needs to consider the inherent risk of federal programs. Inherent risk is the risk that material noncompliance with requirements applicable to a major program could occur, assuming there is no related internal control. Programs with higher inherent risk may be of a higher risk for the purpose of determining major programs. Circular A-133 provides examples of program characteristics with potentially higher inherent risks; these are discussed in paragraphs 6.8 and 6.9.

## Chapter 8

### CONSIDERATION OF INTERNAL CONTROL OVER COMPLIANCE FOR MAJOR PROGRAMS

8.1 Circular A-133 establishes requirements for additional audit procedures and reporting relative to the auditor's consideration of internal control over compliance for major programs. These requirements are beyond those of a financial statement audit conducted in accordance with GAAS and *Government Auditing Standards*. The auditor's consideration of internal control over financial reporting is discussed in chapter 4. In this chapter, the additional considerations of internal control over compliance for major programs are discussed. The reporting on internal control over compliance for major programs is discussed in paragraph 8.3 and chapter 10.

### Summary of Circular A-133 Requirements Related to Internal Control Over Compliance for Federal Programs

#### Auditee Responsibilities

8.2 Circular A-133 requires the auditee to maintain internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs.

#### Auditor Responsibilities

8.3 In addition to the requirements of GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to—

- Perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs.
- Plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program.
- Perform testing of the internal control over compliance as planned.
- Report on internal control over compliance describing the scope of the testing of internal control and the results of the tests and, where applicable, referring to the separate schedule of findings and questioned costs. This schedule includes, where applicable, a statement that reportable conditions in internal control over compliance for major programs were disclosed by the audit and whether any such conditions were material weaknesses.



## Auditor Responsibility for Internal Control Over Compliance for Programs That Are Not Major

8.4 The auditor has no responsibility under Circular A-133 to obtain an understanding of internal control over compliance for programs that are not considered major, or to plan or perform any related testing of internal control over compliance for those programs except for any procedures the auditor may choose to perform as part of the risk assessment process in determining major programs (see chapter 7). However, the auditor should note that a program that is not considered major could still be material to the financial statements. In this situation, in conjunction with the financial statement audit, the auditor may need to obtain an understanding of the internal control over financial reporting that is relative to the program. The auditor's consideration of internal control over financial reporting is discussed in chapter 4.

## Circular A-133 Definition of Internal Control Over Federal Programs

8.5 Circular A-133 defines internal control over federal programs as follows.

Internal control pertaining to the compliance requirements for federal programs (*Internal control over federal programs*) means a process—effected by an entity's management and other personnel—designed to provide reasonable assurance regarding the achievement of the following objectives for federal programs:

1. Transactions are properly recorded and accounted for to:
  - a. Permit the preparation of reliable financial statements and federal reports;
  - b. Maintain accountability over assets; and
  - c. Demonstrate compliance with laws, regulations, and other compliance requirements;
2. Transactions are executed in compliance with:
  - a. Laws, regulations and the provisions of contracts or grant agreements that could have a direct and material effect on a federal program; and
  - b. Any other laws and regulations that are identified in the compliance supplement; and
3. Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

## Control Objectives

8.6 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, states that there are three categories of internal control: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. These distinct but somewhat overlapping categories have differing purposes and allow a directed focus to meet the needs of the auditee and others

regarding each separate purpose. For purposes of this SOP, controls relevant to the audit of the financial statements are referred to as “internal control over financial reporting” and are encompassed in the report on internal control over financial reporting that is required by *Government Auditing Standards* (see paragraphs 10.38 through 10.40). Controls relevant to an audit of compliance with requirements applicable to major federal programs are referred to collectively in this SOP “as internal control over compliance” and are encompassed in the report on internal control over compliance required by Circular A-133 (see paragraphs 10.46 through 10.49). See paragraphs 4.11 and 4.12 for a more detailed discussion.

## **Auditor’s Consideration of Internal Control Over Compliance for Each Major Program**

8.7 The auditor’s consideration of internal control over compliance for each major program is similar to the consideration of internal control over financial reporting in a financial statement audit as described in SAS No. 55, as amended by SAS No. 78. In his or her consideration of internal control over compliance, the auditor—

- Obtains an understanding of internal control over compliance for federal programs that is sufficient to plan the audit, by performing procedures to understand (a) the design of controls relevant to the compliance requirements for each major program and (b) whether they have been placed in operation (note that although Circular A-133 requires the auditor to perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs, it does not actually require the achievement of a low assessed level of control risk).
- Assesses control risk for the assertions relevant to the compliance requirements for each major program. The auditor uses the knowledge provided by the understanding of internal control over compliance and the assessed level of control risk to determine the nature, timing, and extent of substantive tests for assertions relevant to the compliance requirements for each major program. Compliance auditing is discussed in chapter 6.

8.8 An understanding of the internal control over compliance and an assessment of control risk may be performed concurrently in an audit. Similarly, based on the assessed level of control risk that the auditor expects to support and on audit efficiency considerations, the auditor often plans to perform some tests of controls concurrently with obtaining an understanding of controls.

## **Obtaining an Understanding of Internal Control Over Compliance for Major Programs**

### **Understanding Compliance Assertions and Identifying Relevant Controls**

8.9 As noted in paragraph 8.3, the auditor is required to perform procedures to obtain an understanding of internal control over compliance for fed-

eral programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs. The determination of major programs is discussed in chapter 7. The auditor needs to understand the assertions relevant to the compliance requirements for each major program. Those assertions will determine the types of controls the auditor needs to consider in a single audit. In identifying controls relevant to specific assertions, the auditor should consider that the controls can have either a pervasive effect on many assertions or a specific effect on an individual assertion depending on the nature of the particular internal control component involved. An entity generally also has controls relating to objectives that are not relevant to specific assertions and that therefore need not be considered in a Circular A-133 audit.

**8.10** In obtaining an understanding of controls, the auditor should consider the guidance in paragraphs 41 through 43 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.41–43). This includes performing procedures to provide sufficient knowledge of both the design of the relevant controls pertaining to each of the five internal control components (that is, control environment, risk assessment, control activities, information and communication, and monitoring) and whether they have been placed in operation. The auditor ordinarily obtains this knowledge through previous experience with the entity and through such procedures as inquiries of appropriate management, supervisory, and staff personnel; an inspection of the entity's documents and records; and his or her observation of the entity's activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular control, and the nature of the entity's documentation of specific controls.

**8.11** Entities may use the same controls for more than one federal program and for similar transactions (for example, cash disbursements). Accordingly, those controls will often provide assurance regarding the achievement of the compliance objectives related to some or all federal program transactions and assets.

## **OMB Compliance Supplement Internal Control Guidance**

**8.12** When determining the assertions relevant to the compliance requirements for each major program of the entity, the auditor should consider referring to the discussion on internal control found in part 6 of the *Compliance Supplement*. The *Compliance Supplement* provides a general discussion of the control objectives, components, and activities that are likely to apply to the fourteen types of compliance requirements (see the discussion of the types of compliance requirements in paragraph 6.22). This guidance is not a checklist of required internal control characteristics; it is intended, instead, to assist the auditor in planning and performing the single audit. However, the auditee is responsible for designing and implementing internal control that is sufficient to provide reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs. Control activities beyond those discussed in the *Compliance Supplement* may need to be designed and implemented by the auditee to meet this responsibility. Similarly, the auditor is responsible for evaluating internal control over compliance, to plan the audit to support a low assessed level of control risk for each major program. The auditor may need to perform tests of internal control

over compliance that are related to control objectives and activities in addition to those discussed in the *Compliance Supplement*.

## Multiple-Component Considerations

**8.13** Federal programs are often administered by several organizational components within an auditee. Each component may maintain separate internal control over compliance that is relevant to the programs, or parts of the programs, that the component administers. In these situations, the auditor should perform procedures to obtain an understanding of the internal control over compliance that is separately maintained by organizational components and that is relevant to each material part of a major program, and should plan and perform testing of those controls as discussed in this chapter (see also paragraphs 6.34 and 7.29 for other multiple-component considerations).

## Subrecipient Considerations

**8.14** Many entities that are pass-through entities for federal awards make subcontract or subgrant awards and disburse their own funds, as well as federal funds, to subrecipients. The auditor of the pass-through entity has certain considerations related to the entity's internal control over the monitoring of subrecipients. See paragraph 9.23 for a discussion of the audit considerations of federal pass-through awards.

# Planning and Performing Testing of Internal Control Over Compliance for Major Programs

## Assessing Control Risk

**8.15** After obtaining an understanding of internal control over compliance for major programs, the auditor makes a preliminary assessment of control risk for the assertions relevant to the compliance requirements for each major program (see also the related discussion in paragraphs 6.7 through 6.12). Control risk is the risk that material noncompliance that could occur in a major program will not be prevented or detected on a timely basis by the auditee's internal control over compliance. The assessment of control risk is the process of evaluating the effectiveness of an entity's internal control over compliance in preventing or detecting material noncompliance with the compliance requirements for each major program. In assessing control risk, the auditor should consider the guidance in paragraphs 45 through 57 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU secs. 319.45–.57). The auditor should consider the preliminary assessment of control risk when he or she designs the nature and extent of tests of compliance. The Circular A-133 requirement to plan the testing of internal control over compliance to support a low assessed level of control risk is discussed in paragraphs 8.16 through 8.19. The auditor's responsibilities when the internal control over compliance is ineffective in preventing or detecting noncompliance are discussed in paragraphs 8.20 through 8.22.

## Planning the Testing of Internal Control Over Compliance for Major Programs to Support a Low Assessed Level of Control Risk

**8.16** Circular A-133 requires the auditor to plan the testing of internal control over compliance for major programs to support a low assessed level of

control risk for the assertions relevant to the compliance requirements for each major program. Professional standards do not define or quantify a low assessed level of control risk. A low assessed level of control risk can only be understood in relative terms when it is compared with maximum or moderate levels. Therefore, the auditor exercises professional judgment to determine the procedures necessary to obtain a low level of control risk. The auditor should consider the purpose of the requirement to plan the tests of controls to achieve a low assessed level of control risk (that is, federal agencies want to know if conditions indicate that auditees have not implemented adequate internal control over compliance for federal programs to ensure compliance with applicable laws and regulations).

**8.17** Assessing control risk at below the maximum level involves (a) identifying specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions and (b) performing tests of controls to evaluate the effectiveness of such controls.

**8.18** When the auditor assesses control risk at below the maximum level, the auditor should obtain sufficient evidential matter to support that assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusions to which it leads all bear on the degree of assurance the evidential matter provides. In obtaining evidential matter, the auditor should consider the guidance in paragraphs 64 through 78 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU secs. 319.64–78).

**8.19** Paragraph 4.32 of *Government Auditing Standards* provides the following additional guidance related to the assessment of control risk:

- The lower the auditors' assessment of control risk, the more evidence they need to support that assessment.
- Auditors may have to use a combination of different kinds of tests of controls to get sufficient evidence of a control's effectiveness.
- Inquiries alone generally will not support an assessment that control risk is below the maximum.
- Observations provide evidence about a control's effectiveness only at the time observed; they do not provide evidence about its effectiveness during the rest of the period under audit.
- Auditors can use evidence from tests of controls done in prior audits (or at an interim date), but they have to obtain evidence about the nature and extent of significant changes in policies, procedures, and personnel since they last performed those tests.

## **Existence of Ineffective Internal Control in Preventing or Detecting Noncompliance**

**8.20** When internal control over compliance for some or all of the compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance, the auditor is not required to plan and perform tests of internal control over compliance as described in paragraphs 8.3, 8.16, and 8.23. If the internal control over compliance is deemed likely to be ineffective, Circular A-133 requires the auditor to assess control risk at the maximum and consider whether any additional compliance tests are required because of

ineffective internal control. The auditor is also required to report a reportable condition (including whether such condition is a material weakness) as part of the audit findings (see paragraphs 10.46, 10.56, and 10.63 for a discussion of how reportable conditions should be reported).

**8.21** The assessment of the effectiveness of internal control over compliance in preventing or detecting noncompliance is determined in relation to each individual type of compliance requirement for each major program or to an audit objective identified in the *Compliance Supplement*. For example, controls over requirements for eligibility may be ineffective because of a lack of segregation of duties. In this case, the auditor would be required to—

- Report the lack of segregation of incompatible duties as it relates to eligibility as a reportable condition (note that the reportable condition could be a material weakness).
- Assess the control risk related to requirements for eligibility at the maximum.
- Consider the lack of effective control when designing the nature, timing, and extent of procedures designed to test compliance with requirements for eligibility of the major program. In most cases, the extent of testing would need to be expanded.

**8.22** In planning the tests of controls, the auditor will need to consider the results of tests performed in prior years. If the results of the prior year tests of controls prevented a low level of control risk assessment, the auditor may consider expanded testing in the next audit period. That consideration should include the testing of any changes in internal control over compliance that were intended to eliminate deficiencies noted in the previous year. If, however, the auditee has made no changes to its internal control over compliance, the auditor may determine that controls are not likely to be effective and may choose not to plan and perform tests of controls. In this situation, a reportable condition should be reported (see paragraph 8.20).

## Performing Tests to Evaluate the Effectiveness of Controls

**8.23** As noted in paragraph 8.3, Circular A-133 requires the auditor to perform testing of internal control over compliance as planned (see paragraphs 8.20 through 8.22 for an exception related to ineffective internal control over compliance). Tests of controls should include the types of procedures described in paragraphs 34 and 35 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.52 and 319.53). Tests of controls, which are directed toward either the effectiveness of the design or the operation of a control, may include such steps as (a) inquiries of appropriate personnel, including grant and contract managers; (b) the inspection of documents and reports; (c) the observation of the application of the specific controls; and (d) the reperformance of the application of the controls by the auditor. The auditor should perform such procedures (unless control is likely to be ineffective) regardless of whether he or she would otherwise choose to obtain evidence to support an assessment of control risk below the maximum level.

## Evaluating the Results of Tests of Controls

**8.24** If, when evaluating the results of tests of controls, the auditor is not able to support a low assessed level of control risk for major programs, the au-

ditor is not required to expand his or her testing of internal control over compliance. The auditor may choose not to perform further tests. In this situation, the auditor would assess control risk at other than low, design tests of compliance accordingly, and consider the need to report an audit finding (see paragraph 10.63). In general, a reportable condition or a material weakness will need to be reported. Similarly, the auditor may decide to expand the testing of internal control over compliance, but that decision would be based on whether the auditor considered expanded internal control testing to be more efficient than additional tests of compliance. The auditor should consider whether, based on the testing performed, control risk can be assessed at below the maximum to reduce substantive tests of compliance. If it cannot, the auditor should assess control risk at the maximum level.

## **Reportable Conditions and Material Weaknesses Related to Federal Programs**

**8.25** For purposes of reporting on internal control over compliance for federal programs, the definitions of a reportable condition and a material weakness, which are similar to those in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, are as follows:

- A *reportable condition* is a matter coming to the auditor's attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in the auditor's judgment, could adversely affect an entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants.
- A *material weakness* in internal control over compliance is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

**8.26** In performing a single audit, the auditor should be aware that reportable conditions and material weaknesses are to be considered as they relate to a type of compliance requirement for each major program or to an audit objective identified in the *Compliance Supplement*. Furthermore, certain conditions may be reportable conditions for a major program and not be considered reportable conditions as they relate to the assertions of management in the financial statements.

## **Documentation Requirements**

**8.27** The auditor should document his or her understanding of the auditee's internal control components that was obtained to plan the audit, and should document the basis for his or her conclusions about the assessed level of control risk related to the internal control over compliance for major programs. If the auditor has not performed tests of controls relevant to certain requirements or programs, as discussed in paragraphs 8.20 through 8.22, then the rationale for omitting such tests should be documented.

**8.28** As noted in paragraphs 3.16 through 3.18, *Government Auditing Standards* includes an additional standard that requires working papers to

contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments.

**8.29** The form and extent of this documentation is influenced by the size and complexity of the auditee, as well as the nature of the auditee's internal control over compliance. For example, the documentation of the understanding of internal control over compliance of a large, complex entity may include flowcharts, questionnaires, or decision tables. For a small entity, however, the documentation may be less extensive. In general, the more complex the internal control over compliance and the more extensive the procedures performed, the more extensive the auditor's documentation.

### **Program Cluster Considerations**

**8.30** An entity may have separate controls related to individual federal programs that are treated as one program "cluster" under a Circular A-133 audit (for example, SFA and R&D—see paragraphs 1.18, 1.19, 2.18, 5.6, and 7.4 for a discussion of program clusters). In this case, when evaluating whether an identified deficiency is a reportable condition, the auditor should consider the significance of the deficiency in relation to the overall major program (program cluster). Following are some examples:

- Significant deficiencies in specific controls over the time cards of college work-study students would likely be considered a reportable condition when college work-study program expenditures are significant in relation to SFA programs.
- Significant deficiencies in controls over a single campus or department of a university where a significant amount of research was administered would likely be a reportable condition when considered in relation to the total expenditures of R&D programs.
- A deficiency in an SFA or R&D program that was clearly insignificant to SFA or R&D, respectively, as a whole would not necessarily be considered a reportable condition.



## Chapter 9

# AUDIT CONSIDERATIONS OF FEDERAL PASS-THROUGH AWARDS

### Introduction

9.1 Many nonfederal entities receiving federal awards make pass-through payments of federal awards to other entities that are considered subrecipients. The amount of those payments may be material to the pass-through entity's financial statements, individual major programs, or both. The auditor's consideration of pass-through federal awards in an audit of both pass-through entities and subrecipients of federal awards under Circular A-133 is discussed in this chapter. The auditee's and auditor's responsibilities with respect to activities carried out by vendors is also discussed in this chapter. An auditee with multiple federal funding agreements may be a pass-through entity in regard to some awards, a subrecipient in regard to other awards, and a vendor with respect to other agreements.

### Definitions

9.2 Circular A-133 includes the following definitions that are relevant to pass-through awards:

- *Federal award*—federal financial assistance and federal cost-reimbursement contracts that nonfederal entities receive directly from federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts, under grants or contracts, used to buy goods or services from vendors.
- *Nonfederal entity*—a state, local government, or non-profit organization (NPO).
- *Recipient*—a nonfederal entity that expends federal awards received directly from a federal awarding agency to carry out a federal program.
- *Pass-through entity*—a nonfederal entity that provides a federal award to a subrecipient to carry out a federal program.
- *Subrecipient*—a nonfederal entity that expends federal awards received from a pass-through entity to carry out a federal program but does not include an individual who is a beneficiary of such a program. A subrecipient may also be a recipient of other federal awards directly from a federal awarding agency.
- *Vendor*—a dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a federal program. These goods or services may be for an organization's own use or for the use of beneficiaries of the federal program.

## Applicability of Circular A-133

**9.3** Circular A-133 applies to both recipients expending federal awards received directly from federal awarding agencies and subrecipients expending federal awards received from a pass-through entity. Accordingly, both recipients and subrecipients that expend \$300,000 or more in federal awards are required to have a single or program-specific audit in accordance with Circular A-133 (see chapter 11 for a detailed discussion of program-specific audits).

**9.4** The determination of when a federal award is expended is based on when the activity related to the award occurs. With respect to federal awards passed through to subrecipients, the activity that requires the pass-through entity to comply with laws, regulations, and the provisions of contracts or grant agreements is the disbursement of funds to subrecipients. The activity that requires subrecipients to comply with laws, regulations, and the provisions of contracts or grant agreements is the expenditure of the pass-through award.

**9.5** Payments received by a vendor for goods or services provided in connection with a federal program are not considered federal awards. Furthermore, Medicaid payments to a subrecipient for providing patient care services to Medicaid-eligible individuals are not considered federal awards expended under Circular A-133 unless a state requires the funds to be treated as federal awards expended because reimbursement is on a cost-reimbursement basis.

**9.6** If a pass-through entity provides federal awards to subrecipients, the pass-through entity must monitor the subrecipients' activities to provide reasonable assurance that the subrecipients administer federal awards in compliance with federal requirements. As part of the compliance audit, the auditor of the pass-through entity must test and report on subrecipient monitoring (which is one of the fourteen types of compliance requirements in the *Compliance Supplement*—see paragraph 6.22) when federal awards passed through to subrecipients are material to a major program (see paragraphs 9.24 through 9.35). If the federal awards provided are immaterial or relate to a program that is not considered major, the auditor of the pass-through entity has no additional compliance auditing responsibilities related to the funds passed through to subrecipients.

**9.7** Most of this chapter focuses on compliance auditing considerations for auditors of pass-through entities. However, paragraphs 9.43 through 9.47 provide additional considerations for auditors of subrecipients.

## Pass-Through Entities, Subrecipients, and Vendors

### Subrecipient Status Versus Vendor Status

**9.8** The responsibilities for compliance with federal program requirements and the applicable compliance requirements to be tested by the auditor are significantly different for pass-through entities, subrecipients, and vendors. Guidance on distinguishing between a subrecipient and a vendor is provided in section 210 of Circular A-133 and is summarized in paragraphs 9.9 through 9.11.

#### ***Characteristics Indicative of a Federal Award Received by a Subrecipient***

**9.9** According to Circular A-133, characteristics indicative of a federal award received by a subrecipient are when the entity (see paragraph 9.12 for examples of the relationship between pass-through entities and subrecipients)—

- Determines who is eligible to receive what federal financial assistance.
- Has its performance measured against whether the objectives of the federal program are met.
- Has responsibility for programmatic decision making.
- Has responsibility for adherence to applicable federal program compliance requirements.
- Uses the federal funds to carry out a program of the entity as compared to providing goods or services for a program of the pass-through entity.

### ***Characteristics Indicative of a Payment for Goods or Services Received by a Vendor***

**9.10** According to Circular A-133, the characteristics indicative of a payment for goods or services received by a vendor are when the entity (see paragraph 9.13 for examples of the relationship between recipients and vendors)—

- Provides the goods and services within normal business operations.
- Provides similar goods or services to many different purchasers.
- Operates in a competitive environment.
- Provides goods or services that are ancillary to the operation of the federal program.
- Is not subject to the compliance requirements of the federal program.

### ***Use of Judgment in Determining Subrecipient or Vendor Status***

**9.11** Circular A-133 states that there may be unusual circumstances or exceptions to the listed characteristics in paragraphs 9.9 and 9.10. In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. It is not expected that all of the characteristics will be present, and judgment should be used in determining whether an entity is a subrecipient or vendor. In some cases, it may be difficult to determine whether the relationship with the entity is that of a subrecipient or of a vendor. The federal cognizant agency for audit, the oversight agency for audit, or the federal awarding agency may be of assistance in making these determinations.

## **Description of Relationships**

### ***Pass-Through Entity and Subrecipient***

**9.12** Following are examples of a typical relationship between a pass-through entity and a subrecipient:

- A state department of education (pass-through entity) receives a federal award and is responsible for administering and disbursing the federal award to local school districts (subrecipients) according to a formula or some other basis.
- A regional planning commission (pass-through entity) receives a federal award for the feeding of elderly and low-income individuals, and the award is disbursed to NPOs (subrecipients) to support their feeding programs.

- A hospital (subrecipient) receives a federal award from a university (pass-through entity) to conduct research.
- A theater group (subrecipient) receives a federal award from a state arts commission (pass-through entity) to support a summer arts series.

### ***Recipient and Vendor***

**9.13** Following are examples of a typical relationship between a recipient and a vendor:

- A local government (recipient) receives a federal award to provide mental health services in a designated area. Some of the funds are paid to a contractor (vendor) to repair a leaking roof.
- A county (recipient) receives a federal award to operate a Head Start program and pays a NPO (vendor) to provide temporary clerical services.
- An NPO (recipient) receives a federal award to run a preschool and pays a medical doctor (vendor) to perform health screening on a per-student basis.
- An NPO (recipient) receives a federal award to operate a child care center and pays a not-for-profit clinic (vendor) to perform physical exams.

### ***Entity is Both a Subrecipient and a Pass-Through Entity***

**9.14** There are instances in which an entity can be both a subrecipient and a pass-through entity as shown in the following examples:

- A local government receives a pass-through federal award from a state government agency (the local government is a subrecipient) and further passes through a portion of the federal award to an NPO (the local government is also a pass-through entity) to administer a federal program.
- A not-for-profit area agency receives a pass-through federal award from a state (the not-for-profit area agency is a subrecipient) and further passes through a portion of the federal award to a for-profit health care provider (the not-for-profit area agency is also a pass-through entity). See paragraph 9.40 for a discussion of a pass-through entity's responsibilities when the subrecipient is a for-profit entity.

## **Vendor Compliance Considerations**

### ***Auditee's Responsibilities***

**9.15** Circular A-133 states that in most cases, the auditee's compliance responsibility for a vendor is only to ensure that the procurement, receipt, and payment for goods and services comply with laws, regulations, and the provisions of contracts or grant agreements. A program's compliance requirements normally do not pass through to vendors. However, the auditee is responsible for ensuring compliance for vendor transactions that are structured such that the vendor is responsible for program compliance or the vendor's records must be reviewed to determine compliance.

## ***Auditor's Responsibilities***

**9.16** When vendors are responsible for program compliance, the auditor should determine whether vendor transactions are in compliance with laws, regulations, and the provisions of contracts or grant agreements if such transactions are material to a major program of the auditee. In such a case, the auditor would normally evaluate a vendor's compliance by reviewing the auditee's records and the results of the auditee's procedures for ensuring compliance by the vendor. When the auditor cannot obtain sufficient assurance from reviewing the auditee's records and procedures, the auditor should consider the need to report a reportable condition. The auditor will also ordinarily need to perform additional procedures to determine compliance. These procedures may include testing the vendor's records or obtaining reports on compliance procedures performed by the vendor's independent auditor.

**9.17** Prior to performing a single or program-specific audit, it is important for the auditor to understand the nature of the auditee's vendor relationships, whether the vendors are responsible for program compliance, the auditee's procedures for ensuring vendor compliance, and whether it will be necessary for the auditor to test vendor records. The auditor should consider including such information in the communication used to establish an understanding with the auditee (see paragraphs 3.6 and 3.7). If subsequent to undertaking a single or program-specific audit the auditor becomes aware of a significant vendor relationship that will require the auditor to perform additional procedures on vendor records, the auditor should inform the auditee that the requirements of Circular A-133 will not be met unless additional procedures are performed. If the auditee or vendor precludes the auditor from performing such additional procedures, the auditor should qualify his or her opinion or disclaim an opinion because of a scope limitation (see paragraphs 10.43 through 10.45 for a further discussion of scope limitations).

## **Single Audit Considerations of Pass-Through Entities**

**9.18** The following matters are relevant to planning and conducting a single audit of a pass-through entity:

- Pass-through entity responsibilities (see paragraph 9.19)
- Audit planning considerations (see paragraphs 9.20 through 9.22)
- Consideration of internal control over compliance (see paragraph 9.23)
- Subrecipient monitoring (see paragraphs 9.24 through 9.35)
- Reporting considerations (see paragraphs 9.36 through 9.39)
- For-profit subrecipients (see paragraph 9.40)
- Non-U.S.-based entities (see paragraph 9.41)
- A state's designation of a cluster of programs (see paragraph 9.42)

## **Pass-Through Entity Responsibilities**

**9.19** A pass-through entity is responsible for ensuring that subrecipients expend awards in accordance with applicable laws, regulations, and provisions of contracts or grants. Circular A-133 requires a pass-through entity to perform the following for the federal awards it provides to subrecipients:

- Identify the federal awards made by informing each subrecipient of the CFDA title and number, the award's name and number, the award year, whether the award is for R&D, and the name of the federal agency. When some of this information is not available, the pass-through entity should provide the best information available to describe the federal award.
- Advise subrecipients of the requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements, as well as any supplemental requirements imposed by the pass-through entity.
- Monitor the activities of subrecipients as necessary to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
- Ensure that subrecipients expending \$300,000 or more in federal awards during the subrecipient's fiscal year have met the audit requirements of Circular A-133 for that fiscal year.
- Issue management decisions on audit findings within six months after receipt of subrecipients' audit reports, and ensure that subrecipients take appropriate and timely corrective action.
- Consider whether subrecipient audits necessitate the adjustment of the pass-through entity's own records.
- Require subrecipients to permit the pass-through entity and auditors to have access to the records and financial statements as necessary for the pass-through entity to comply with Circular A-133.
- Keep subrecipients' report submissions (or other written notification when the subrecipient is not required to submit a reporting package) on the file for three years from the date of receipt (see paragraphs 9.47, 10.76, and 10.78).

## **Audit Planning Considerations**

### ***Impact of Pass-Through Federal Awards on the Determination of Major Programs***

**9.20** As noted in paragraph 9.4, the determination of when a federal award is expended is based on when the activity related to the award occurs. With respect to federal awards provided by a pass-through entity to subrecipients, the federal awards are deemed to be expended by the pass-through entity when the funds are disbursed to subrecipients, regardless of when subrecipients expend the federal funds. Accordingly, the amount of federal funds disbursed to subrecipients should be included in the total expenditures of federal awards of the pass-through entity and in the determination of the pass-through entity's major programs (see chapter 7 for a more detailed discussion of the determination of major programs).

### ***Pass-Through Entity Request for a Program to Be Audited as a Major Program***

**9.21** When a subrecipient expends \$300,000 or more of federal awards, Circular A-133 permits the pass-through entity to request that the program be

audited as a major program in lieu of the pass-through entity conducting or arranging for additional audits. If the pass-through entity makes such a request, it is required to pay the full incremental cost for such an audit (see paragraph 2.19 for additional information).

### **Materiality**

**9.22** The auditor of the pass-through entity should compare the amount of federal funds passed through to subrecipients with the total expenditures for each individual major program or cluster to determine if the amount is material. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person who will rely upon the auditor's work. When the amount of federal funds passed through to subrecipients is material in relation to the major program being audited, the greater the need for the auditor to test the subrecipient-monitoring requirements. It should be noted that some federal programs are designed in such a manner that subrecipient expenditures are intended to be material to the pass-through entity's award. For example, the Community Services Block Grant requires a state to subgrant at least 90 percent of the state's award.

### **Consideration of Internal Control Over Compliance**

**9.23** As part of performing procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit of the pass-through entity to support a low assessed level of control risk for major programs, the auditor should consider the pass-through entity's internal control over compliance used to monitor subrecipients (see chapter 8 for an additional discussion of considerations concerning internal control over compliance). Tests of internal control over compliance used to monitor subrecipients may include inquiry, observation and inspection of documentation, or a reperformance by the auditor of some or all of the monitoring procedures identified in paragraph 9.28. The nature and extent of the tests performed will vary depending on the auditor's assessment of inherent risk, understanding of the internal control over compliance, materiality, and professional judgment. Auditors should consider referring to part 6 of the *Compliance Supplement*, which describes (among other things) certain characteristics of internal control over compliance that, when present and operating effectively, may ensure compliance with program requirements for subrecipient monitoring. The results of the auditor's testing of internal control over compliance assist in determining the nature, timing, and extent of subrecipient monitoring compliance testing.

### **Subrecipient Monitoring**

**9.24** The Single Audit Act requires the pass-through entity to monitor subrecipients' use of federal awards through site visits, limited scope audits, or other means. Since the pass-through entity is held accountable for federal awards administered by their subrecipients, the pass-through entity needs to establish an appropriate subrecipient-monitoring process and to decide what, if any, additional monitoring procedures may be necessary to ensure the subrecipients' compliance. Arrangements for subrecipient monitoring should be made by the pass-through entity in its agreements with subrecipients.

**9.25** Auditors must consider subrecipient monitoring in a compliance audit of an entity that disburses to subrecipients federal awards that are mater-

ial to a major program (see the discussion of materiality in paragraph 9.22). The auditor should consider whether the pass-through entity monitors subrecipients and has established internal control over compliance that provides reasonable assurance that subrecipients are managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of the pass-through entity's major programs.

### **Compliance Supplement Guidance**

**9.26** One of the fourteen types of compliance requirements included in the *Compliance Supplement* is subrecipient monitoring. The *Compliance Supplement* identifies several audit objectives for subrecipient monitoring. According to the *Compliance Supplement*, in a single audit of a pass-through entity, the auditor should determine whether the pass-through entity—

- Identified the federal award's information and compliance requirements to the subrecipient.
- Monitored the subrecipient's activities to provide reasonable assurance that the subrecipient administered federal awards in compliance with federal requirements.
- Ensured that the required audits were performed, and required appropriate corrective action concerning monitoring and audit findings.
- Evaluated the impact of subrecipient activities on the pass-through entity.

**9.27** The *Compliance Supplement* also identifies the suggested audit procedures for testing the compliance audit objectives for pass-through entities (see paragraph 6.44 for a further discussion of suggested audit procedures). The auditor may consider coordinating the subrecipient-related tests performed as part of activities allowed or unallowed (tests that subrecipient agreements were for allowable activities), cash management (tests of cash reports submitted by subrecipients), eligibility (tests that subawards were made only to eligible subrecipients), and procurement (tests of suspension and debarment certifications) with the tests of subrecipient monitoring.

### **Pass-Through Entity Monitoring Procedures**

**9.28** The monitoring procedures used by the pass-through entity may include on-site visits, reviews of documentation supporting requests for reimbursement, and limited-scope audits. Section 230(b)(2) of Circular A-133 defines limited-scope audits as agreed-upon procedures engagements that are conducted in accordance with either GAAS or the AICPA attestation standards, and that are paid for and arranged by a pass-through entity and only address one or more of the following types of compliance requirements: activities allowed or unallowed; allowable costs/cost principles; eligibility; matching; level of effort, earmarking; and reporting. Following are other monitoring procedures that a pass-through entity may perform:

- Reviewing grant applications submitted by subrecipients to determine that—
  - Applications are filed and approved in a timely manner
  - Each application contains the condition that the subrecipient comply with the federal requirements set by the federal agency



- Establishing internal control over compliance to provide reasonable assurance that—
  - Funds are disbursed to subrecipients only on an as-needed basis
  - Funds are disbursed to subrecipients only on the basis of approved, properly completed reports submitted on a timely basis
  - Refunds that are due from subrecipients are billed and collected in a timely manner
  - Subrecipients and other entities and individuals receiving federal funds meet eligibility requirements
- Reviewing financial and technical reports received from subrecipients on a timely basis and investigating unusual items
- Reviewing subrecipient audit reports, to evaluate them for completeness and for compliance with applicable laws and regulations
- Evaluating audit findings; issuing appropriate management decisions, if necessary; and determining if an acceptable plan for corrective action has been prepared and implemented
- Reviewing previously detected deficiencies and determining that corrective action was taken

### ***Monitoring When the Subrecipient Has a Single or Program-Specific Audit***

**9.29** As noted in paragraph 9.3, subrecipients that expend \$300,000 or more in federal awards are required to have a single or program-specific audit in accordance with Circular A-133. If subrecipients have a single or program-specific audit, the pass-through entity's receipt and review of the results of that audit and its action on related findings may be sufficient to meet the subrecipient-monitoring requirements of Circular A-133. However, it is more likely that the receipt and review of such audit results should be merely one tool that should be used by the pass-through entity as part of a comprehensive subrecipient-monitoring process. Pass-through entities should be aware that a single audit is likely to provide varying degrees of assurance concerning a particular program. For example, a pass-through award may not have been tested as a major program as part of a subrecipient's audit. For this reason, the pass-through entity should consider the testing and results of the single audit of the subrecipient to determine what effect those results should have on other monitoring procedures employed by the pass-through entity.

**9.30** In many cases, the pass-through entity will not have received all the subrecipient audit reports covering the time period being audited at the pass-through entity in time to incorporate the results into its own audit. The reports for the pass-through entity and the subrecipient are not required to be issued simultaneously, but the pass-through entity is required to have internal control over compliance in place, to determine that subrecipient audit reports have been received and that corrective action is taken after the receipt of the subrecipient's audit. If the subrecipient's audit report is current, it need not cover the same period as the pass-through entity's audit. If the pass-through entity has an effective system for monitoring subrecipients, its auditor should be able to rely on the subrecipient's audit cycle, even if it is not coterminous with the pass-through recipient's fiscal year.

### ***Considering Risk Factors When Developing Monitoring Procedures***

**9.31** The preamble to Circular A-133 states that the OMB expects pass-through entities to consider various risk factors (such as the relative size and

complexity of the federal awards administered by subrecipients, the entity's prior experience with each subrecipient, and the cost-effectiveness of various monitoring procedures) in developing subrecipient-monitoring procedures. For example, if a pass-through entity provides a large percentage of the only federal award it expends to ten subrecipients that each expend less than \$300,000 in federal awards annually, the pass-through entity should carefully consider the most cost-effective method of monitoring these federal awards. Perhaps the majority of this federal award is provided to two subrecipients. The pass-through entity might consider conducting site visits at these two subrecipients and simply reviewing the documentation supporting requests for reimbursement from the other eight subrecipients. Conversely, if a small percentage of a federal award is provided to subrecipients that each expend less than \$300,000 in federal awards, the risk to the pass-through entity is most likely low and, therefore, the monitoring procedures could be minimal.

### **Unallowable Audit Costs**

**9.32** For subrecipients that expend less than \$300,000 in federal awards annually, the cost of any audits or attestation engagements (other than the limited-scope audits paid for and arranged by a pass-through entity as described in paragraph 9.28), are not allowable costs and, therefore, cannot be charged to any federal award. Accordingly, Circular A-133 would prohibit the cost of a financial statement audit conducted in accordance with GAAS or *Government Auditing Standards* from being charged (by either a pass-through entity or subrecipient) to federal awards for a subrecipient that expends less than \$300,000 in federal awards annually. The allowability of audit costs is discussed in greater detail in paragraph 2.12.

### **When the Subrecipient Monitoring System Is Not Sufficient**

**9.33** The auditor may determine that the pass-through entity's subrecipient-monitoring system is not sufficient to ensure subrecipient's compliance with laws, regulations, and the provisions of grants and contracts. In this situation, the auditor should report a reportable condition (and possibly a material weakness) and consider whether the insufficient monitoring system represents an instance of noncompliance that should be reported as a compliance finding. The effect of the noncompliance on the opinion on compliance for major programs is primarily a function of the pervasiveness of the lack of monitoring and the materiality of subrecipient funding to a program. For example, if the pass-through entity did not perform subrecipient-monitoring procedures and 90 percent of the program was passed through to subrecipients, an opinion modification would likely be warranted. This would likely be the case even if the scope of the audit was expanded to include additional audit procedures to determine that the subrecipients actually complied with laws and regulations.

**9.34** There may be instances in which the pass-through entity asks the auditor to perform additional procedures to determine the compliance of a subrecipient (such as conducting tests of records at the subrecipient's site). This would be considered an expansion of the scope of the audit. The auditor should be aware that such an expansion of the scope of the audit would not be sufficient to remedy the reportable condition (or material weakness) and, if applicable, noncompliance of the pass-through entity's monitoring system. However, an expansion of the scope of the audit may remedy the noncompliance related to the type of compliance requirement being tested (for example, eligibility).

**9.35** The auditor should also consider any implications of an insufficient subrecipient-monitoring system on the opinion on the financial statements. If amounts passed through to subrecipients are considered material to the financial statements of the pass-through entity, the auditor should determine whether the report on the financial statements should be modified. Before making this determination, the auditor should take into consideration any evidential matter that may be available to the auditor (such as subrecipients' Circular A-133 audit reports and other financial reports that may have been submitted to the pass-through entity) that could indicate that the subrecipients administered the program in compliance with laws and regulations. Further, the auditor should also consider whether it is necessary to report an internal control or compliance finding in the report issued to meet the requirements of *Government Auditing Standards*.

## **Reporting Considerations**

### ***Schedule of Expenditures of Federal Awards***

**9.36** Circular A-133 states that, to the extent practical, pass-through entities should identify in the schedule of expenditures of federal awards the total amount provided to subrecipients from each federal program (see chapter 5 for an additional discussion of the schedule). If a pass-through entity is unable to identify amounts provided to subrecipients, the auditor should consider whether a reportable condition (and possibly a material weakness) should be reported. The auditor should also consider whether material non-compliance (for subrecipient monitoring) that is required to be reported as an audit finding has occurred.

### ***Evaluation of Audit Findings***

**9.37** Circular A-133 requires the auditor to consider a finding in relation to the type of compliance requirement (subrecipient monitoring, in this case) or an audit objective identified in the *Compliance Supplement*, whether or not the finding can be quantified. For example, the auditor may discover that a pass-through entity consistently failed to provide its subrecipients with federal award information, including applicable compliance requirements. The pertinent audit objective included in the *Compliance Supplement* and relating to this example is for the auditor to "determine whether the pass-through entity identifies federal award information and compliance requirements to the subrecipient." Because the pass-through entity failed to provide federal award information to its subrecipients, this noncompliance is material in relation to the audit objective and, therefore, must be reported as an audit finding. In addition, the auditor must consider whether reportable conditions (and possibly, material weaknesses in internal control) exist and require reporting with respect to subrecipient monitoring.

### ***Effect of Subrecipients' Noncompliance on the Pass-Through Entity's Report***

**9.38** The instances of noncompliance reported in subrecipients' audit reports are not required to be included in the pass-through entity's audit report. However, the auditor of the pass-through entity should consider the effects of reported instances of subrecipient noncompliance or indications of weaknesses in the pass-through entity's subrecipient-monitoring system that could have a material effect on each of the pass-through entity's major programs.

### ***Adjustment of Pass-Through Entity Financial Records and Reports***

**9.39** Questioned costs at the subrecipient level that are found to be unallowable by the pass-through entity may require the pass-through entity to adjust its financial records and its federal expenditure reports. The total of allowable program costs in excess of required expenditure levels and the requirements of individual programs regarding the timing of claims will affect whether the pass-through entity will need to reflect a liability to the awarding agency in its financial statements. As part of the finding-resolution process, the pass-through entity should estimate the total unallowable costs that are associated with each subrecipient finding and consider the need to adjust financial records and federal expenditure reports. The failure of the pass-through entity to adjust its records and federal reports should be considered by the auditor in forming an opinion on compliance for major programs.

### **For-Profit Subrecipients**

**9.40** Since Circular A-133 does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. Circular A-133 states that the contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the contract, and post-award audits. The auditor's responsibilities related to for-profit subrecipients are similar to those of not-for-profit subrecipients, see paragraphs 9.24 through 9.35 (as applicable) for a further discussion of subrecipient monitoring.

### **Non-U.S.-Based Entities**

**9.41** Circular A-133 does not apply to non-U.S.-based entities expending federal awards received either directly as a recipient or indirectly as a subrecipient (see paragraph 2.6 for a further discussion of non-U.S.-based entities). Therefore, the responsibilities that a pass-through entity and its auditor have for a non-U.S.-based entity are the same as those for a for-profit subrecipient (see paragraph 9.40).

### **State Designation of a Cluster of Programs**

**9.42** Circular A-133 includes a provision that allows a state to designate as a cluster a grouping of closely related programs that share common compliance requirements. When designating a cluster of programs, a state is required by Circular A-133 to identify the federal awards included in the cluster and to advise subrecipients of the compliance requirements applicable to the cluster. See paragraphs 1.18, 1.19, 2.18, 5.6, 7.4, and 8.30 for additional discussion of clusters.

### **Circular A-133 Audit Considerations of Subrecipients**

**9.43** Auditors of subrecipients should be aware that subrecipients have additional considerations under Circular A-133. These considerations are related to additional compliance requirements established by the pass-through entity, information included in the schedule of expenditures of federal awards, audit findings, and the submission of the report.

## **Additional Compliance Requirements Established by Pass-Through Entities**

**9.44** Federal awards are normally distributed to subrecipients only on the basis of properly completed and approved awards. These written agreements require subrecipients to comply with the requirements of the federal agency and, in some instances, additional requirements established by the pass-through entity. Hence, in addition to providing an audit satisfying the requirements of Circular A-133, the auditor may be engaged to test compliance with requirements specified by the pass-through entity.

## **Information Included in the Schedule of Expenditures of Federal Awards**

**9.45** For federal awards received as a subrecipient, the schedule of expenditures of federal awards is required to include the name of the pass-through entity and identifying number assigned by the pass-through entity. Circular A-133 states that to make the schedule easier to use, subrecipients may choose to provide information requested by federal awarding agencies and pass-through entities, although this information is not required. Chapter 5 includes more detailed information about the schedule.

## **Audit Findings**

**9.46** Audit findings (for example, internal control findings, compliance findings, questioned costs, or fraud) that relate to the same issue should be presented as a single audit finding. Circular A-133 states that where practical, audit findings should be organized by federal agency or pass-through entity (see chapter 10 for an additional discussion of audit findings).

## **Submission of Report**

**9.47** Section 320(e) of Circular A-133 has additional report-submission responsibilities for subrecipients. When a subrecipient is not required to submit a reporting package to the pass-through entity (because it has no audit findings or the summary schedule of prior audit findings does not report the status of any audit findings), the subrecipient is required to provide written notification of this to the pass-through entity. The required contents of the written notification and the submission of the report by subrecipients are discussed in paragraph 10.76.

## Chapter 10

# AUDITOR REPORTING REQUIREMENTS AND OTHER COMMUNICATION CONSIDERATIONS IN A SINGLE AUDIT

### Overview

**10.1** In this chapter the auditor's reporting requirements and other communication considerations in a single audit under Circular A-133 are discussed. The auditor's reporting requirements in a program-specific audit are discussed in chapter 11.

**10.2** The auditor's reporting responsibilities in a single audit are driven by the three levels of auditing standards and requirements: GAAS, *Government Auditing Standards*, and Circular A-133. These standards and requirements expand the level of auditor responsibility from reporting on an auditee's financial statements to also reporting on internal control and on compliance. The auditor has additional reporting responsibilities for the audit of the financial statements in accordance with *Government Auditing Standards* (see chapter 4), and for the compliance audit applicable to major programs in accordance with Circular A-133 (see chapters 6 through 8). The auditor also has additional communication considerations under GAAS and *Government Auditing Standards* related to matters noted in the single audit.

### Circular A-133 Requirements

#### *Auditor's Reports*

**10.3** Circular A-133 requires the auditor's report(s) to include—

- An opinion (or disclaimer of opinion) on whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP) (see paragraph 10.12 for a discussion of the basis of accounting) and an opinion (or a disclaimer of opinion) on whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole.
- A report on the internal control related to the financial statements and on the internal control related to major programs. This report must describe the scope of testing of internal control and the results of the tests and, where applicable, must refer to the separate schedule of findings and questioned costs.
- A report on compliance with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements. This report must also include an opinion (or a disclaimer of opinion) on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each major program, and where applicable, must refer to the separate schedule of findings and questioned costs.

- A schedule of findings and questioned costs (see paragraphs 10.55 through 10.67).

The auditor's reports recommended in this SOP are described in paragraphs 10.8 through 10.10 below.

### **Data Collection Form**

10.4 Circular A-133 also requires the auditor to complete applicable sections and sign a data collection form that summarizes the auditor's results, findings, and questioned costs (see paragraphs 10.71 through 10.73).

### **Other Communication Considerations**

10.5 The auditor has certain additional communication considerations under GAAS and *Government Auditing Standards* related to internal control, noncompliance, fraud, illegal acts, and other matters noted in the single audit (see paragraphs 10.13 through 10.30).

### **Reporting Package**

10.6 The auditee is required to submit a reporting package that includes the following:

- Financial statements and a supplementary schedule of expenditures of federal awards (see chapters 4 and 5);
- Auditor's reports (see paragraphs 10.8 through 10.10);
- A summary schedule of prior audit findings (see paragraphs 10.68 through 10.70);
- A corrective action plan (see paragraphs 10.68 through 10.70).

10.7 Although not part of the reporting package, the report submission to the Federal Audit Clearinghouse (FAC) must also include the data collection form described in paragraphs 10.71 through 10.73. The requirements for report submission are discussed in paragraphs 10.74 through 10.79.

### **Recommended Auditor's Reports**

10.8 Reporting on a financial statement audit and on the compliance requirements applicable to each major program involves varying levels of materiality and different forms of reporting. Circular A-133 states that the auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in the circular. In an effort to make the reports understandable and to reduce the number of reports issued, this SOP recommends that the following reports be issued:

- a. An opinion on the financial statements and on the supplementary schedule of expenditures of federal awards (see paragraph 10.35 through 10.37)<sup>1</sup>
- b. A report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards* (see paragraphs 10.38 through 10.40)

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<sup>1</sup> Note that in certain circumstances the auditor may report on the schedule of expenditures of federal awards in his or her report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with Circular A-133. See paragraph 10.36 for a further discussion.

- c. A report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with Circular A-133 (see paragraphs 10.46 through 10.54)
- d. A schedule of findings and questioned costs (see paragraphs 10.55 through 10.67)

10.9 Example reports are provided in appendix D of this SOP. As noted previously, those reports combine reports on compliance and internal control at the financial statement audit level and at the major program compliance audit level. Auditors need to understand the intended purpose of the reports and should tailor the reporting to the specific auditee situation. Because the reports issued to comply with Circular A-133 involve varying levels of materiality and different forms of reporting, auditors should exercise care in issuing reports to ensure that they meet all of the varying reporting requirements of GAAS, *Government Auditing Standards*, and Circular A-133. The basic elements of each of the recommended reports are discussed later in this chapter. Professional judgment should be exercised in any situation not specifically addressed in this SOP.

10.10 Table 10.1 provides a matrix depicting the recommended auditor's reports in a single audit required by GAAS, *Government Auditing Standards*, and Circular A-133.

Table 10.1

Report	Required by—		
	GAAS	Government Auditing Standards	Circular A-133
Opinion (or disclaimer of opinion) on financial statements and supplementary schedule of expenditures of federal awards	X	X	X
Report on compliance and on internal control over financial reporting based on an audit of financial statements		X	X
Report on compliance and internal control over compliance applicable to each major program (this report must include an opinion [or a disclaimer of opinion] on compliance)			X
Schedule of findings and questioned costs			X

Reporting on the Financial Statements and Supplementary Schedule of Expenditures of Federal Awards in Accordance With GAAS and *Government Auditing Standards*

10.11 In this section the reporting and additional communication requirements under GAAS and *Government Auditing Standards* that are related to a financial statement audit and the supplementary schedule of expenditures of federal awards are discussed.



## Basis of Accounting

**10.12** Circular A-133 and *Government Auditing Standards* do not prescribe the basis of accounting that must be used by auditees to prepare their financial statements and the schedule of expenditures of federal awards. However, auditees are required to disclose the basis of accounting and the significant accounting policies used in preparing the financial statements and the schedule of expenditures of federal awards. The auditee must also be able to reconcile amounts presented in the financial statements to related amounts included in the schedule of expenditures of federal awards. The auditor is required to report whether the financial statements are presented fairly in all material respects in conformity with GAAP and whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole (see paragraphs 4.3 and 10.13 for a discussion of the auditor's responsibilities when the auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP).

## GAAS Requirements

**10.13** The applicable reporting requirements are established in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508). For an auditee that prepares its financial statements in conformity with a basis of accounting other than GAAP, auditors should follow the guidance in SAS No. 62, *Special Reports*. In reporting on the supplementary schedule of expenditures of federal awards, auditors should follow the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551). Auditors may also refer to the AICPA Audit and Accounting Guides *Not-For-Profit Organizations*, *Audits of State and Local Governmental Units*, *Health Care Organizations*, and *Audits of Colleges and Universities*<sup>2</sup> for additional guidance on reporting on the financial statements of specific industries. See also paragraphs 10.17 through 10.30 for a discussion of additional reporting and communication requirements.

**10.14** SAS No. 61, *Communication With Audit Committees*, requires the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for the oversight of the financial reporting process. Matters to be communicated include (among other things) the auditor's responsibilities, significant accounting policies, management judgments and accounting estimates, significant audit adjustments, disagreements with management, and difficulties encountered in performing the audit. In addition to the SAS No. 61 requirements described above, *Government Auditing Standards* also requires the auditor to communicate certain information to the audit committee. See paragraph 10.16 for a further discussion.

## Government Auditing Standards Requirements

**10.15** Government Auditing Standards requires that in addition to reporting on the financial statements, the auditor report on (1) compliance with laws, regulations, and provisions of contracts and grant agreements that could

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<sup>2</sup> Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

have a direct and material effect on the financial statements amounts and (2) the scope of testing of the auditee's internal control over financial reporting and on the results of the tests.

**10.16** The reporting standards for financial audits in *Government Auditing Standards* contain five additional reporting standards for financial statement audits beyond GAAS (see also paragraphs 3.19 through 3.21):

- a. Auditors should communicate certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit. Such matters include the auditor's responsibility in a financial statement audit, as well as the nature of any additional testing of internal control and compliance required by laws or regulations. To help audit committees and other responsible parties understand the limitations of auditors' responsibilities for testing and reporting on internal control and compliance, auditors should contrast those responsibilities with other financial related audits of controls and compliance. The communication may be oral or in writing. If the information is communicated orally, the auditor is required to document the communication in the working papers (see paragraphs 5.5 through 5.10 of *Government Auditing Standards* and paragraphs 3.19 through 3.20 of this SOP for a further discussion).
- b. When the report on the financial statement is submitted to comply with a requirement for an audit in accordance with *Government Auditing Standards*, audit reports should state that the audit was made in accordance with generally accepted government auditing standards. This SOP recommends the following language be included in the auditor's report to meet this requirement: "we conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States."<sup>3</sup> *Government Auditing Standards* also acknowledges that an auditee may need a financial statement audit for purposes other than to comply with a requirement calling for an audit in accordance with *Government Auditing Standards*. For example, the auditee may need a financial statement audit to issue bonds. In this case, *Government Auditing Standards* permits auditors to issue a separate report on the financial statements conforming only to the requirements of GAAS (see paragraphs 5.11 through 5.14 of *Government Auditing Standards*).
- c. The report on the audit of the financial statements should either (1) describe the scope of the auditor's testing of compliance with laws and regulations and internal control and present the results of those tests or (2) refer to separate reports containing that information (see paragraphs 5.15 through 5.28 of *Government Auditing Standards*). The financial statement reporting recommended in this SOP (appendix D, examples 1 and 1a), illustrates the second option to refer to a separate report on compliance with certain provisions of laws, regulations, contracts, and grants and on internal control over financial reporting. In presenting the results of tests, the auditor should report

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<sup>3</sup> The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

fraud, illegal acts, other material noncompliance, and reportable conditions in internal control (see paragraphs 10.17 through 10.30). In some circumstances, the auditor should report fraud and illegal acts directly to parties external to the audited entity (see paragraphs 10.23 through 10.25).

- d. If certain information is prohibited from general disclosure (that is, prohibited from general disclosure by federal, state, or local laws or regulations), the audit report should state the nature of the information omitted and the requirement that makes the omission necessary (see paragraphs 5.29 through 5.31 of *Government Auditing Standards*).
- e. Written audit reports are to be submitted by the audit organization to the appropriate officials of the auditee and to the appropriate officials of the organizations requiring or arranging for the audit (including external funding organizations), unless legal restrictions prevent it.<sup>4</sup> Copies of the reports should also be sent to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations and to others authorized to receive such reports. Unless restricted by law or regulation, copies should be made available for public inspection (see paragraphs 5.32 through 5.35 of *Government Auditing Standards*).

## Fraud, Illegal Acts, and Other Noncompliance

### GAAS Requirements

**10.17** In SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317.17), the auditor's responsibilities with respect to the consideration of illegal acts,<sup>5</sup> including communications with the audit committee or others with equivalent authority or responsibility are discussed.<sup>6</sup> Paragraph 17 of SAS No. 54, requires the auditor to assure himself or herself that the audit committee or others with equivalent authority and responsibility are adequately informed with respect to illegal acts that come to the auditor's attention. The auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the audit committee on the nature of such matters to be communicated. The communication should describe the act, the circumstances of its occurrence, and its effect on the financial statements. If senior management is involved, the auditor should communicate directly with the audit committee. The communication may be oral or written. If the communication is oral, the auditor should document it. Paragraphs 4.24 through 4.31 summarize the other requirements of SAS No. 54. The auditor should also consider the effect of any noncompliance on the financial statements, and should modify the auditor's report on those financial statements as necessary in accordance with SAS No. 58.

**10.18** The auditor's responsibilities for communications about fraud to management, the audit committee, and others based on a financial statement

<sup>4</sup> Note that when public accountants are engaged, the engaging organization should ensure that the report is distributed appropriately.

<sup>5</sup> SAS No. 54 defines the term *illegal acts* as violations of laws or government regulations.

<sup>6</sup> For auditees that do not have audit committees, the phrase "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, or the owner in owner-managed entities.

audit in accordance with GAAS are discussed in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*. Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is generally appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the auditee's organization. Fraud involving senior management and fraud that causes a material misstatement of the financial statements should be reported directly to the audit committee. The disclosure of possible fraud to parties other than the auditee's senior management and its audit committee is ordinarily not part of the auditor's responsibility and would ordinarily be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report. The auditor should recognize, however, that in the following circumstances a duty to disclose outside the auditee may exist:

- To comply with certain legal and regulatory requirements
- To a successor auditor when the successor makes inquiries in accordance with SAS No. 84, *Communications Between Predecessor and Successor Auditors*
- In response to a subpoena
- To a funding agency or other specified agency in accordance with the requirements for audits of entities that receive governmental financial assistance (see paragraphs 10.23 through 10.25)

**10.19** When the auditor, as a result of the assessment of the risk of material misstatement due to fraud, has identified risk factors that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected), the auditor should consider whether these risk factors represent reportable conditions that relate to the auditee's internal control and that should be communicated to senior management and the audit committee (see paragraphs 10.26 through 10.30). The auditor may also wish to communicate other risk factors that are identified, when the auditee can reasonably take actions to address the risk.

**10.20** In paragraphs 38 through 40 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.38–40), the communication requirements of SAS No. 82 are further discussed. In paragraphs 4.32 through 4.37 of this SOP, the other requirements of SAS No. 82 are summarized. See paragraphs 6.7 through 6.12 for a discussion of the auditor's consideration of fraud risk in an audit of an auditee's compliance with specified requirements applicable to its major programs.

### **Government Auditing Standards Requirements**

**10.21** With regard to fraud and illegal acts, *Government Auditing Standards* requires auditors to report relevant information (in writing) when the auditor concludes, based on evidence obtained, that fraud or an illegal act has occurred or is likely to have occurred.<sup>7</sup> Auditors do not need to report information about fraud or illegal acts that is clearly inconsequential. Therefore, auditors are required to present in the report the same fraud and illegal acts that they report to audit committees under GAAS (see paragraphs 10.17 through

<sup>7</sup> The term *fraud*, as used in SAS No. 82, is synonymous with *irregularities* as used in *Government Auditing Standards*. Therefore, in discussing the requirements of *Government Auditing Standards*, this SOP will use the term *fraud* instead of the term *irregularities*.

10.20). *Government Auditing Standards* also requires auditors to report other noncompliance (for example, a violation of a contract provision) that is material to the financial statements. In presenting fraud, illegal acts, or other noncompliance that are required to be reported, auditors should follow the report contents standards in chapter 7 of *Government Auditing Standards* for objectives, scope, and methodology; audit results; the views of responsible officials; and report presentation standards (as appropriate).

**10.22** When auditors detect fraud, illegal acts, or other noncompliance that do not meet the criteria in paragraph 5.18 of *Government Auditing Standards* for reporting (summarized in paragraph 10.21), paragraph 5.20 of *Government Auditing Standards* requires auditors to communicate those findings to the auditee, preferably in writing. If auditors have communicated those findings in a management letter to top management, they should refer to that management letter when they are reporting on compliance. Auditors should document in their working papers all communications to the auditee about fraud, illegal acts, or other noncompliance.

### ***Direct Reporting of Fraud and Illegal Acts***

**10.23** Paragraphs 5.21 through 5.25 of *Government Auditing Standards* provide guidance on the direct reporting of fraud and illegal acts. *Government Auditing Standards* requires that in addition to any legal requirements for the direct reporting of fraud or illegal acts, auditors must report fraud or illegal acts directly to parties outside the auditee in the following two circumstances (auditors should meet these requirement even if they have resigned or been dismissed from the audit):

- a. The auditee may be required by law or regulation to report certain fraud or illegal acts to specified external parties (for example, to a federal inspector general or a state attorney general). If auditors have communicated such fraud or illegal acts to the auditee, and it fails to report them, then auditors should communicate their awareness of that failure to the auditee's governing body. If the auditee does not make the required report as soon as practicable after the auditors' communication with its governing body, then the auditors should report the fraud or illegal acts directly to the external party specified in the law or regulation.
- b. When fraud or an illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report it directly if management fails to take remedial steps. If auditors conclude that such failure is likely to cause them to depart from the standard report on the financial statement or resign from the audit, then they should communicate that conclusion to the auditee's governing body. Then, if the auditee does not report the fraud or illegal act as soon as practicable to the entity that provided the government assistance, the auditors should report the fraud or illegal act directly to that entity.

**10.24** In both of these situations, auditors should obtain sufficient, competent, and relevant evidence (for example, by confirmation with outside parties) to corroborate assertions by management that it has reported fraud or illegal acts. If they are unable to do so, the auditors should report the fraud or illegal acts directly, as discussed previously.

**10.25** Paragraph 4.16 of *Government Auditing Standards* reminds auditors that under some circumstances, laws, regulations, or policies may require

them to report indications of certain types of fraud or illegal acts promptly to law enforcement or investigatory authorities. When auditors conclude that this type of fraud or illegal act either has occurred or is likely to have occurred, they should ask those authorities, legal counsel, or both, if reporting certain information about that fraud or illegal act would compromise investigative or legal proceedings. Auditors should limit their reporting to matters that would not compromise those proceedings, such as information that is already a part of the public record.

## Internal Control Over Financial Reporting

**10.26** SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, provides guidance in identifying and reporting conditions that relate to an auditee's internal control observed during an audit of financial statements. In addition to providing guidance on communicating reportable conditions and identifying material weaknesses in the internal control over financial reporting, SAS No. 60 states that because timely communication may be important, the auditor may choose to communicate significant matters related to the internal control over financial reporting during the course of the audit rather than after the audit is concluded.

**10.27** Written reporting on internal control matters under *Government Auditing Standards* is based on the auditor's consideration of the internal control over financial reporting as required by SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*. The report does not express an opinion on the auditee's internal control over financial reporting, but rather describes the extent of the work performed, as required by SAS No. 55. The report includes the requirements of SAS No. 60, as well as the additional requirements of *Government Auditing Standards*.

**10.28** With regard to matters noted in an audit that relate to the internal control over financial reporting, paragraph 5.26 of *Government Auditing Standards* requires auditors to report deficiencies in internal control that they consider to be reportable conditions as defined by SAS No. 60. Paragraph 17 of SAS No. 60 prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. The illustrative report in example 2 of appendix D provides recommended language that satisfies the requirements of *Government Auditing Standards* when no reportable conditions are noted during an audit. In reporting reportable conditions, auditors are required to identify those that are individually or cumulatively material weaknesses. Auditors should follow the report contents standards in chapter 7 of *Government Auditing Standards* when reporting reportable conditions or material weaknesses. The illustrative report in example 2a of appendix D provides recommended language that satisfies the requirements of *Government Auditing Standards* when reportable conditions (whether or not they are considered to be material weaknesses) are noted during an audit.

**10.29** Paragraph 5.28 of *Government Auditing Standards* states that when auditors detect deficiencies in the internal control that are not reportable conditions, they should communicate those deficiencies to the auditee, preferably in writing. If the auditors have communicated those deficiencies in internal control in a management letter to top management, they should refer to that management letter when they report on internal control (examples 2 and

2a of appendix D illustrate such a reference to the management letter). All communications to the auditee about deficiencies in the internal control should be documented in the working papers.

**10.30** The following table summarizes the differences between SAS No. 60 and *Government Auditing Standards* with respect to reporting internal control matters.

	Government Auditing Standards	SAS No. 60
When is reporting required?	In every financial statement audit	When reportable conditions are noted
What is the form of the report?	Written	Oral or written, preferably in writing
Should the auditor separately identify those reportable conditions that are significant enough to be material weaknesses?	Yes	Permitted but not required

### Reporting When Portions of a Governmental Reporting Entity Do Not Have an Audit in Accordance With *Government Auditing Standards*

**10.31** Since the implementation of Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, it is becoming more frequent for governments that are required to have an audit in accordance with *Government Auditing Standards* to include as part of the reporting entity component units that are not required to have such an audit. When this occurs, the auditor should consider modifying his or her report on the financial statements and also the report issued to meet the requirements of *Government Auditing Standards*.

**10.32** With regard to the report on the financial statements of the reporting entity, if a material component unit or fund is not required to have an audit in accordance with *Government Auditing Standards* and the report on the financial statements is required to state that the audit was performed in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of the report on the financial statements to indicate the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards*. Example wording that could be used in this situation follows:

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of [name of fund or component unit] were not audited in accordance with *Government Auditing Standards*. An audit includes examining . . .

**10.33** With regard to the report issued on compliance and on the internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of example 2 or 2a of appendix D to indicate

the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards*. Example wording that could be used in this situation follows:

We have audited the financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The financial statements of [name of fund or component unit] were not audited in accordance with *Government Auditing Standards*.

### **Implementing Regulations of Certain Federal Awarding Agencies May Define Entity to Be Audited Differently Than GAAP**

**10.34** The regulations implementing Circular A-133 may define the entity to be audited for single audit purposes differently than the reporting entity would be defined in accordance with GAAP. For example, SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, requires presentation of consolidated financial statements when one NPO (the parent) controls the voting majority of the Board of and has an economic interest in another NPO. If the regulations of the federal agency that provides federal awards to the parent define the entity for single audit purposes to consist of only the parent, audited parent-only financial statements instead of consolidated financial statements must be submitted to comply with these regulations. If consolidated financial statements are not also prepared as required by GAAP, the auditor should consider whether other than an unqualified opinion due to a material departure from GAAP should be expressed on the parent-only financial statements. See paragraphs 35 through 60 of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.35–.60) for guidance on reporting when there is a departure from GAAP.

### **Opinion on the Financial Statements and on the Supplementary Schedule of Expenditures of Federal Awards**

#### **Report Requirements**

**10.35** The auditor's standard report on the financial statements and on the supplementary schedule of expenditures of federal awards identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion on the financial statements and supplementary schedule of expenditures of federal awards in separate opinion paragraphs. The basic elements of the report are—

- a. A title that includes the word *independent*.
- b. A statement that the financial statements identified in the report were audited.
- c. A statement that the financial statements are the responsibility of the auditee's management and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit.



- d. A statement that the audit was conducted in accordance with GAAS and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.<sup>8</sup>
- e. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
- f. A statement that an audit includes—
  - Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
  - Assessing the accounting principles used and significant estimates made by management.
  - Evaluating the overall financial statement presentation.
- g. A statement that the auditor believes that the audit provides a reasonable basis for his or her opinion.
- h. For a government, an opinion on whether the financial statements present fairly, in all material respects, the financial position of the auditee as of the balance sheet date, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the period then ended in conformity with GAAP; for a not-for-profit organization, an opinion on whether the financial statements present fairly, in all material respects, the financial position of the auditee as of the date of the statement of financial position, and the changes in its net assets and its cash flows for the period then ended in conformity with GAAP.<sup>9</sup>
- i. A reference to the separate report on compliance with certain provisions of laws, regulations, contracts, and grant agreements and on the internal control over financial reporting prepared in accordance with *Government Auditing Standards*.<sup>10</sup> If this reporting is included in the report on the financial statements, this reference is not required (this SOP recommends separate reporting). See paragraph 10.16.
- j. A description of the accompanying supplementary information (for example, the schedule of expenditures of federal awards, combining and individual fund and account group financial statements and schedules, etc.). This identification may be by descriptive title or by page number of the document.
- k. A statement that the accompanying supplementary information, including the schedule of expenditures of federal awards required by Circular A-133, is presented for purposes of additional analysis and is not a required part of the financial statements.<sup>11</sup> See paragraph 10.36.

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<sup>8</sup> See footnote 3.

<sup>9</sup> If an auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP, the auditor is still required to express or disclaim an opinion and should follow the reporting in SAS No. 62, *Special Reports*.

<sup>10</sup> See paragraphs 10.15, 10.16, and 10.21 through 10.30 for a discussion of reporting on compliance and on the internal control based on a financial statement audit in accordance with *Government Auditing Standards*.

<sup>11</sup> If the report on the financial statements is issued for an audit that is not subject to Circular A-133 (that is, an audit in accordance with GAAS and *Government Auditing Standards* only), this reference to the schedule of expenditures of federal awards and Circular A-133 should be deleted.

- l. An opinion on whether the accompanying supplementary information is fairly stated, in all material respects, in relation to the financial statements taken as a whole.
- m. The manual or printed signature of the auditor's firm.
- n. The date of the audit report.

### **Reporting on the Schedule of Expenditures of Federal Awards**

**10.36** This SOP recommends that the auditor report on the schedule of expenditures of federal awards in the report on the financial statements. However, some entities do not present the schedule with the financial statements (that is, a separate single audit package is issued). In such a circumstance, the required reporting on the schedule may be incorporated in the report issued to meet the requirements of Circular A-133. Examples 3 (footnote 34) and 3a (footnote 40) of appendix D, illustrate how to incorporate the reporting on the schedule into the Circular A-133 report. See also paragraphs 10.50 through 10.52 for information on dating the reports in this situation and paragraph 10.13 for a further discussion of reporting on the schedule.

**10.37** Examples of the auditor's opinion on the financial statements and on the supplementary schedule of expenditures of federal awards are presented in examples 1 and 1a of appendix D.

### **Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards***

**10.38** This SOP recommends that the reporting on the scope of the auditor's testing of compliance and on the internal control over financial reporting based on an audit of the financial statements as required by *Government Auditing Standards* be combined in one report (see paragraphs 10.8 through 10.10).

**10.39** The basic elements of the auditor's standard report on compliance and on the internal control over financial reporting (see paragraph 4.12) based on an audit of the financial statements in accordance with *Government Auditing Standards* are—

- a. A statement that the auditor has audited the financial statements of the auditee and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the audit was conducted in accordance with GAAS and with the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.<sup>12</sup>
- c. A statement that as part of obtaining reasonable assurance about whether the auditee's financial statements are free of material misstatement, the auditor performed tests of the auditee's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts.

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<sup>12</sup> See footnote 3.

- d. A statement that providing an opinion on compliance with those provisions was not an objective of the audit and that, accordingly, the auditor does not express such an opinion.
- e. A statement that notes whether the results of tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*<sup>13</sup> and, if they are, describes the instances of noncompliance or refers to the schedule of findings and questioned costs in which they are described.<sup>14</sup>
- f. If applicable, a statement that certain immaterial instances of non-compliance were communicated to management in a separate letter.<sup>15</sup>
- g. A statement that in planning and performing the audit, the auditor considered the auditee's internal control over financial reporting in order to determine the auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.
- h. If applicable, a statement that reportable conditions were noted and the definition of a reportable condition.
- i. If no reportable conditions are noted, a statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses; if reportable conditions are noted, a statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.
- j. If applicable, a description of the reportable conditions noted or a reference to the schedule of findings and questioned costs in which the reportable conditions are described.<sup>16</sup>
- k. The definition of a material weakness.
- l. If applicable, a statement about whether the auditor believes any of the reportable conditions noted are material weaknesses and, if they are, describes the material weaknesses noted or refers to the schedule of findings and questioned costs in which they are described.<sup>17</sup> If there are no reportable conditions noted, a statement is made that no material weaknesses were noted.

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<sup>13</sup> See paragraph 10.21 for a discussion of noncompliance matters that need to be reported under *Government Auditing Standards*.

<sup>14</sup> For an audit that is not subject to Circular A-133 (that is, in accordance with *Government Auditing Standards* only), any reportable instances of noncompliance, reportable conditions, and material weaknesses can either be described in the body of the report or the report can refer to a separate schedule that summarizes the findings noted. This statement should be modified accordingly. For an audit in accordance with Circular A-133, all findings, including those required to be reported under *Government Auditing Standards*, must be included in the schedule of findings and questioned costs.

<sup>15</sup> See paragraph 10.22 for a discussion of reporting other noncompliance matters to top management in accordance with *Government Auditing Standards*.

<sup>16</sup> See footnote 14.

<sup>17</sup> See footnote 14.

- m. If applicable, a statement that other matters involving the internal control over financial reporting were communicated to management in a separate letter.<sup>18</sup>
- n. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of the audit committee, management, specified legislative or regulatory bodies, federal awarding agencies, and (if applicable) pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>19, 20</sup>
- o. The manual or printed signature of the auditor's firm.
- p. The date of the auditor's report.

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

**10.40** Examples of the auditor's report on compliance and on the internal control over financial reporting based on an audit of the financial statements in accordance with *Government Auditing Standards* are included in examples 2 and 2a of appendix D.

## Reporting on a Compliance Audit of Major Federal Programs

**10.41** In this section the auditor's reports that are issued based on a compliance audit of major programs in accordance with Circular A-133 are discussed. The report on compliance with requirements applicable to major programs expresses the auditor's opinion on whether the auditee complied with the requirements that, if noncompliance occurred, could have a direct and material effect on a major program. Although the guidance in SAS No. 58 addresses reporting on audited financial statements, auditors may find its guidance useful when reporting on a compliance audit of major programs.

### Material Instances of Noncompliance

**10.42** When the audit of an auditee's compliance with requirements applicable to a major program detects material instances of noncompliance with those requirements, the auditor should express a qualified or adverse opinion. The auditor should state the basis for such an opinion in the report (see examples 3a and 5 of appendix D). The auditor should also consider the cumulative effect of all instances of noncompliance on the financial statements. See paragraphs 6.13 through 6.16 for a further discussion of material instances of noncompliance.

### Scope Limitations

**10.43** Testing an auditee's compliance with laws, regulations, and the provisions of contracts or grant agreements (referred to as "compliance require-

<sup>18</sup> See paragraph 10.29 for a discussion of other internal control matters to be communicated to top management in accordance with *Government Auditing Standards*.

<sup>19</sup> For an audit that is not subject to Circular A-133 (that is, in accordance with *Government Auditing Standards* only), the reference to federal awarding agencies and pass-through entities should be deleted.

<sup>20</sup> This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports. [Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

ments”) requires the auditor to make a comply/noncomply decision about an auditee’s adherence to those compliance requirements. The auditor is able to express an unqualified opinion only if he or she has been able to apply all the procedures the auditor considers necessary in the circumstances. Restrictions on the scope of the audit—whether imposed by the client or by circumstances such as the timing of the auditor’s work, an inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records—may require auditors to qualify their opinion or to disclaim an opinion. In these instances, the reasons for such a qualification or disclaimer of opinion should be described in the auditor’s report. Furthermore, the auditor should consider the effects of such instances on his or her ability to express an unqualified opinion on the financial statements. See example 4 of appendix D for an illustration of a qualified opinion on compliance due to a scope limitation.

**10.44** The auditor’s decision to qualify or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on compliance with requirements governing each major program. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to each major program. When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on compliance.

**10.45** When disclaiming an opinion because of a scope limitation, the auditor should indicate in a separate paragraph all of the substantive reasons for the disclaimer. The auditor should state that the scope of his or her audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed or include a paragraph describing the characteristics of an audit (that is, the scope paragraph); to do so may tend to overshadow the disclaimer. In addition, the auditor should disclose any reservations he or she has regarding compliance with applicable laws and regulations.

## **Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With Circular A-133**

### ***Report Requirements***

**10.46** The basic elements of the auditor’s standard report on compliance with requirements applicable to each major program and on the internal control over compliance (see paragraph 4.12) in accordance with Circular A-133 are—

- a. A statement that the auditor has audited the compliance of the auditee with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that are applicable to each of its major programs.
- b. A statement that the auditee’s major programs are identified in the summary of the auditor’s results section of the accompanying schedule of findings and questioned costs (see paragraph 10.56).
- c. A statement that compliance with the requirements of laws, regulations, contracts, and grants applicable to each of the auditee’s major

federal programs is the responsibility of the auditee's management, and that the auditor's responsibility is to express an opinion on the auditee's compliance based on the audit.

- d. A statement that the audit of compliance was conducted in accordance with GAAS, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States,<sup>21</sup> and Circular A-133.
- e. A statement that those standards and Circular A-133 require that the auditor plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements that could have a direct and material effect on a major federal program occurred.
- f. A statement that an audit includes the examining, on a test basis, evidence about the auditee's compliance with those requirements and performing of such other procedures as the auditor considered necessary in the circumstances.
- g. A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion.
- h. A statement that the audit does not provide a legal determination of the auditee's compliance with those requirements.
- i. If instances of noncompliance are noted that result in an opinion modification, a reference to a description in the accompanying schedule of findings and questioned costs, including—
  - The reference number(s) of the finding(s).
  - An identification of the type(s) of compliance requirements and related major program(s).
  - A statement that compliance with such requirements is necessary, in the auditor's opinion, for the auditee to comply with the requirements applicable to the program(s).
- j. An opinion on whether the auditee complied, in all material respects, with the types of compliance requirements that are applicable to each of its major federal programs.
- k. If applicable, a statement that the results of the auditing procedures disclosed instances of noncompliance that are required to be reported in accordance with Circular A-133 and a reference to the schedule of findings and questioned costs in which they are described.<sup>22</sup>
- l. A statement that the auditee's management is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs.
- m. A statement that in planning and performing the audit, the auditor considered the auditee's internal control over compliance with require-

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<sup>21</sup> See footnote 3.

<sup>22</sup> See paragraph 10.63 for a discussion of the audit findings that are required to be reported under Circular A-133.

ments that could have a direct and material effect on a major federal program, to determine the auditing procedures for the purpose of expressing an opinion on compliance and to test and report on the internal control over compliance in accordance with Circular A-133.

- n. If applicable, a statement that reportable conditions were noted and the definition of a reportable condition.
- o. If applicable, a reference to a description of reportable conditions noted in the accompanying schedule of findings and questioned costs, including the reference number of the finding(s).
- p. If no reportable conditions are noted, a statement that the auditor's consideration of the internal control over compliance would not necessarily disclose all matters in internal control that might be material weaknesses; if reportable conditions are noted, a statement that the auditor's consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.
- q. The definition of a material weakness.
- r. If applicable, a statement about whether the auditor believes any of the reportable conditions noted are material weaknesses and, if they are, a reference to a description of the material weaknesses in the schedule of findings and questioned costs, including the reference number of the finding(s). If there are no reportable conditions, a statement is made that no material weaknesses were noted.
- s. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of the audit committee, management, specified legislative or regulatory bodies, federal awarding agencies, and (if applicable) pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>23</sup>
- t. The manual or printed signature of the auditor's firm.
- u. The date of the auditor's report.

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

### ***Option to Report on the Schedule of Expenditures of Federal Awards***

**10.47** This SOP recommends reporting on the schedule of expenditures of federal awards in the report on the financial statements. However, in certain circumstances (for example, when a separate single-audit package is issued), the required reporting on the schedule may be incorporated into the report described in paragraph 10.46. See paragraph 10.36 for a further discussion. Examples 3 (footnote 34) and 3a (footnote 40) of appendix D, illustrate this reporting option.

### ***No Requirement to Refer to Management Letter***

**10.48** It is important to note that all audit findings required to be reported under Circular A-133 must be included in the schedule of findings and ques-

<sup>23</sup> This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports. [Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

tioned costs (see paragraphs 10.55 and 10.56). A separate letter (that is, management letter) may not be used to communicate such matters to top management in lieu of reporting them as audit findings in accordance with Circular A-133. Since all reportable findings are included in the schedule, there is no requirement for the auditor to refer to the management letter in the report described in paragraph 10.46.

**10.49** An example of the auditor's report on compliance with requirements applicable to each major program and on the internal control over compliance in accordance with Circular A-133 is presented in examples 3, 3a, 4, and 5 of appendix D.

## Other Reporting Considerations

### Dating of Reports

**10.50** Since the report on the supplementary schedule of expenditures of federal awards indicates that the auditor is reporting "in relation to" the basic financial statements, it should carry the same date as that on the report on these statements. Furthermore, since the report on compliance and internal control over financial reporting, as required by *Government Auditing Standards*, relates to the audit of the financial statements and is based on the GAAS audit procedures performed, it should also carry the same date.

**10.51** The auditor's report on compliance and on the internal control over compliance related to major programs, as required by Circular A-133, should ordinarily have the same date as that of the other reports, but may carry a later date, because some of the audit work to satisfy Circular A-133 requirements may be done subsequent to the work on the financial statements. When this is the case, the reporting required by Circular A-133 should be dated at the later date (that is, when the fieldwork required to support the report on the audit of compliance is completed). The auditor should perform subsequent events procedures from the date of the report on the financial statements to the date of the report on the compliance audit in accordance with SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560). If, after issuing the report on the financial statements, the auditor becomes aware of instances of noncompliance that could be material to such statements, he or she should follow the guidance in SAS No. 1, section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 561).

**10.52** This SOP recommends reporting on the schedule of expenditures of federal awards in the report on the financial statements. However, as noted in paragraphs 10.36 and 10.47, there may be circumstances in which the auditor reports on the schedule in the report on compliance and the internal control over compliance issued to meet Circular A-133 requirements. In this situation, the report issued to meet Circular A-133 requirements must be dated the same as the report on the financial statements. This is because the report on the schedule is "in relation to" the basic financial statements. If using the same date is not possible because the work to satisfy Circular A-133 requirements is not complete as of the date of the financial statement report, the auditor has two options:

- a. The auditor can dual date the report issued to meet Circular A-133 requirements. The date relating to the portion of the report pertain-



ing to the schedule of expenditures of federal awards would be the same as the date of the financial statement report. The date pertaining to the remainder of the report would be the date on which the work done to satisfy Circular A-133 requirements is completed. Refer to SAS No. 1, section 530 *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530).

- b. The auditor can issue a separate report on the schedule of expenditures of federal awards, dated the same date as that of the financial statement report.

In some instances, the auditor may be engaged to issue a stand-alone opinion on the schedule either as part of the report issued to meet the requirements of Circular A-133 or separately (dated the same as the Circular A-133 report). The auditor should follow the guidance in SAS No. 58 when issuing such a report.

## Other Auditors

**10.53** When more than one independent auditor is involved in a single audit performed under Circular A-133, the auditor should refer to guidance in paragraphs 12 and 13 of SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 508.12 and .13) regarding an opinion on financial statements based in part on the report of another auditor, as well as SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 543).

## When the Audit of Federal Awards Does Not Encompass the Entirety of the Auditee's Operations

**10.54** If the audit of federal awards did not encompass the entirety of the auditee's operations expending federal awards, the operations that are not included should be identified in a separate paragraph following the first paragraph of the report on major programs (see also the discussion in paragraph 3.25). An example of such a paragraph follows:

Example Entity's general-purpose financial statements include the operations of the [identify component unit or department], which received [include dollar amount] in federal awards which is not included in schedule during the year ended June 30, 19X1. Our audit, described below, did not include the operations of [identify component unit or department] because [state the reason for the omission, such as the component unit engaged other auditors to perform an audit in accordance with OMB Circular A-133].

## Schedule of Findings and Questioned Costs

**10.55** Circular A-133 requires the auditor to prepare a schedule of findings and questioned costs, which should include the following three sections:

- a. A summary of the auditor's results
- b. Findings relating to the financial statements which are required to be reported in accordance with *Government Auditing Standards*
- c. Findings and questioned costs for federal awards

## What Should Be Reported

**10.56** Specifically, Circular A-133 requires the schedule of findings and questioned costs to contain—

- a. A summary of the auditor's results, which must include—

- The type of report the auditor issued on the financial statements of the auditee (that is, unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
  - Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.<sup>24</sup>
  - A statement on whether the audit disclosed any noncompliance that is material to the financial statements of the auditee.
  - Where applicable, a statement that reportable conditions in the internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.<sup>25</sup>
  - The type of report the auditor issued on compliance for major programs (that is, unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
  - A statement on whether the audit disclosed any audit findings that the auditor is required to report under section 510(a) of Circular A-133 (see paragraph 10.63).
  - An identification of major programs.
  - The dollar threshold used to distinguish between type A and type B programs as described in section 520(b) of Circular A-133 (see paragraphs 7.4 through 7.9).
  - A statement on whether the auditee qualified as a low-risk auditee under section 530 of Circular A-133 (see paragraph 7.25).
- b. Findings relating to the financial statements which are required to be reported in accordance with *Government Auditing Standards* (see the discussion in paragraphs 10.57 through 10.62 for further detail).
- c. Findings and questioned costs for federal awards, which must include audit findings as defined in section 510(a) of Circular A-133 (see paragraph 10.63). Circular A-133 also requires the following with regard to this section of the schedule:
- Audit findings (for example, internal control findings, compliance findings, questioned costs, or fraud) that relate to the same issue should be presented as a single audit finding. Where practical, audit findings should be organized by federal agency or pass-through entity.
  - Audit findings that relate to both the financial statements and the federal awards should be reported in both sections of the

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<sup>24</sup> Auditors should note that SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, precludes an auditor from issuing a written report representing that no reportable conditions were noted during an audit. Therefore, the sample schedule of findings and questioned costs included in appendix E uses the term "none reported" to indicate that no reportable conditions were included in the auditor's report (versus "none," which would imply that there were no reportable conditions).

<sup>25</sup> See footnote 24.

schedule. However, the reporting in one section of the schedule may be in summary form, with a reference to a detailed reporting in the other section of the schedule. For example, a material weakness in internal control that affects the auditee as a whole, including its federal awards, should usually be reported in detail in the section of the schedule of findings and questioned costs that is related to the financial statements, with a summary identification and reference given in the section related to federal awards. Conversely, a finding of noncompliance with a federal program law that is also material to the financial statements should be reported in detail in the federal awards section of the schedule, with a summary identification and reference given in the financial statement section.

## Findings Relating to the Financial Statements

**10.57** As noted before, Circular A-133 requires the schedule of findings and questioned costs to include a section that reports the findings relating to the financial statements (note that these findings must also be addressed in the auditor's report issued to meet the requirements of *Government Auditing Standards*—see paragraphs 10.15, 10.16, and 10.21 through 10.30). This section of the schedule should include all reportable conditions in the internal control over financial reporting and other findings relative to the audit of the financial statements that are required to be reported by GAAS and *Government Auditing Standards*, including those that do not affect federal awards. In addition to requiring auditors to report reportable conditions in the internal control over financial reporting, *Government Auditing Standards* requires auditors to report all but clearly inconsequential fraud and illegal acts that the auditor concludes, based on the evidence obtained, either occurred or are likely to have occurred. *Government Auditing Standards* also requires the auditor to report other noncompliance (for example, violations of the provisions of contract or grant agreements) that is material to the financial statements (see paragraphs 10.21 and 10.22).

**10.58** In reporting reportable conditions, fraud, illegal acts, and other noncompliance, auditors should place their findings in proper perspective. This perspective is both quantitative and qualitative. To give the reader a basis to judge the prevalence and consequences of these conditions, the instances that are identified should be related to the universe or the number of cases examined and be quantified in terms of dollar value, if appropriate. Reportable conditions that are—either individually or in the aggregate—material weaknesses should be so identified.

**10.59** *Government Auditing Standards* suggests that well-developed findings generally include the following elements:

- Criteria (what should be)
- The condition (what is)
- The effect (the difference between what is and what should be)
- The cause (why it happened)

**10.60** *Government Auditing Standards* recognizes reportable conditions and noncompliance identified by the auditor may not always have all of the elements fully developed. However, to provide sufficient information to users

to permit them to determine the effect and cause in order to take prompt and proper corrective action, auditors should identify at least the criteria, condition, and possible asserted effect.

**10.61** In presenting reportable conditions, fraud, illegal acts, and other noncompliance, auditors should follow the report content standards in chapter 7 of *Government Auditing Standards* that pertain to objectives, scope, and methodology; audit results; the views of responsible officials; and the reports presentation standards (as appropriate). Auditors may provide less extensive disclosure of fraud and illegal acts that are not material in either a quantitative or qualitative sense.

**10.62** *Government Auditing Standards* also requires the auditor to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit (see paragraph 6.65 for a discussion of the auditor's responsibility for audit follow-up under *Government Auditing Standards*). The auditor should report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit. Material findings and recommendations from previous audits that are repeated as current-year findings should be identified as repeat findings. If there are uncorrected findings from previous audits that are not repeated as current-year findings, their status should also be reported by the auditor. In either case, this information should be provided for in the section of the schedule of findings and questioned costs related to the financial statements.

## Audit Findings Reported—Federal Awards

**10.63** Section 510(a) of Circular A-133 requires the auditor to report as audit findings in the schedule of findings and questioned costs—

- a. Reportable conditions in the internal control over major programs. The auditor's determination of whether a deficiency in internal control is a reportable condition for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or to an audit objective identified in the *Compliance Supplement*. The auditor should identify reportable conditions that are individually or cumulatively material weaknesses (see paragraphs 8.25 and 8.26).
- b. Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements that are related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the *Compliance Supplement* (see paragraphs 6.51 through 6.60 for a further discussion of the evaluation and reporting of noncompliance).
- c. Known questioned costs that are greater than \$10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. In evaluating the effect of questioned costs on the opinion on compliance, the auditor should consider the best estimate of the total costs questioned (likely questioned costs), not just the questioned costs specifi-

cally identified (known questioned costs). The auditor should also report (in the schedule of findings and questioned costs) known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement for a major program. For example, if the auditor specifically identifies \$7,000 in questioned costs but, based on his or her evaluation of the effect of questioned costs on the opinion on compliance, estimates that the total questioned costs are in the \$50,000–\$60,000 range, the auditor should report a finding that identifies the known questioned costs of \$7,000. Although the auditor is not required to report his or her estimate of the total questioned costs, the auditor should include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

- d. Known questioned costs that are greater than \$10,000 for programs that are not audited as major. Since (except for audit follow-up) the auditor is not required to perform audit procedures for federal programs that are not major, the auditor will normally not find questioned costs. However, if the auditor does become aware of questioned costs for a federal program that is not audited as a major program (for example, as part of audit follow-up or other audit procedures) and the known questioned costs are greater than \$10,000, then the auditor should report this as an audit finding.
- e. The circumstances concerning why the auditor's report on compliance for major programs is other than an unqualified opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs for federal awards (for example, a scope limitation that is not otherwise reported as a finding).
- f. Known fraud affecting a federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for federal awards. This paragraph does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of *Government Auditing Standards* (see paragraphs 10.23 through 10.25).
- g. Instances where the results of audit follow-up procedures disclosed that the summary schedule of prior audit findings prepared by the auditee in accordance with section 315(b) of Circular A-133 materially misrepresents the status of any prior audit finding (see paragraphs 10.68 through 10.70).

## Detail of Audit Findings—Federal Awards

**10.64** Section 510(b) of Circular A-133 requires that audit findings should be presented in sufficient detail for the auditee to prepare a corrective action plan and take corrective action and for federal agencies and pass-through entities to arrive at a management decision. The specific information that Circular A-133 requires in audit findings consists of (as applicable)—

- a. Identification of the federal program and specific federal award including the CFDA title and number, the federal award number and year, the name of federal agency, and the name of the applicable

pass-through entity. When information such as the CFDA title and number or the federal award number is not available, the auditor should provide the best information available to describe the federal award.

- b. The criteria or specific requirement upon which the audit finding is based, including the statutory, regulatory, or other citation.
- c. The condition found, including facts that support the deficiency identified in the audit finding.
- d. Identification of questioned costs and how they were computed.
- e. Information to provide a proper perspective for judging the prevalence and consequences of the audit findings, (for example, whether the audit findings represent an isolated instance or a systemic problem). Where appropriate, the instances identified should be related to the universe and the number of cases examined and be quantified in terms of the dollar value.
- f. The possible asserted effect to provide sufficient information to the auditee and federal agency (or pass-through entity, in the case of a subrecipient) to permit them to determine the cause and effect, to facilitate prompt and proper corrective action.
- g. Recommendations to prevent future occurrences of the deficiency identified in the audit finding.
- h. To the extent practical, the views of responsible officials of the auditee when there is disagreement with the audit findings. If the auditee's corrective action plan is available and contains the views of the responsible officials, the auditor can indicate in the finding that the auditee disagreed with the finding and refer to the details of the auditee's position in the corrective action plan. However, if the auditor does not agree with the auditee's position, the auditor should state his or her reasons for rejecting it.

## Other Preparation Guidance

**10.65** Each audit finding in the schedule of findings and questioned costs should include a reference number to allow for easy referencing of the audit findings during follow-up. One option for assigning reference numbers is to use the last two digits of the fiscal year being audited as the first two digits of each reference number, followed by a numeric sequence. For example, findings identified and reported in the audit of fiscal year 199X would be assigned reference numbers 9X-1, 9X-2, etc.

**10.66** A schedule of findings and questioned costs must be issued for every single audit, regardless of whether any findings or questioned costs are noted. This is because Circular A-133 requires that one section of the schedule summarize the audit results (see paragraphs 10.55 and 10.56). In a situation in which there are no findings or questioned costs, the auditor should prepare the summary of auditor's results section of the schedule and indicate in the other required sections that no matters were reportable.

**10.67** Appendix E contains an illustrative schedule of findings and questioned costs.

## Summary Schedule of Prior Audit Findings and Corrective Action Plan

**10.68** The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee is required to prepare a summary schedule of prior audit findings. The auditee is not required to prepare a summary schedule of prior audit findings if there are no matters reportable therein. However, to best serve the needs of federal agencies and to avoid any potential future misunderstanding or allegation of nonconformity with the requirements of Circular A-133, the auditee may consider preparing in this circumstance a summary schedule circumstance that indicates that no matters are reportable. The auditee is also required to prepare a corrective action plan for each of the current-year audit findings. The summary schedule of prior audit findings and the corrective action plan, which are both part of the reporting package, must include the reference numbers the auditor assigns to audit findings in the schedule of findings and questioned costs. This numbering (or other identification) should include the fiscal year in which the finding initially occurred.

**10.69** The auditor is required to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding in accordance with the requirements of section 500(e) of Circular A-133 (see paragraphs 6.61 through 6.65).

**10.70** The auditor has no responsibility for the corrective action plan; however, the auditor may be separately engaged by the auditee for assistance in developing appropriate corrective actions in response to audit findings. The auditor may find the auditee's corrective action plan useful in performing follow-up on prior audit findings (in addition to the schedule of prior audit findings), because it may provide an indication of the corrective steps planned by the auditee.

## Data Collection Form

**10.71** Circular A-133 requires the auditee to complete and sign certain sections of a data collection form that states whether the audit was completed in accordance with Circular A-133 and provides information about the auditee, its federal programs, and the results of the audit. This form is not part of the reporting package (see paragraph 10.7). The information required to be included in the form, however, represents a summary of the information contained in the reporting package, including the auditor's reports and the auditee's schedule of expenditures of federal awards.

**10.72** The auditor is also required to complete certain sections of the form, including information on the auditor and information on the results of the financial statement audit and the audit of federal programs. The auditor is also required to sign a statement in the form that indicates, at a minimum, the source of the information included in the form, the auditor's responsibility for the information, that the form is not a substitute for the reporting package, and that the content of the form is limited to the data elements prescribed by the OMB. As part of completing the form, the auditor is asked to date it. The date

that is entered by the auditor should be the date on which he or she completes and signs the form. The wording of the auditor's statement section of the form indicates that no additional procedures were performed since the date of the audit reports. This wording alleviates the auditor from any subsequent-event responsibility with regard to the timing of the completion of the form and the completion of the audit. The form includes detailed instructions, which should be carefully followed by the auditor.

**10.73** The data collection form and related instructions are available on the OMB's home page at [www.whitehouse.gov/WH/EOP/OMB/Grants](http://www.whitehouse.gov/WH/EOP/OMB/Grants) (note that this address is "case sensitive," that is, upper- and lowercase letters must be as shown). A copy of the form and instructions can also be obtained from the Federal Audit Clearinghouse at (888) 222-9907. The form number is SF-SAC.<sup>26</sup>

## Submission of Reporting Package and Data Collection Form

**10.74** The submission of the data collection form and the reporting package, including the audit reports, is the responsibility of the auditee. The data collection form and the reporting package must be submitted by the auditee within the earlier of thirty days after the receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. However, it should be noted that Circular A-133 includes a delayed implementation date for report-submission deadlines. For fiscal years beginning on or before June 30, 1998, the audit must be completed and the data collection form and reporting package must be submitted within thirty days after the receipt of the auditor's reports, or thirteen months after the end of the audit period.

## Submission to Clearinghouse

**10.75** All auditees must submit to the federal clearinghouse designated by the OMB the data collection form and one copy of the reporting package (see paragraph 10.6 for a description) for (a) the federal clearinghouse to retain as an archival copy and (b) each federal awarding agency, when the schedule of findings and questioned costs disclosed audit findings relating to federal awards that the federal awarding agency provided directly or when the summary schedule of prior audit findings reported the status of any audit findings relating to federal awards that the federal awarding agency provided directly.

## Submission by Subrecipients

**10.76** In addition to the requirements in paragraph 10.75, auditees that are also subrecipients must submit to each pass-through entity one copy of the reporting package for each pass-through entity when the schedule of findings and questioned costs disclosed audit findings relating to federal awards that the pass-through entity provided or when the summary schedule of prior audit

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<sup>26</sup> As of the issuance of this SOP, the Federal Audit Clearinghouse is developing the data collection form in various word processing packages, as well as a process for electronic submission. Auditors can review the Federal Audit Clearinghouse home page at <http://harvester.census.gov/sac> for the most current information on these developments.



findings reported the status of any audit findings relating to federal awards that the pass-through entity provided. When a subrecipient is not required to submit a reporting package to a pass-through entity, the subrecipient must instead provide written notification to the pass-through entity that—

- An audit of the subrecipient was conducted in accordance with Circular A-133 (including the period covered by the audit and the name, amount, and CFDA number of the federal awards provided by the pass-through entity).
- The schedule of findings and questioned costs disclosed no audit findings relating to the federal awards that the pass-through entity provided.
- The summary schedule of prior audit findings did not report on the status of any audit findings relating to the federal awards that the pass-through entity provided.

A subrecipient may submit a copy of the reporting package to a pass-through entity to comply with this notification.

## **Requests for Copies**

**10.77** In response to a request by a federal agency or pass-through entity, auditees should submit the appropriate copies of the reporting package and, if requested, a copy of any management letters issued by the auditor.

## **Report Retention Requirements**

**10.78** Auditees are required to keep one copy of the data collection form and the reporting package on file for three years from the date of submission to the federal clearinghouse designated by the OMB. Pass-through entities should keep subrecipients' submissions on file for three years from the date of receipt.

## **Clearinghouse Address**

**10.79** The name and address of the federal clearinghouse currently designated by the OMB are as follows: Federal Audit Clearinghouse, Bureau of the Census, 1201 E. 10th St., Jeffersonville, IN 47132.

## **Freedom of Information Act**

**10.80** In accordance with the principles of the Freedom of Information Act (U.S. Code title 5, section 552), audit agency and nonfederal reports issued to grantees and contractors are available, if they are requested, to members of the press and the general public, to the extent that the information contained in them is not subject to exemptions of the act that the cognizant agency for audit chooses to exercise. Accordingly, the auditor should not include names, social security numbers, other personal identification, or other potentially sensitive matters in either the body of the report or any attached schedules.

## Chapter 11

### PROGRAM-SPECIFIC AUDITS

**11.1** A program-specific audit is an audit of an individual federal program (rather than a single audit of an entity's financial statements and federal programs). Section 235 of Circular A-133 provides guidance on program-specific audits.

### Use of a Program-Specific Audit to Satisfy Circular A-133 Audit Requirements

**11.2** Circular A-133 states that when an auditee expends federal awards under only one federal program (excluding research and development) and the federal program's laws, regulations, or grant agreements do not require a financial statement audit of the auditee, the auditee may elect to have a program-specific audit performed in accordance with section 235 of the circular.<sup>1</sup> Therefore, the auditor should determine whether there is a financial statement audit requirement before performing a program-specific audit. A program-specific audit may not be elected for research and development unless all federal awards expended were received from the same federal agency (or the same federal agency and the same pass-through entity) and that federal agency (or pass-through entity, in the case of a subrecipient) approves a program-specific audit in advance.

### Program-Specific Audit Requirements

**11.3** Circular A-133 requires program-specific audits to be subject to the following sections of Circular A-133 as they may apply to program-specific audits, unless contrary to the provisions of section 235 of Circular A-133, a federal program-specific audit guide, or the program's laws and regulations:

- Purpose; definitions; audit requirements; basis for determining the federal awards expended; subrecipient and vendor determinations; relation to other audit requirements (sections 100 through 215(b))
- Frequency of audits; sanctions; audit costs (sections 220 through 230)
- Auditee responsibilities; auditor selection (sections 300 through 305)
- Follow-up on audit findings (section 315)
- Submission of report (sections 320(f) through 320(j))
- Responsibilities of federal agencies and pass-through entities; management decisions (sections 400 through 405)
- Audit findings and audit working papers (sections 510 through 515)

Program-specific audits are also subject to other provisions, referred to in section 235 of the circular.

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<sup>1</sup> An example of a situation where a program-specific audit would not be allowed would be a not-for-profit college that receives SFA (and no other federal awards). This is because the Higher Education Act of 1965, as amended, requires institutions that receive SFA to undergo an annual financial statement audit.

## Availability of Program-Specific Audit Guides

**11.4** In many cases, a federal agency's Office of Inspector General will have issued a program-specific audit guide that provides guidance on internal control, compliance requirements, suggested audit procedures, and audit reporting requirements for a particular federal program. The auditor should contact the Office of Inspector General of the federal agency to determine whether such a guide is available and current. When a current program-specific audit guide is available, the auditor should follow *Government Auditing Standards* and the guide when performing a program-specific audit. However, if there have been significant changes made to a program's compliance requirements and the related program-specific audit guide has not been updated with regard to the changes, the auditor should follow section 235 of Circular A-133 and the *Compliance Supplement* in lieu of an outdated guide. If a guide is current with regard to a program's compliance requirements but has not been updated to conform to current authoritative standards and guidance (such as current revisions of GAAS or *Government Auditing Standards*), the auditor should follow current applicable professional standards and guidance in lieu of the outdated or inconsistent standards and guidance in the guide.

**11.5** When a program-specific audit guide is not available, the auditee and the auditor have basically the same responsibilities for the federal program as they have for an audit of a major program in a single audit as discussed in chapters 6 and 8 of this SOP.

## Auditee's Responsibilities When a Program-Specific Audit Guide is Not Available

**11.6** In addition to having the responsibilities included in the sections of Circular A-133 that are described in paragraph 11.3, the auditee is required to prepare the following:

- The financial statements for the federal program, which include, at a minimum, a schedule of expenditures of federal awards for the program and notes that describe the significant accounting policies used in preparing the schedule
- A summary schedule of prior audit findings consistent with the requirements of section 315(b) of Circular A-133 (see paragraphs 10.68 through 10.70)
- If applicable, a corrective action plan consistent with the requirements of section 315(c) of the circular (see paragraphs 10.68 through 10.70)

## Auditor's Responsibilities When a Program-Specific Audit Guide is Not Available

### Audit Scope and Requirements

**11.7** Circular A-133 requires the auditor to—

- Perform an audit of the financial statement(s) for the federal program in accordance with *Government Auditing Standards* (see chapter 4 of this SOP for guidance on financial statement audits). See paragraph 11.10 for a further discussion of *Government Auditing Standards*.

- Obtain an understanding of the internal control over compliance and perform tests of the internal control over compliance for the federal program, so that they are consistent with the requirements of section 500(c) of the circular for a major program (see chapter 8 of this SOP for guidance on the internal control considerations for major programs).
- Perform procedures to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the federal program consistent with the requirements of section 500(d) of the circular for a major program (see chapter 6 of this SOP for guidance on the compliance-auditing considerations for major programs).
- Follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings that has been prepared by the auditee, and when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding, report this as a current-year audit finding, in accordance with the requirements of section 500(e) of the circular (see paragraphs 10.69 through 10.70).

## Auditor's Reports

### ***Circular A-133 Requirements***

11.8 Circular A-133 states that the auditor's reports may be in the form of either combined or separate reports and may be organized differently from the manner described below. The auditor's reports should state that the audit was conducted in accordance with GAAS, *Government Auditing Standards*, and Circular A-133 and should include the following:

- An opinion (or disclaimer of opinion) on whether the financial statement(s) of the federal program are presented fairly in all material respects in conformity with the stated accounting policies
- A report on the internal control related to the federal program, which describes the scope of the testing of the internal control and the results of the tests
- A report on compliance, which includes an opinion (or a disclaimer of opinion) on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the federal program
- A schedule of findings and questioned costs for the federal program, which includes a summary of the auditor's results relative to the audit of the federal program in a format consistent with the requirements for the summary of auditor's results in section 505(d)(1) of the circular, as well as findings and questioned costs for federal awards consistent with the requirements of section 505(d)(3) of the circular (see paragraph 10.55 and 10.56)

### ***Recommended Auditor's Reports***

11.9 In an effort to make program-specific audit reporting understandable and to reduce the number of reports issued, this SOP recommends

that the following reports be issued for a program-specific audit (a) an opinion on the financial statement(s) of the federal program and (b) a report on compliance with requirements applicable to the federal program and on the internal control over compliance in accordance with the program-specific audit option under OMB Circular A-133. See the following paragraph for a discussion of the possible issuance of a third report to meet the reporting requirements of *Government Auditing Standards*. Illustrations of program-specific audit reports are included in examples 6 and 6a of appendix D.

### **Reporting in Accordance With Government Auditing Standards**

**11.10** If the financial statement(s) of the program only present the activity of the federal program, the auditor is not required to issue a separate report to meet the reporting requirements of *Government Auditing Standards*. This is because, in many cases, by definition the financial statements of the program consist only of the schedule of expenditures of federal awards. In this situation, examples 6 and 6a of appendix D, would meet the financial, compliance, and internal control over compliance reporting requirements of both *Government Auditing Standards* and Circular A-133. However, it should be noted that the auditor always has the option of issuing a separate *Government Auditing Standards* report (in addition to the two reports described in paragraph 11.9). Although it is not as common, the financial statement(s) of the federal program may present more than the program's activity (for example, a municipal sewer district issues financial statements that include both normal operations and the federal program activity related to a grant for the purpose of building a new sewage-treatment facility). In this situation, the auditor should issue a separate *Government Auditing Standards* report (example 2 or 2a of appendix D), and modify it so that it refers only to the financial statement(s) of the federal program.

## **Submission of Report**

### **Timing of Submission**

**11.11** Circular A-133 requires the audit to be completed and the reporting required by sections 235(c)(2) and 235(c)(3) of the circular to be submitted, within the earlier of thirty days after the receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the federal agency that provided the funding or unless a different period is specified in a program-specific audit guide.<sup>2</sup> Unless restricted by law or regulation, Circular A-133 requires the auditee to make copies of the report available for public inspection.

### **Submission When a Program-Specific Audit Guide is Available**

**11.12** When a program-specific audit guide is available, the auditee must submit to the federal clearinghouse designated by the OMB (see paragraph 10.79) the data collection form prepared in accordance with section 320(b) of the Circular (see paragraphs 10.71 through 10.73), as applicable for a program-

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<sup>2</sup> It should be noted that Circular A-133 includes a delayed implementation date for deadlines for the submission of reports. For fiscal years beginning on or before June 30, 1998, the audit must be completed and the required reports submitted within the earlier of thirty days after the receipt of the auditor's report or thirteen months after the end of the audit period.

specific audit, and must also submit the reporting that is required by the program-specific audit guide which is to be retained as an archival copy. The auditee must also submit to the federal awarding agency or pass-through entity the reporting required by the program-specific audit guide.

### **Submission When a Program-Specific Audit Guide is Not Available**

**11.13** When a program-specific audit guide is not available, the reporting package for a program-specific audit consists of the following:

- The financial statement(s) of the federal program
- A summary schedule of prior audit findings (see paragraphs 10.68 through 10.70)
- A corrective action plan (see paragraphs 10.68 through 10.70)
- The auditor's report(s) described in paragraphs 11.8 through 11.10

**11.14** The data collection form, as applicable to a program-specific audit, and one copy of the reporting package must be submitted to the federal clearinghouse designated by the OMB (see paragraph 10.79), to be retained as an archival copy. Furthermore, when the schedule of findings and questioned costs discloses audit findings or the summary schedule of prior audit findings reports the status of any audit findings, the auditee must submit one copy of the reporting package to the federal clearinghouse on behalf of the federal awarding agency or, in the case of a subrecipient, directly to the pass-through entity. When a subrecipient is not required to submit a reporting package to the pass-through entity, the subrecipient is instead required to provide written notification to the pass-through entity, consistent with the requirements of section 320(e)(2) of Circular A-133 (see paragraph 10.76). A subrecipient may submit a copy of the reporting package to the pass-through entity, to comply with the notification requirement.

## Appendix A

### Single Audit Act Amendments of 1996

Public Law 104-156  
104th Congress

#### An Act

July 5, 1996  
[S. 1579]

To streamline and improve the effectiveness of chapter 75 of title 31, United States Code (commonly referred to as the "Single Audit Act").

Single Audit Act  
Amendments of  
1996.  
31 USC 7501  
note.

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

#### SECTION 1. SHORT TITLE; PURPOSES.

(a) SHORT TITLE—This Act may be cited as the "Single Audit Act Amendments of 1996".

(b) PURPOSES—The purposes of this Act are to—

- (1) promote sound financial management, including effective internal controls, with respect to Federal awards administered by non-Federal entities;
- (2) establish uniform requirements for audits of Federal awards administered by non-Federal entities;
- (3) promote the efficient and effective use of audit resources;
- (4) reduce burdens on State and local governments, Indian tribes, and nonprofit organizations; and
- (5) ensure that Federal departments and agencies, to the maximum extent practicable, rely upon and use audit work done pursuant to chapter 75 of title 31, United States Code (as amended by this Act).

#### SEC. 2. AMENDMENT TO TITLE 31, UNITED STATES CODE.

Chapter 75 of title 31, United States Code, is amended to read as follows:

#### "CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS

"Sec.

"7501. Definitions.

"7502. Audit requirements; exemptions.

"7503. Relation to other audit requirements.

"7504. Federal agency responsibilities and relations with non-Federal entities.

"7505. Regulations.

"7506. Monitoring responsibilities of the Comptroller General.

"7507. Effective date.

#### "§ 7501. Definitions

"(a) As used in this chapter, the term—

"(1) 'Comptroller General' means the Comptroller General of the United States;

"(2) 'Director' means the Director of the Office of Management and Budget;

"(3) 'Federal agency' has the same meaning as the term 'agency' in section 551(1) of title 5;

"(4) 'Federal awards' means Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities;

“(5) ‘Federal financial assistance’ means assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, or other assistance, but does not include amounts received as reimbursement for services rendered to individuals in accordance with guidance issued by the Director;

“(6) ‘Federal program’ means all Federal awards to a non-Federal entity assigned a single number in the Catalog of Federal Domestic Assistance or encompassed in a group of numbers or other category as defined by the Director;

“(7) ‘generally accepted government auditing standards’ means the government auditing standards issued by the Comptroller General;

“(8) ‘independent auditor’ means—

“(A) an external State or local government auditor who meets the independence standards included in generally accepted government auditing standards; or

“(B) a public accountant who meets such independence standards;

“(9) ‘Indian tribe’ means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians;

“(10) ‘internal controls’ means a process, effected by an entity’s management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

“(A) Effectiveness and efficiency of operations.

“(B) Reliability of financial reporting.

“(C) Compliance with applicable laws and regulations;

“(11) ‘local government’ means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, any other instrumentality of local government and, in accordance with guidelines issued by the Director, a group of local governments;

“(12) ‘major program’ means a Federal program identified in accordance with risk-based criteria prescribed by the Director under this chapter, subject to the limitations described under subsection (b);

“(13) ‘non-Federal entity’ means a State, local government, or nonprofit organization;

“(14) ‘nonprofit organization’ means any corporation, trust, association, cooperative, or other organization that—

“(A) is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest;

“(B) is not organized primarily for profit; and

“(C) uses net proceeds to maintain, improve, or expand the operations of the organization;



“(15) ‘pass-through entity’ means a non-Federal entity that provides Federal awards to a subrecipient to carry out a Federal program;

“(16) ‘program-specific audit’ means an audit of one Federal program;

“(17) ‘recipient’ means a non-Federal entity that receives awards directly from a Federal agency to carry out a Federal program;

“(18) ‘single audit’ means an audit, as described under section 7502(d), of a non-Federal entity that includes the entity’s financial statements and Federal awards;

“(19) ‘State’ means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or inter-state entity which has governmental functions, and any Indian tribe; and

“(20) ‘subrecipient’ means a non-Federal entity that receives Federal awards through another non-Federal entity to carry out a Federal program, but does not include an individual who receives financial assistance through such awards.

“(b) In prescribing risk-based program selection criteria for major programs, the Director shall not require more programs to be identified as major for a particular non-Federal entity, except as prescribed under subsection (c) or as provided under subsection (d), than would be identified if the major programs were defined as any program for which total expenditures of Federal awards by the non-Federal entity during the applicable year exceed—

“(1) the larger of \$30,000,000 or 0.15 percent of the non-Federal entity’s total Federal expenditures, in the case of a non-Federal entity for which such total expenditures for all programs exceed \$10,000,000,000;

“(2) the larger of \$3,000,000, or 0.30 percent of the non-Federal entity’s total Federal expenditures, in the case of a non-Federal entity for which such total expenditures for all programs exceed \$100,000,000 but are less than or equal to \$10,000,000,000; or

“(3) the larger of \$300,000, or 3 percent of such total Federal expenditures for all programs, in the case of a non-Federal entity for which such total expenditures for all programs equal or exceed \$300,000 but are less than or equal to \$100,000,000.

“(c) When the total expenditures of a non-Federal entity’s major programs are less than 50 percent of the non-Federal entity’s total expenditures of all Federal awards (or such lower percentage as specified by the Director), the auditor shall select and test additional programs as major programs as necessary to achieve audit coverage of at least 50 percent of Federal expenditures by the non-Federal entity (or such lower percentage as specified by the Director), in accordance with guidance issued by the Director.

“(d) Loan or loan guarantee programs, as specified by the Director, shall not be subject to the application of subsection (b).

**“§ 7502. Audit requirements; exemptions**

“(a)(1)(A) Each non-Federal entity that expends a total amount of Federal awards equal to or in excess of \$300,000 or such other amount

specified by the Director under subsection (a)(3) in any fiscal year of such non-Federal entity shall have either a single audit or a program-specific audit made for such fiscal year in accordance with the requirements of this chapter.

“(B) Each such non-Federal entity that expends Federal awards under more than one Federal program shall undergo a single audit in accordance with the requirements of subsections (b) through (i) of this section and guidance issued by the Director under section 7505.

“(C) Each such non-Federal entity that expends awards under only one Federal program and is not subject to laws, regulations, or Federal award agreements that require a financial statement audit of the non-Federal entity, may elect to have a program-specific audit conducted in accordance with applicable provisions of this section and guidance issued by the Director under section 7505.

“(2)(A) Each non-Federal entity that expends a total amount of Federal awards of less than \$300,000 or such other amount specified by the Director under subsection (a)(3) in any fiscal year of such entity, shall be exempt for such fiscal year from compliance with—

“(i) the audit requirements of this chapter; and

“(ii) any applicable requirements concerning financial audits contained in Federal statutes and regulations governing programs under which such Federal awards are provided to that non-Federal entity.

“(B) The provisions of subparagraph (A)(ii) of this paragraph shall not exempt a non-Federal entity from compliance with any provision of a Federal statute or regulation that requires such non-Federal entity to maintain records concerning Federal awards provided to such non-Federal entity or that permits a Federal agency, pass-through entity, or the Comptroller General access to such records.

“(3) Every 2 years, the Director shall review the amount for requiring audits prescribed under paragraph (1)(A) and may adjust such dollar amount consistent with the purposes of this chapter, provided the Director does not make such adjustments below \$300,000.

“(b)(1) Except as provided in paragraphs (2) and (3), audits conducted pursuant to this chapter shall be conducted annually.

“(2) A State or local government that is required by constitution or statute, in effect on January 1, 1987, to undergo its audits less frequently than annually, is permitted to undergo its audits pursuant to this chapter biennially. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

“(3) Any nonprofit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, is permitted to undergo its audits pursuant to this chapter biennially. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

“(c) Each audit conducted pursuant to subsection (a) shall be conducted by an independent auditor in accordance with generally

accepted government auditing standards, except that, for the purposes of this chapter, performance audits shall not be required except as authorized by the Director.

“(d) Each single audit conducted pursuant to subsection (a) for any fiscal year shall—

“(1) cover the operations of the entire non-Federal entity; or

“(2) at the option of such non-Federal entity such audit shall include a series of audits that cover departments, agencies, and other organizational units which expended or otherwise administered Federal awards during such fiscal year provided that each such audit shall encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and organizational unit, which shall be considered to be a non-Federal entity.

“(e) The auditor shall—

“(1) determine whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles;

“(2) determine whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole;

“(3) with respect to internal controls pertaining to the compliance requirements for each major program—

“(A) obtain an understanding of such internal controls;

“(B) assess control risk; and

“(C) perform tests of controls unless the controls are deemed to be ineffective; and

“(4) determine whether the non-Federal entity has complied with the provisions of laws, regulations, and contracts or grants pertaining to Federal awards that have a direct and material effect on each major program.

“(f)(1) Each Federal agency which provides Federal awards to a recipient shall—

“(A) provide such recipient the program names (and any identifying numbers) from which such awards are derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter; and

“(B) review the audit of a recipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the recipient by the Federal agency.

“(2) Each pass-through entity shall—

“(A) provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;

“(B) monitor the subrecipient's use of Federal awards through site visits, limited scope audits, or other means;

“(C) review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and

“(D) require each of its subrecipients of Federal awards to permit, as a condition of receiving Federal awards, the independent auditor of the pass-through entity to have such access to the subrecipient’s records and financial statements as may be necessary for the pass-through entity to comply with this chapter.

“(g)(1) The auditor shall report on the results of any audit conducted pursuant to this section, in accordance with guidance issued by the Director. Reports.

“(2) When reporting on any single audit, the auditor shall include a summary of the auditor’s results regarding the non-Federal entity’s financial statements, internal controls, and compliance with laws and regulations.

“(h) The non-Federal entity shall transmit the reporting package, which shall include the non-Federal entity’s financial statements, schedule of expenditures of Federal awards, corrective action plan defined under subsection (i), and auditor’s reports developed pursuant to this section, to a Federal clearinghouse designated by the Director, and make it available for public inspection within the earlier of—

“(1) 30 days after receipt of the auditor’s report; or

“(2)(A) for a transition period of at least 2 years after the effective date of the Single Audit Act Amendments of 1996, as established by the Director, 13 months after the end of the period audited; or

“(B) for fiscal years beginning after the period specified in subparagraph (A), 9 months after the end of the period audited, or within a longer time frame authorized by the Federal agency, determined under criteria issued under section 7504, when the 9-month time frame would place an undue burden on the non-Federal entity.

“(i) If an audit conducted pursuant to this section discloses any audit findings, as defined by the Director, including material noncompliance with individual compliance requirements for a major program by, or reportable conditions in the internal controls of, the non-Federal entity with respect to the matters described in subsection (e), the non-Federal entity shall submit to Federal officials designated by the Director, a plan for corrective action to eliminate such audit findings or reportable conditions or a statement describing the reasons that corrective action is not necessary. Such plan shall be consistent with the audit resolution standard promulgated by the Comptroller General (as part of the standards for internal controls in the Federal Government) pursuant to section 3512(c).

“(j) The Director may authorize pilot projects to test alternative methods of achieving the purposes of this chapter. Such pilot projects may begin only after consultation with the Chair and Ranking Minority Member of the Committee on Governmental Affairs of the Senate and the Chair and Ranking Minority Member of the Committee on Government Reform and Oversight of the House of Representatives.

#### **§ 7503. Relation to other audit requirements**

“(a) An audit conducted in accordance with this chapter shall be in lieu of any financial audit of Federal awards which a non-Federal entity is required to undergo under any other Federal law or regulation. To the extent that such audit provides a Federal agency with the information it requires to carry out its responsibilities under Federal

law or regulation, a Federal agency shall rely upon and use that information.

“(b) Notwithstanding subsection (a), a Federal agency may conduct or arrange for additional audits which are necessary to carry out its responsibilities under Federal law or regulation. The provisions of this chapter do not authorize any non-Federal entity (or subrecipient thereof) to constrain, in any manner, such agency from carrying out or arranging for such additional audits, except that the Federal agency shall plan such audits to not be duplicative of other audits of Federal awards.

“(c) The provisions of this chapter do not limit the authority of Federal agencies to conduct, or arrange for the conduct of, audits and evaluations of Federal awards, nor limit the authority of any Federal agency Inspector General or other Federal official.

“(d) Subsection (a) shall apply to a non-Federal entity which undergoes an audit in accordance with this chapter even though it is not required by section 7502(a) to have such an audit.

“(e) A Federal agency that provides Federal awards and conducts or arranges for audits of non-Federal entities receiving such awards that are in addition to the audits of non-Federal entities conducted pursuant to this chapter shall, consistent with other applicable law, arrange for funding the full cost of such additional audits. Any such additional audits shall be coordinated with the Federal agency determined under criteria issued under section 7504 to preclude duplication of the audits conducted pursuant to this chapter or other additional audits.

“(f) Upon request by a Federal agency or the Comptroller General, any independent auditor conducting an audit pursuant to this chapter shall make the auditor's working papers available to the Federal agency or the Comptroller General as part of a quality review, to resolve audit findings, or to carry out oversight responsibilities consistent with the purposes of this chapter. Such access to auditor's working papers shall include the right to obtain copies.

**“§ 7504. Federal agency responsibilities and relations with non-Federal entities**

“(a) Each Federal agency shall, in accordance with guidance issued by the Director under section 7505, with regard to Federal awards provided by the agency—

“(1) monitor non-Federal entity use of Federal awards, and

“(2) assess the quality of audits conducted under this chapter for audits of entities for which the agency is the single Federal agency determined under subsection (b).

“(b) Each non-Federal entity shall have a single Federal agency, determined in accordance with criteria established by the Director, to provide the non-Federal entity with technical assistance and assist with implementation of this chapter.

“(c) The Director shall designate a Federal clearinghouse to—

“(1) receive copies of all reporting packages developed in accordance with this chapter;

“(2) identify recipients that expend \$300,000 or more in Federal awards or such other amount specified by the Director under section 7502(a)(3) during the recipient's fiscal year but did not undergo an audit in accordance with this chapter; and

“(3) perform analyses to assist the Director in carrying out responsibilities under this chapter.

**“§ 7505. Regulations**

“(a) The Director, after consultation with the Comptroller General, and appropriate officials from Federal, State, and local governments and nonprofit organizations shall prescribe guidance to implement this chapter. Each Federal agency shall promulgate such amendments to its regulations as may be necessary to conform such regulations to the requirements of this chapter and of such guidance.

“(b)(1) The guidance prescribed pursuant to subsection (a) shall include criteria for determining the appropriate charges to Federal awards for the cost of audits. Such criteria shall prohibit a non-Federal entity from charging to any Federal awards—

“(A) the cost of any audit which is—

“(i) not conducted in accordance with this chapter; or

“(ii) conducted in accordance with this chapter when expenditures of Federal awards are less than amounts cited in section 7502(a)(1)(A) or specified by the Director under section 7502(a)(3), except that the Director may allow the cost of limited scope audits to monitor subrecipients in accordance with section 7502(f)(2)(B); and

“(B) more than a reasonably proportionate share of the cost of any such audit that is conducted in accordance with this chapter.

“(2) The criteria prescribed pursuant to paragraph (1) shall not, in the absence of documentation demonstrating a higher actual cost, permit the percentage of the cost of audits performed pursuant to this chapter charged to Federal awards, to exceed the ratio of total Federal awards expended by such non-Federal entity during the applicable fiscal year or years, to such non-Federal entity's total expenditures during such fiscal year or years.

“(c) Such guidance shall include such provisions as may be necessary to ensure that small business concerns and business concerns owned and controlled by socially and economically disadvantaged individuals will have the opportunity to participate in the performance of contracts awarded to fulfill the audit requirements of this chapter.

**“§ 7506. Monitoring responsibilities of the Comptroller General**

“(a) The Comptroller General shall review provisions requiring financial audits of non-Federal entities that receive Federal awards that are contained in bills and resolutions reported by the committees of the Senate and the House of Representatives.

“(b) If the Comptroller General determines that a bill or resolution contains provisions that are inconsistent with the requirements of this chapter, the Comptroller General shall, at the earliest practicable date, notify in writing—

“(1) the committee that reported such bill or resolution; and

“(2)(A) the Committee on Governmental Affairs of the Senate (in the case of a bill or resolution reported by a committee of the Senate); or

“(B) the Committee on Government Reform and Oversight of the House of Representatives (in the case of a bill or resolution reported by a committee of the House of Representatives).

**"§ 7507. Effective date**

"This chapter shall apply to any non-Federal entity with respect to any of its fiscal years which begin after June 30, 1996."

31 USC 7501  
note.

**SEC. 3. TRANSITIONAL APPLICATION**

Subject to section 7507 of title 31, United States Code (as amended by section 2 of this Act) the provisions of chapter 75 of such title (before amendment by section 2 of this Act) shall continue to apply to any State or local government with respect to any of its fiscal years beginning before July 1, 1996.

Approved July 5, 1996.

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**LEGISLATIVE HISTORY—S. 1579 (H.R. 3184):**

**HOUSE REPORTS:** No. 104–607 accompanying H.R. 3184 (Comm. on Government Reform and Oversight).

**SENATE REPORTS:** No. 104–266 (Comm. On Governmental Affairs).

**CONGRESSIONAL RECORD, Vol. 142 (1996):**

June 14, considered and passed Senate.

June 18, considered and passed House.

**WEEKLY COMPILATION OF PRESIDENTIAL DOCUMENTS, Vol. 32 (1996):**  
July 5, Presidential statement.

## Appendix B

### OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations

**Franklin D. Raines,**  
Director

1. OMB rescinds Circular A-128 July 30, 1997
2. OMB revises Circular A-133 to read as follows:

[Circular No. A-133—Revised]

**To the Heads of Executive Departments and Establishments**

#### **SUBJECT: Audits of States, Local Governments, and Non-Profit Organizations.**

1. *Purpose.* This Circular is issued pursuant to the Single Audit Act of 1984, P.L. 98-502, and the Single Audit Act Amendments of 1996, P.L. 104-156. It sets forth standards for obtaining consistency and uniformity among Federal agencies for the audit of States, local governments, and non-profit organizations expending Federal awards.

2. *Authority.* Circular A-133 is issued under the authority of sections 503, 1111, and 7501 *et seq.* of title 31, United States Code, and Executive Orders 8248 and 11541.

3. *Rescission and Supersession.* This Circular rescinds Circular A-128, "Audits of State and Local Governments," issued April 12, 1985, and supersedes the prior Circular A-133, "Audits of Institutions of Higher Education and Other Non-Profit Institutions," issued April 22, 1996. For effective dates, see paragraph 10.

4. *Policy.* Except as provided herein, the standards set forth in this Circular shall be applied by all Federal agencies. If any statute specifically prescribes policies or specific requirements that differ from the standards provided herein, the provisions of the subsequent statute shall govern.

Federal agencies shall apply the provisions of the sections of this Circular to non-Federal entities, whether they are recipients expending Federal awards received directly from Federal awarding agencies, or are subrecipients expending Federal awards received from a pass-through entity (a recipient or another subrecipient).

This Circular does not apply to non-U.S. based entities expending Federal awards received either directly as a recipient or indirectly as a subrecipient.

5. *Definitions.* The definitions of key terms used in this Circular are contained in §\_\_\_105 in the Attachment to this Circular.

6. *Required Action.* The specific requirements and responsibilities of Federal agencies and non-Federal entities are set forth in the Attachment to this



Circular. Federal agencies making awards to non-Federal entities, either directly or indirectly, shall adopt the language in the Circular in codified regulations as provided in Section 10 (below), unless different provisions are required by Federal statute or are approved by the Office of Management and Budget (OMB).

7. *OMB Responsibilities.* OMB will review Federal agency regulations and implementation of this Circular, and will provide interpretations of policy requirements and assistance to ensure uniform, effective and efficient implementation.

8. *Information Contact.* Further information concerning Circular A-133 may be obtained by contacting the Financial Standards and Reporting Branch, Office of Federal Financial Management, Office of Management and Budget, Washington, DC 20503, telephone (202) 395-3993.

9. *Review Date.* This Circular will have a policy review three years from the date of issuance.

10. *Effective Dates.* The standards set forth in § \_\_.400 of the Attachment to this Circular, which apply directly to Federal agencies, shall be effective July 1, 1996, and shall apply to audits of fiscal years beginning after June 30, 1996, except as otherwise specified in § \_\_.400(a).

The standards set forth in this Circular that Federal agencies shall apply to non-Federal entities shall be adopted by Federal agencies in codified regulations not later than 60 days after publication of this final revision in the **Federal Register**, so that they will apply to audits of fiscal years beginning after June 30, 1996, with the exception that § \_\_.305(b) of the Attachment applies to audits of fiscal years beginning after June 30, 1998. The requirements of Circular A-128, although the Circular is rescinded, and the 1990 version of Circular A-133 remain in effect for audits of fiscal years beginning on or before June 30, 1996.

Franklin D. Raines,  
*Director.*

Attachment

**PART\_\_—AUDITS OF STATES, LOCAL GOVERNMENTS, AND NON-PROFIT ORGANIZATIONS****Subpart A—General**

Sec. .

\_\_\_.100 Purpose.

\_\_\_.105 Definitions.

**Subpart B—Audits**

\_\_\_.200 Audit requirements.

\_\_\_.205 Basis for determining Federal awards expended.

\_\_\_.210 Subrecipient and vendor determinations.

\_\_\_.215 Relation to other audit requirements.

\_\_\_.220 Frequency of audits.

\_\_\_.225 Sanctions.

\_\_\_.230 Audit costs.

\_\_\_.235 Program-specific audits.

**Subpart C—Auditees**

\_\_\_.300 Auditee responsibilities.

\_\_\_.305 Auditor selection.

\_\_\_.310 Financial statements.

\_\_\_.315 Audit findings follow-up.

\_\_\_.320 Report submission.

**Subpart D—Federal Agencies and Pass-Through Entities**

\_\_\_.400 Responsibilities.

\_\_\_.405 Management decision.

**Subpart E—Auditors**

\_\_\_.500 Scope of audit.

\_\_\_.505 Audit reporting.

\_\_\_.510 Audit findings.

\_\_\_.515 Audit working papers.

\_\_\_.520 Major program determination.

\_\_\_.525 Criteria for Federal program risk.

\_\_\_.530 Criteria for a low-risk auditee.

**Appendix A to Part\_\_—Data Collection Form (Form SF-SAC)****Appendix B to Part\_\_—Circular A-133 Compliance Supplement****Subpart A—General**

§ \_\_\_.100 Purpose.

This part sets forth standards for obtaining consistency and uniformity among Federal agencies for the audit of non-Federal entities expending Federal awards.

**§ \_\_.105 Definitions.**

*Auditee* means any non-Federal entity that expends Federal awards which must be audited under this part.

*Auditor* means an auditor, that is a public accountant or a Federal, State or local government audit organization, which meets the general standards specified in generally accepted government auditing standards (GAGAS). The term auditor does not include internal auditors of non-profit organizations.

*Audit finding* means deficiencies which the auditor is required by § \_\_.510(a) to report in the schedule of findings and questioned costs.

*CFDA number* means the number assigned to a Federal program in the *Catalog of Federal Domestic Assistance (CFDA)*.

*Cluster of programs* means a grouping of closely related programs that share common compliance requirements. The types of clusters of programs are research and development (R&D), student financial aid (SFA), and other clusters. "Other clusters" are as defined by the Office of Management and Budget (OMB) in the compliance supplement or as designated by a State for Federal awards the State provides to its subrecipients that meet the definition of a cluster of programs. When designating an "other cluster," a State shall identify the Federal awards included in the cluster and advise the subrecipients of compliance requirements applicable to the cluster, consistent with § \_\_.400(d)(1) and § \_\_.400(d)(2), respectively. A cluster of programs shall be considered as one program for determining major programs, as described in § \_\_.520, and, with the exception of R&D as described in § \_\_.200(c), whether a program-specific audit may be elected.

*Cognizant agency for audit* means the Federal agency designated to carry out the responsibilities described in § \_\_.400(a).

*Compliance supplement* refers to the *Circular A-133 Compliance Supplement*, included as Appendix B to Circular A-133, or such documents as OMB or its designee may issue to replace it. This document is available from the Government Printing Office, Superintendent of Documents, Washington, DC 20402-9325.

*Corrective action* means action taken by the auditee that:

- (1) Corrects identified deficiencies;
- (2) Produces recommended improvements; or
- (3) Demonstrates that audit findings are either invalid or do not warrant auditee action.

*Federal agency* has the same meaning as the term *agency* in Section 551(1) of title 5, United States Code.

*Federal award* means Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts, under grants or contracts, used to buy goods or services from vendors. Any audits of such vendors shall be covered by the terms and conditions of the contract. Contracts to operate Federal Government owned, contractor operated facilities (GOCOs) are excluded from the requirements of this part.

*Federal awarding agency* means the Federal agency that provides an award directly to the recipient.

*Federal financial assistance* means assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property (including donated surplus property), cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, and other assistance, but does not include amounts received as reimbursement for services rendered to individuals as described in §\_\_\_.205(h) and §\_\_\_.205(i).

*Federal program* means:

- (1) All Federal awards to a non-Federal entity assigned a single number in the CFDA.
- (2) When no CFDA number is assigned, all Federal awards from the same agency made for the same purpose should be combined and considered one program.
- (3) Notwithstanding paragraphs (1) and (2) of this definition, a cluster of programs. The types of clusters of programs are:
  - (i) Research and development (R&D);
  - (ii) Student financial aid (SFA); and
  - (iii) "Other clusters," as described in the definition of cluster of programs in this section.

*GAGAS* means generally accepted government auditing standards issued by the Comptroller General of the United States, which are applicable to financial audits.

*Generally accepted accounting principles* has the meaning specified in generally accepted auditing standards issued by the American Institute of Certified Public Accountants (AICPA).

*Indian tribe* means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

*Internal control* means a process, effected by an entity's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- (1) Effectiveness and efficiency of operations;
- (2) Reliability of financial reporting; and
- (3) Compliance with applicable laws and regulations.

*Internal control pertaining to the compliance requirements for Federal programs* (Internal control over Federal programs) means a process—effected by an entity's management and other personnel—designed to provide reasonable assurance regarding the achievement of the following objectives for Federal programs:

- (1) Transactions are properly recorded and accounted for to:
  - (i) Permit the preparation of reliable financial statements and Federal reports;

- (ii) Maintain accountability over assets; and
- (iii) Demonstrate compliance with laws, regulations, and other compliance requirements;
- (2) Transactions are executed in compliance with:
  - (i) Laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on a Federal program; and
  - (ii) Any other laws and regulations that are identified in the compliance supplement; and
- (3) Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

*Loan* means a Federal loan or loan guarantee received or administered by a non-Federal entity.

*Local government* means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, and any other instrumentality of local government.

*Major program* means a Federal program determined by the auditor to be a major program in accordance with §\_\_.520 or a program identified as a major program by a Federal agency or pass-through entity in accordance with §\_\_.215(c).

*Management decision* means the evaluation by the Federal awarding agency or pass-through entity of the audit findings and corrective action plan and the issuance of a written decision as to what corrective action is necessary.

*Non-Federal entity* means a State, local government, or non-profit organization.

*Non-profit organization* means:

- (1) any corporation, trust, association, cooperative, or other organization that:
  - (i) Is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest;
  - (ii) Is not organized primarily for profit; and
  - (iii) Uses its net proceeds to maintain, improve, or expand its operations; and
- (2) The term *non-profit organization* includes non-profit institutions of higher education and hospitals.

*OMB* means the Executive Office of the President, Office of Management and Budget.

*Oversight agency for audit* means the Federal awarding agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency for audit. When there is no direct funding, the Federal agency with the predominant indirect funding shall assume the oversight responsibilities. The duties of the oversight agency for audit are described in §\_\_.400(b).

*Pass-through entity* means a non-Federal entity that provides a Federal award to a subrecipient to carry out a Federal program.

*Program-specific audit* means an audit of one Federal program as provided for in §\_\_\_\_.200(c) and §\_\_\_\_.235.

*Questioned cost* means a cost that is questioned by the auditor because of an audit finding:

- (1) Which resulted from a violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of Federal funds, including funds used to match Federal funds;
- (2) Where the costs, at the time of the audit, are not supported by adequate documentation; or
- (3) Where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

*Recipient* means a non-Federal entity that expends Federal awards received directly from a Federal awarding agency to carry out a Federal program.

*Research and development (R&D)* means all research activities, both basic and applied, and all development activities that are performed by a non-Federal entity. *Research* is defined as a systematic study directed toward fuller scientific knowledge or understanding of the subject studied. The term research also includes activities involving the training of individuals in research techniques where such activities utilize the same facilities as other research and development activities and where such activities are not included in the instruction function. *Development* is the systematic use of knowledge and understanding gained from research directed toward the production of useful materials, devices, systems, or methods, including design and development of prototypes and processes.

*Single audit* means an audit which includes both the entity's financial statements and the Federal awards as described in §\_\_\_\_.500.

*State* means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or interstate entity which has governmental functions, and any Indian tribe as defined in this section.

*Student Financial Aid (SFA)* includes those programs of general student assistance, such as those authorized by Title IV of the Higher Education Act of 1965, as amended, (20 U.S.C. 1070 *et seq.*) which is administered by the U.S. Department of Education, and similar programs provided by other Federal agencies. It does not include programs which provide fellowships or similar Federal awards to students on a competitive basis, or for specified studies or research.

*Subrecipient* means a non-Federal entity that expends Federal awards received from a pass-through entity to carry out a Federal program, but does not include an individual that is a beneficiary of such a program. A subrecipient may also be a recipient of other Federal awards directly from a Federal awarding agency. Guidance on distinguishing between a subrecipient and a vendor is provided in §\_\_\_\_.210.

*Types of compliance requirements* refers to the types of compliance requirements listed in the compliance supplement. Examples include: activities allowed or unallowed; allowable costs/cost principles; cash management; eligibility; matching; level of effort, earmarking; and, reporting.

*Vendor* means a dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a Federal program. These goods or services may be for an organization's own use or for the use of beneficiaries of the Federal program. Additional guidance on distinguishing between a subrecipient and a vendor is provided in § \_\_\_.210.

## **Subpart B—Audits**

### **§ \_\_\_.200 Audit requirements.**

(a) *Audit required.* Non-Federal entities that expend \$300,000 or more in a year in Federal awards shall have a single or program-specific audit conducted for that year in accordance with the provisions of this part. Guidance on determining Federal awards expended is provided in § \_\_\_.205.

(b) *Single audit.* Non-Federal entities that expend \$300,000 or more in a year in Federal awards shall have a single audit conducted in accordance with § \_\_\_.500 except when they elect to have a program-specific audit conducted in accordance with paragraph (c) of this section.

(c) *Program-specific audit election.* When an auditee expends Federal awards under only one Federal program (excluding R&D) and the Federal program's laws, regulations, or grant agreements do not require a financial statement audit of the auditee, the auditee may elect to have a program-specific audit conducted in accordance with § \_\_\_.235. A program-specific audit may not be elected for R&D unless all of the Federal awards expended were received from the same Federal agency, or the same Federal agency and the same pass-through entity, and that Federal agency, or pass-through entity in the case of a subrecipient, approves in advance a program-specific audit.

(d) *Exemption when Federal awards expended are less than \$300,000.* Non-Federal entities that expend less than \$300,000 a year in Federal awards are exempt from Federal audit requirements for that year, except as noted in § \_\_\_.215(a), but records must be available for review or audit by appropriate officials of the Federal agency, pass-through entity, and General Accounting Office (GAO).

(e) *Federally Funded Research and Development Centers (FFRDC).* Management of an auditee that owns or operates a FFRDC may elect to treat the FFRDC as a separate entity for purposes of this part.

### **§ \_\_\_.205 Basis for determining Federal awards expended.**

(a) *Determining Federal awards expended.* The determination of when an award is expended should be based on when the activity related to the award occurs. Generally, the activity pertains to events that require the non-Federal entity to comply with laws, regulations, and the provisions of contracts or grant agreements, such as: expenditure/expense transactions associated with grants, cost-reimbursement contracts, cooperative agreements, and direct appropriations; the disbursement of funds passed through to subrecipients; the use of loan proceeds under loan and loan guarantee programs; the receipt of property; the receipt of surplus property; the receipt or use of program income; the distribution or consumption of food commodities; the disbursement of amounts entitling the non-Federal entity to an interest subsidy; and, the period when insurance is in force.

(b) *Loan and loan guarantees (loans).* Since the Federal Government is at risk for loans until the debt is repaid, the following guidelines shall be used to

calculate the value of Federal awards expended under loan programs, except as noted in paragraphs (c) and (d) of this section:

- (1) Value of new loans made or received during the fiscal year; plus
- (2) Balance of loans from previous years for which the Federal Government imposes continuing compliance requirements; plus
- (3) Any interest subsidy, cash, or administrative cost allowance received.

(c) *Loan and loan guarantees (loans) at institutions of higher education.* When loans are made to students of an institution of higher education but the institution does not make the loans, then only the value of loans made during the year shall be considered Federal awards expended in that year. The balance of loans for previous years is not included as Federal awards expended because the lender accounts for the prior balances.

(d) *Prior loan and loan guarantees (loans).* Loans, the proceeds of which were received and expended in prior-years, are not considered Federal awards expended under this part when the laws, regulations, and the provisions of contracts or grant agreements pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

(e) *Endowment funds.* The cumulative balance of Federal awards for endowment funds which are federally restricted are considered awards expended in each year in which the funds are still restricted.

(f) *Free rent.* Free rent received by itself is not considered a Federal award expended under this part. However, free rent received as part of an award to carry out a Federal program shall be included in determining Federal awards expended and subject to audit under this part.

(g) *Valuing non-cash assistance.* Federal non-cash assistance, such as free rent, food stamps, food commodities, donated property, or donated surplus property, shall be valued at fair market value at the time of receipt or the assessed value provided by the Federal agency.

(h) *Medicare.* Medicare payments to a non-Federal entity for providing patient care services to Medicare eligible individuals are not considered Federal awards expended under this part.

(i) *Medicaid.* Medicaid payments to a subrecipient for providing patient care services to Medicaid eligible individuals are not considered Federal awards expended under this part unless a State requires the funds to be treated as Federal awards expended because reimbursement is on a cost-reimbursement basis.

(j) *Certain loans provided by the National Credit Union Administration.* For purposes of this part, loans made from the National Credit Union Share Insurance Fund and the Central Liquidity Facility that are funded by contributions from insured institutions are not considered Federal awards expended.

#### **§\_\_\_.210 Subrecipient and vendor determinations.**

(a) *General.* An auditee may be a recipient, a subrecipient, and a vendor. Federal awards expended as a recipient or a subrecipient would be subject to audit under this part. The payments received for goods or services provided as a vendor would not be considered Federal awards. The guidance in paragraphs (b) and (c) of this section should be considered in determining whether payments constitute a Federal award or a payment for goods and services.



(b) *Federal award.* Characteristics indicative of a Federal award received by a subrecipient are when the organization:

- (1) Determines who is eligible to receive what Federal financial assistance;
- (2) Has its performance measured against whether the objectives of the Federal program are met;
- (3) Has responsibility for programmatic decision making;
- (4) Has responsibility for adherence to applicable Federal program compliance requirements; and
- (5) Uses the Federal funds to carry out a program of the organization as compared to providing goods or services for a program of the pass-through entity.

(c) *Payment for goods and services.* Characteristics indicative of a payment for goods and services received by a vendor are when the organization:

- (1) Provides the goods and services within normal business operations;
- (2) Provides similar goods or services to many different purchasers;
- (3) Operates in a competitive environment;
- (4) Provides goods or services that are ancillary to the operation of the Federal program; and
- (5) Is not subject to compliance requirements of the Federal program.

(d) *Use of judgment in making determination.* There may be unusual circumstances or exceptions to the listed characteristics. In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. It is not expected that all of the characteristics will be present and judgment should be used in determining whether an entity is a subrecipient or vendor.

(e) *For-profit subrecipient.* Since this part does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. The contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for Federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the contract, and post-award audits.

(f) *Compliance responsibility for vendors.* In most cases, the auditee's compliance responsibility for vendors is only to ensure that the procurement, receipt, and payment for goods and services comply with laws, regulations, and the provisions of contracts or grant agreements. Program compliance requirements normally do not pass through to vendors. However, the auditee is responsible for ensuring compliance for vendor transactions which are structured such that the vendor is responsible for program compliance or the vendor's records must be reviewed to determine program compliance. Also, when these vendor transactions relate to a major program, the scope of the audit shall include determining whether these transactions are in compliance with laws, regulations, and the provisions of contracts or grant agreements.

#### **§\_\_\_.215 Relation to other audit requirements.**

(a) *Audit under this part in lieu of other audits.* An audit made in accordance with this part shall be in lieu of any financial audit required under individual

**Federal awards.** To the extent this audit meets a Federal agency's needs, it shall rely upon and use such audits. The provisions of this part neither limit the authority of Federal agencies, including their Inspectors General, or GAO to conduct or arrange for additional audits (e.g., financial audits, performance audits, evaluations, inspections, or reviews) nor authorize any auditee to constrain Federal agencies from carrying out additional audits. Any additional audits shall be planned and performed in such a way as to build upon work performed by other auditors.

(b) *Federal agency to pay for additional audits.* A Federal agency that conducts or contracts for additional audits shall, consistent with other applicable laws and regulations, arrange for funding the full cost of such additional audits.

(c) *Request for a program to be audited as a major program.* A Federal agency may request an auditee to have a particular Federal program audited as a major program in lieu of the Federal agency conducting or arranging for the additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. The auditee, after consultation with its auditor, should promptly respond to such request by informing the Federal agency whether the program would otherwise be audited as a major program using the risk-based audit approach described in § \_\_.520 and, if not, the estimated incremental cost. The Federal agency shall then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based upon this Federal agency request, and the Federal agency agrees to pay the full incremental costs, then the auditee shall have the program audited as a major program. A pass-through entity may use the provisions of this paragraph for a subrecipient.

#### **§ \_\_.220 Frequency of audits.**

Except for the provisions for biennial audits provided in paragraphs (a) and (b) of this section, audits required by this part shall be performed annually. Any biennial audit shall cover both years within the biennial period.

- (a) A State or local government that is required by constitution or statute, in effect on January 1, 1987, to undergo its audits less frequently than annually, is permitted to undergo its audits pursuant to this part biennially. This requirement must still be in effect for the biennial period under audit.
- (b) Any non-profit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, is permitted to undergo its audits pursuant to this part biennially.

#### **§ \_\_.225 Sanctions.**

No audit costs may be charged to Federal awards when audits required by this part have not been made or have been made but not in accordance with this part. In cases of continued inability or unwillingness to have an audit conducted in accordance with this part, Federal agencies and pass-through entities shall take appropriate action using sanctions such as:

- (a) Withholding a percentage of Federal awards until the audit is completed satisfactorily;
- (b) Withholding or disallowing overhead costs;
- (c) Suspending Federal awards until the audit is conducted; or
- (d) Terminating the Federal award.

**§\_\_.230 Audit costs.**

(a) *Allowable costs.* Unless prohibited by law, the cost of audits made in accordance with the provisions of this part are allowable charges to Federal awards. The charges may be considered a direct cost or an allocated indirect cost, as determined in accordance with the provisions of applicable OMB cost principles circulars, the Federal Acquisition Regulation (FAR) (48 CFR parts 30 and 31), or other applicable cost principles or regulations.

(b) *Unallowable costs.* A non-Federal entity shall not charge the following to a Federal award:

- (1) The cost of any audit under the Single Audit Act Amendments of 1996 (31 U.S.C. 7501 *et seq.*) not conducted in accordance with this part.
- (2) The cost of auditing a non-Federal entity which has Federal awards expended of less than \$300,000 per year and is thereby exempted under §\_\_.200(d) from having an audit conducted under this part. However, this does not prohibit a pass-through entity from charging Federal awards for the cost of limited scope audits to monitor its subrecipients in accordance with §\_\_.400(d)(3), provided the subrecipient does not have a single audit. For purposes of this part, limited scope audits only include agreed-upon procedures engagements conducted in accordance with either the AICPA's generally accepted auditing standards or attestation standards, that are paid for and arranged by a pass-through entity and address only one or more of the following types of compliance requirements: activities allowed or unallowed; allowable costs/cost principles; eligibility; matching; level of effort, earmarking; and, reporting.

**§\_\_.235 Program-specific audits.**

(a) *Program-specific audit guide available.* In many cases, a program-specific audit guide will be available to provide specific guidance to the auditor with respect to internal control, compliance requirements, suggested audit procedures, and audit reporting requirements. The auditor should contact the Office of Inspector General of the Federal agency to determine whether such a guide is available. When a current program-specific audit guide is available, the auditor shall follow GAGAS and the guide when performing a program-specific audit.

(b) *Program-specific audit guide not available.* (1) When a program-specific audit guide is not available, the auditee and auditor shall have basically the same responsibilities for the Federal program as they would have for an audit of a major program in a single audit.

- (2) The auditee shall prepare the financial statement(s) for the Federal program that includes, at a minimum, a schedule of expenditures of Federal awards for the program and notes that describe the significant accounting policies used in preparing the schedule, a summary schedule of prior audit findings consistent with the requirements of §\_\_.315(b), and a corrective action plan consistent with the requirements of §\_\_.315(c).
- (3) The auditor shall:
  - (i) Perform an audit of the financial statement(s) for the Federal program in accordance with GAGAS;

- (ii) Obtain an understanding of internal control and perform tests of internal control over the Federal program consistent with the requirements of § \_\_.500(c) for a major program;
  - (iii) Perform procedures to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the Federal program consistent with the requirements of § \_\_.500(d) for a major program; and
  - (iv) Follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding in accordance with the requirements of § \_\_.500(e).
- (4) The auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in this section. The auditor's report(s) shall state that the audit was conducted in accordance with this part and include the following:
- (i) An opinion (or disclaimer of opinion) as to whether the financial statement(s) of the Federal program is presented fairly in all material respects in conformity with the stated accounting policies;
  - (ii) A report on internal control related to the Federal program, which shall describe the scope of testing of internal control and the results of the tests;
  - (iii) A report on compliance which includes an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements which could have a direct and material effect on the Federal program; and
  - (iv) A schedule of findings and questioned costs for the Federal program that includes a summary of the auditor's results relative to the Federal program in a format consistent with § \_\_.505(d)(1) and findings and questioned costs consistent with the requirements of § \_\_.505(d)(3).
- (c) *Report submission for program-specific audits.* (1) The audit shall be completed and the reporting required by paragraph (c)(2) or (c)(3) of this section submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the Federal agency that provided the funding or a different period is specified in a program-specific audit guide. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the required reporting shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period, unless a different period is specified in a program-specific audit guide.) Unless restricted by law or regulation, the auditee shall make report copies available for public inspection.
- (2) When a program-specific audit guide is available, the auditee shall submit to the Federal clearinghouse designated by OMB the data

collection form prepared in accordance with § \_\_.320(b), as applicable to a program-specific audit, and the reporting required by the program-specific audit guide to be retained as an archival copy. Also, the auditee shall submit to the Federal awarding agency or pass-through entity the reporting required by the program-specific audit guide.

- (3) When a program-specific audit guide is not available, the reporting package for a program-specific audit shall consist of the financial statement(s) of the Federal program, a summary schedule of prior audit findings, and a corrective action plan as described in paragraph (b)(2) of this section, and the auditor's report(s) described in paragraph (b)(4) of this section. The data collection form prepared in accordance with § \_\_.320(b), as applicable to a program-specific audit, and one copy of this reporting package shall be submitted to the Federal clearinghouse designated by OMB to be retained as an archival copy. Also, when the schedule of findings and questioned costs disclosed audit findings or the summary schedule of prior audit findings reported the status of any audit findings, the auditee shall submit one copy of the reporting package to the Federal clearinghouse on behalf of the Federal awarding agency, or directly to the pass-through entity in the case of a subrecipient. Instead of submitting the reporting package to the pass-through entity, when a subrecipient is not required to submit a reporting package to the pass-through entity, the subrecipient shall provide written notification to the pass-through entity, consistent with the requirements of § \_\_.320(e)(2). A subrecipient may submit a copy of the reporting package to the pass-through entity to comply with this notification requirement.

(d) *Other sections of this part may apply.* Program-specific audits are subject to § \_\_.100 through § \_\_.215(b), § \_\_.220 through § \_\_.230, § \_\_.300 through § \_\_.305, § \_\_.315, § \_\_.320(f) through § \_\_.320(j), § \_\_.400 through § \_\_.405, § \_\_.510 through § \_\_.515, and other referenced provisions of this part unless contrary to the provisions of this section, a program-specific audit guide, or program laws and regulations.

### **Subpart C—Auditees**

#### **§ \_\_.300 Auditee responsibilities.**

The auditee shall:

- (a) Identify, in its accounts, all Federal awards received and expended and the Federal programs under which they were received. Federal program and award identification shall include, as applicable, the CFDA title and number, award number and year, name of the Federal agency, and name of the pass-through entity.
- (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs.
- (c) Comply with laws, regulations, and the provisions of contracts or grant agreements related to each of its Federal programs.

- (d) Prepare appropriate financial statements, including the schedule of expenditures of Federal awards in accordance with § \_\_\_.310.
- (e) Ensure that the audits required by this part are properly performed and submitted when due. When extensions to the report submission due date required by § \_\_\_.320(a) are granted by the cognizant or oversight agency for audit, promptly notify the Federal clearinghouse designated by OMB and each pass-through entity providing Federal awards of the extension.
- (f) Follow up and take corrective action on audit findings, including preparation of a summary schedule of prior audit findings and a corrective action plan in accordance with § \_\_\_.315(b) and § \_\_\_.315(c), respectively.

**§ \_\_\_.305 Auditor selection.**

(a) *Auditor procurement.* In procuring audit services, auditees shall follow the procurement standards prescribed by the Grants Management Common Rule (hereinafter referred to as the "A-102 Common Rule") published March 11, 1988 and amended April 19, 1995 [insert appropriate CFR citation], Circular A-110, "Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations," or the FAR (48 CFR part 42), as applicable (OMB Circulars are available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503). Whenever possible, auditees shall make positive efforts to utilize small businesses, minority-owned firms, and women's business enterprises, in procuring audit services as stated in the A-102 Common Rule, OMB Circular A-110, or the FAR (48 CFR part 42), as applicable. In requesting proposals for audit services, the objectives and scope of the audit should be made clear. Factors to be considered in evaluating each proposal for audit services include the responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and technical abilities, the results of external quality control reviews, and price.

(b) *Restriction on auditor preparing indirect cost proposals.* An auditor who prepares the indirect cost proposal or cost allocation plan may not also be selected to perform the audit required by this part when the indirect costs recovered by the auditee during the prior year exceeded \$1 million. This restriction applies to the base year used in the preparation of the indirect cost proposal or cost allocation plan and any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs. To minimize any disruption in existing contracts for audit services, this paragraph applies to audits of fiscal years beginning after June 30, 1998.

(c) *Use of Federal auditors.* Federal auditors may perform all or part of the work required under this part if they comply fully with the requirements of this part.

**§ \_\_\_.310 Financial statements.**

(a) *Financial statements.* The auditee shall prepare financial statements that reflect its financial position, results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements shall be for the same organizational unit and fiscal year that is chosen to meet the requirements of this part. However, organization-wide financial

statements may also include departments, agencies, and other organizational units that have separate audits in accordance with §\_\_\_.500(a) and prepare separate financial statements.

(b) *Schedule of expenditures of Federal awards.* The auditee shall also prepare a schedule of expenditures of Federal awards for the period covered by the auditee's financial statements. While not required, the auditee may choose to provide information requested by Federal awarding agencies and pass-through entities to make the schedule easier to use. For example, when a Federal program has multiple award years, the auditee may list the amount of Federal awards expended for each award year separately. At a minimum, the schedule shall:

- (1) List individual Federal programs by Federal agency. For Federal programs included in a cluster of programs, list individual Federal programs within a cluster of programs. For R&D, total Federal awards expended shall be shown either by individual award or by Federal agency and major subdivision within the Federal agency. For example, the National Institutes of Health is a major subdivision in the Department of Health and Human Services.
- (2) For Federal awards received as a subrecipient, the name of the pass-through entity and identifying number assigned by the pass-through entity shall be included.
- (3) Provide total Federal awards expended for each individual Federal program and the CFDA number or other identifying number when the CFDA information is not available.
- (4) Include notes that describe the significant accounting policies used in preparing the schedule.
- (5) To the extent practical, pass-through entities should identify in the schedule the total amount provided to subrecipients from each Federal program.
- (6) Include, in either the schedule or a note to the schedule, the value of the Federal awards expended in the form of non-cash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end. While not required, it is preferable to present this information in the schedule.

#### **§\_\_\_.315 Audit findings follow-up.**

(a) *General.* The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee shall prepare a summary schedule of prior audit findings. The auditee shall also prepare a corrective action plan for current year audit findings. The summary schedule of prior audit findings and the corrective action plan shall include the reference numbers the auditor assigns to audit findings under §\_\_\_.510(c). Since the summary schedule may include audit findings from multiple years, it shall include the fiscal year in which the finding initially occurred.

(b) *Summary schedule of prior audit findings.* The summary schedule of prior audit findings shall report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to Federal awards. The summary schedule shall also include audit findings reported in the prior audit's summary schedule of prior audit findings except audit findings listed as corrected in accordance with paragraph (b)(1) of this section, or no longer valid or not warranting further action in accordance with paragraph (b)(4) of this section.

- (1) When audit findings were fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.
  - (2) When audit findings were not corrected or were only partially corrected, the summary schedule shall describe the planned corrective action as well as any partial corrective action taken.
  - (3) When corrective action taken is significantly different from corrective action previously reported in a corrective action plan or in the Federal agency's or pass-through entity's management decision, the summary schedule shall provide an explanation.
  - (4) When the auditee believes the audit findings are no longer valid or do not warrant further action, the reasons for this position shall be described in the summary schedule. A valid reason for considering an audit finding as not warranting further action is that all of the following have occurred:
    - (i) Two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse;
    - (ii) The Federal agency or pass-through entity is not currently following up with the auditee on the audit finding; and
    - (iii) A management decision was not issued.
- (c) *Corrective action plan.* At the completion of the audit, the auditee shall prepare a corrective action plan to address each audit finding included in the current year auditor's reports. The corrective action plan shall provide the name(s) of the contact person(s) responsible for corrective action, the corrective action planned, and the anticipated completion date. If the auditee does not agree with the audit findings or believes corrective action is not required, then the corrective action plan shall include an explanation and specific reasons.

#### **§ \_\_.320 Report submission.**

(a) *General.* The audit shall be completed and the data collection form described in paragraph (b) of this section and reporting package described in paragraph (c) of this section shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the data collection form and reporting package shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period.) Unless restricted by law or regulation, the auditee shall make copies available for public inspection.

(b) *Data Collection.* (1) The auditee shall submit a data collection form which states whether the audit was completed in accordance with this part and provides information about the auditee, its Federal programs, and the results of the audit. The form shall be approved by OMB, available from the Federal clearinghouse designated by OMB, and include data elements similar to those presented in this paragraph. A senior level representative of the auditee (e.g., State controller, director of finance, chief executive officer, or chief financial officer) shall sign a statement to be included as part of the form certifying that: the auditee complied with the requirements of this part, the form was prepared in accordance with this part (and the instructions accompanying the form), and the information included in the form, in its entirety, are accurate and complete.



- (2) The data collection form shall include the following data elements:
- (i) The type of report the auditor issued on the financial statements of the auditee (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
  - (ii) Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.
  - (iii) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee.
  - (iv) Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.
  - (v) The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
  - (vi) A list of the Federal awarding agencies which will receive a copy of the reporting package pursuant to § \_\_.320(d)(2).
  - (vii) A yes or no statement as to whether the auditee qualified as a low-risk auditee under § \_\_.530.
  - (viii) The dollar threshold used to distinguish between Type A and Type B programs as defined in § \_\_.520(b).
  - (ix) The *Catalog of Federal Domestic Assistance* (CFDA) number for each Federal program, as applicable.
  - (x) The name of each Federal program and identification of each major program. Individual programs within a cluster of programs should be listed in the same level of detail as they are listed in the schedule of expenditures of Federal awards.
  - (xi) The amount of expenditures in the schedule of expenditures of Federal awards associated with each Federal program.
  - (xii) For each Federal program, a yes or no statement as to whether there are audit findings in each of the following types of compliance requirements and the total amount of any questioned costs:
    - (A) Activities allowed or unallowed.
    - (B) Allowable costs/cost principles.
    - (C) Cash management.
    - (D) Davis-Bacon Act.
    - (E) Eligibility.
    - (F) Equipment and real property management.
    - (G) Matching, level of effort, earmarking.
    - (H) Period of availability of Federal funds.
    - (I) Procurement and suspension and debarment.
    - (J) Program income.
    - (K) Real property acquisition and relocation assistance.

- (L) Reporting.
- (M) Subrecipient monitoring.
- (N) Special tests and provisions.
- (xiii) Auditee Name, Employer Identification Number(s), Name and Title of Certifying Official, Telephone Number, Signature, and Date.
- (xiv) Auditor Name, Name and Title of Contact Person, Auditor Address, Auditor Telephone Number, Signature, and Date.
- (xv) Whether the auditee has either a cognizant or oversight agency for audit.
- (xvi) The name of the cognizant or oversight agency for audit determined in accordance with §\_\_\_\_.400(a) and §\_\_\_\_.400(b), respectively.
- (3) Using the information included in the reporting package described in paragraph (c) of this section, the auditor shall complete the applicable sections of the form. The auditor shall sign a statement to be included as part of the data collection form that indicates, at a minimum, the source of the information included in the form, the auditor's responsibility for the information, that the form is not a substitute for the reporting package described in paragraph (c) of this section, and that the content of the form is limited to the data elements prescribed by OMB.
- (c) *Reporting package.* The reporting package shall include the:
  - (1) Financial statements and schedule of expenditures of Federal awards discussed in §\_\_\_\_.310(a) and §\_\_\_\_.310(b), respectively;
  - (2) Summary schedule of prior audit findings discussed in §\_\_\_\_.315(b);
  - (3) Auditor's report(s) discussed in §\_\_\_\_.505; and
  - (4) Corrective action plan discussed in §\_\_\_\_.315(c).
- (d) *Submission to clearinghouse.* All auditees shall submit to the Federal clearinghouse designated by OMB the data collection form described in paragraph (b) of this section and one copy of the reporting package described in paragraph (c) of this section for:
  - (1) The Federal clearinghouse to retain as an archival copy; and
  - (2) Each Federal awarding agency when the schedule of findings and questioned costs disclosed audit findings relating to Federal awards that the Federal awarding agency provided directly or the summary schedule of prior audit findings reported the status of any audit findings relating to Federal awards that the Federal awarding agency provided directly.
- (e) *Additional submission by subrecipients.* (1) In addition to the requirements discussed in paragraph (d) of this section, auditees that are also subrecipients shall submit to each pass-through entity one copy of the reporting package described in paragraph (c) of this section for each pass-through entity when the schedule of findings and questioned costs disclosed audit findings relating to Federal awards that the pass-through entity provided or the summary schedule of prior audit findings reported the status of any audit findings relating to Federal awards that the pass-through entity provided.

- (2) Instead of submitting the reporting package to a pass-through entity, when a subrecipient is not required to submit a reporting package to a pass-through entity pursuant to paragraph (e)(1) of this section, the subrecipient shall provide written notification to the pass-through entity that: an audit of the subrecipient was conducted in accordance with this part (including the period covered by the audit and the name, amount, and CFDA number of the Federal award(s) provided by the pass-through entity); the schedule of findings and questioned costs disclosed no audit findings relating to the Federal award(s) that the pass-through entity provided; and, the summary schedule of prior audit findings did not report on the status of any audit findings relating to the Federal award(s) that the pass-through entity provided. A subrecipient may submit a copy of the reporting package described in paragraph (c) of this section to a pass-through entity to comply with this notification requirement.

(f) *Requests for report copies.* In response to requests by a Federal agency or pass-through entity, auditees shall submit the appropriate copies of the reporting package described in paragraph (c) of this section and, if requested, a copy of any management letters issued by the auditor.

(g) *Report retention requirements.* Auditees shall keep one copy of the data collection form described in paragraph (b) of this section and one copy of the reporting package described in paragraph (c) of this section on file for three years from the date of submission to the Federal clearinghouse designated by OMB. Pass-through entities shall keep subrecipients' submissions on file for three years from date of receipt.

(h) *Clearinghouse responsibilities.* The Federal clearinghouse designated by OMB shall distribute the reporting packages received in accordance with paragraph (d)(2) of this section and § \_\_.235(c)(3) to applicable Federal awarding agencies, maintain a data base of completed audits, provide appropriate information to Federal agencies, and follow up with known auditees which have not submitted the required data collection forms and reporting packages.

(i) *Clearinghouse address.* The address of the Federal clearinghouse currently designated by OMB is Federal Audit Clearinghouse, Bureau of the Census, 1201 E. 10th Street, Jeffersonville, IN 47132.

(j) *Electronic filing.* Nothing in this part shall preclude electronic submissions to the Federal clearinghouse in such manner as may be approved by OMB. With OMB approval, the Federal clearinghouse may pilot test methods of electronic submissions.

#### **Subpart D—Federal Agencies and Pass-Through Entities**

##### **§ \_\_.400 Responsibilities.**

(a) *Cognizant agency for audit responsibilities.* Recipients expending more than \$25 million a year in Federal awards shall have a cognizant agency for audit. The designated cognizant agency for audit shall be the Federal awarding agency that provides the predominant amount of direct funding to a recipient unless OMB makes a specific cognizant agency for audit assignment. To provide for continuity of cognizance, the determination of the predominant amount of direct funding shall be based upon direct Federal awards expended in the recipient's fiscal years ending in 1995, 2000, 2005, and every fifth year thereafter. For example, audit cognizance for periods ending in 1997 through 2000

will be determined based on Federal awards expended in 1995. (However, for States and local governments that expend more than \$25 million a year in Federal awards and have previously assigned cognizant agencies for audit, the requirements of this paragraph are not effective until fiscal years beginning after June 30, 2000.) Notwithstanding the manner in which audit cognizance is determined, a Federal awarding agency with cognizance for an auditee may reassign cognizance to another Federal awarding agency which provides substantial direct funding and agrees to be the cognizant agency for audit. Within 30 days after any reassignment, both the old and the new cognizant agency for audit shall notify the auditee, and, if known, the auditor of the reassignment. The cognizant agency for audit shall:

- (1) Provide technical audit advice and liaison to auditees and auditors.
- (2) Consider auditee requests for extensions to the report submission due date required by § \_\_.320(a). The cognizant agency for audit may grant extensions for good cause.
- (3) Obtain or conduct quality control reviews of selected audits made by non-Federal auditors, and provide the results, when appropriate, to other interested organizations.
- (4) Promptly inform other affected Federal agencies and appropriate Federal law enforcement officials of any direct reporting by the auditee or its auditor of irregularities or illegal acts, as required by GAGAS or laws and regulations.
- (5) Advise the auditor and, where appropriate, the auditee of any deficiencies found in the audits when the deficiencies require corrective action by the auditor. When advised of deficiencies, the auditee shall work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency for audit shall notify the auditor, the auditee, and applicable Federal awarding agencies and pass-through entities of the facts and make recommendations for follow-up action. Major inadequacies or repetitive substandard performance by auditors shall be referred to appropriate State licensing agencies and professional bodies for disciplinary action.
- (6) Coordinate, to the extent practical, audits or reviews made by or for Federal agencies that are in addition to the audits made pursuant to this part, so that the additional audits or reviews build upon audits performed in accordance with this part.
- (7) Coordinate a management decision for audit findings that affect the Federal programs of more than one agency.
- (8) Coordinate the audit work and reporting responsibilities among auditors to achieve the most cost-effective audit.
- (9) For biennial audits permitted under § \_\_.220, consider auditee requests to qualify as a low-risk auditee under § \_\_.530(a).

(b) *Oversight agency for audit responsibilities.* An auditee which does not have a designated cognizant agency for audit will be under the general oversight of the Federal agency determined in accordance with § \_\_.105. The oversight agency for audit:

- (1) Shall provide technical advice to auditees and auditors as requested.

- (2) May assume all or some of the responsibilities normally performed by a cognizant agency for audit.
- (c) *Federal awarding agency responsibilities.* The Federal awarding agency shall perform the following for the Federal awards it makes:
  - (1) Identify Federal awards made by informing each recipient of the CFDA title and number, award name and number, award year, and if the award is for R&D. When some of this information is not available, the Federal agency shall provide information necessary to clearly describe the Federal award.
  - (2) Advise recipients of requirements imposed on them by Federal laws, regulations, and the provisions of contracts or grant agreements.
  - (3) Ensure that audits are completed and reports are received in a timely manner and in accordance with the requirements of this part.
  - (4) Provide technical advice and counsel to auditees and auditors as requested.
  - (5) Issue a management decision on audit findings within six months after receipt of the audit report and ensure that the recipient takes appropriate and timely corrective action.
  - (6) Assign a person responsible for providing annual updates of the compliance supplement to OMB.
- (d) *Pass-through entity responsibilities.* A pass-through entity shall perform the following for the Federal awards it makes:
  - (1) Identify Federal awards made by informing each subrecipient of CFDA title and number, award name and number, award year, if the award is R&D, and name of Federal agency. When some of this information is not available, the pass-through entity shall provide the best information available to describe the Federal award.
  - (2) Advise subrecipients of requirements imposed on them by Federal laws, regulations, and the provisions of contracts or grant agreements as well as any supplemental requirements imposed by the pass-through entity.
  - (3) Monitor the activities of subrecipients as necessary to ensure that Federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
  - (4) Ensure that subrecipients expending \$300,000 or more in Federal awards during the subrecipient's fiscal year have met the audit requirements of this part for that fiscal year.
  - (5) Issue a management decision on audit findings within six months after receipt of the subrecipient's audit report and ensure that the subrecipient takes appropriate and timely corrective action.
  - (6) Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.
  - (7) Require each subrecipient to permit the pass-through entity and auditors to have access to the records and financial statements as necessary for the pass-through entity to comply with this part.

**§ \_\_.405 Management decision.**

- (a) *General.* The management decision shall clearly state whether or not the audit finding is sustained, the reasons for the decision, and the expected auditee

action to repay disallowed costs, make financial adjustments, or take other action. If the auditee has not completed corrective action, a timetable for follow-up should be given. Prior to issuing the management decision, the Federal agency or pass-through entity may request additional information or documentation from the auditee, including a request for auditor assurance related to the documentation, as a way of mitigating disallowed costs. The management decision should describe any appeal process available to the auditee.

(b) *Federal agency.* As provided in § \_\_.400(a)(7), the cognizant agency for audit shall be responsible for coordinating a management decision for audit findings that affect the programs of more than one Federal agency. As provided in § \_\_.400(c)(5), a Federal awarding agency is responsible for issuing a management decision for findings that relate to Federal awards it makes to recipients. Alternate arrangements may be made on a case-by-case basis by agreement among the Federal agencies concerned.

(c) *Pass-through entity.* As provided in § \_\_.400(d)(5), the pass-through entity shall be responsible for making the management decision for audit findings that relate to Federal awards it makes to subrecipients.

(d) *Time requirements.* The entity responsible for making the management decision shall do so within six months of receipt of the audit report. Corrective action should be initiated within six months after receipt of the audit report and proceed as rapidly as possible.

(e) *Reference numbers.* Management decisions shall include the reference numbers the auditor assigned to each audit finding in accordance with § \_\_.510(c).

### **Subpart E—Auditors**

#### **§ \_\_.500 Scope of audit.**

(a) *General.* The audit shall be conducted in accordance with GAGAS. The audit shall cover the entire operations of the auditee; or, at the option of the auditee, such audit shall include a series of audits that cover departments, agencies, and other organizational units which expended or otherwise administered Federal awards during such fiscal year, provided that each such audit shall encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and other organizational unit, which shall be considered to be a non-Federal entity. The financial statements and schedule of expenditures of Federal awards shall be for the same fiscal year.

(b) *Financial statements.* The auditor shall determine whether the financial statements of the auditee are presented fairly in all material respects in conformity with generally accepted accounting principles. The auditor shall also determine whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole.

(c) *Internal control.* (1) In addition to the requirements of GAGAS, the auditor shall perform procedures to obtain an understanding of internal control over Federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs.

(2) Except as provided in paragraph (c)(3) of this section, the auditor shall:

- (i) Plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program; and
  - (ii) Perform testing of internal control as planned in paragraph (c)(2)(i) of this section.
- (3) When internal control over some or all of the compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance, the planning and performing of testing described in paragraph (c)(2) of this section are not required for those compliance requirements. However, the auditor shall report a reportable condition (including whether any such condition is a material weakness) in accordance with §\_\_\_.510, assess the related control risk at the maximum, and consider whether additional compliance tests are required because of ineffective internal control.
- (d) *Compliance.* (1) In addition to the requirements of GAGAS, the auditor shall determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs.
  - (2) The principal compliance requirements applicable to most Federal programs and the compliance requirements of the largest Federal programs are included in the compliance supplement.
  - (3) For the compliance requirements related to Federal programs contained in the compliance supplement, an audit of these compliance requirements will meet the requirements of this part. Where there have been changes to the compliance requirements and the changes are not reflected in the compliance supplement, the auditor shall determine the current compliance requirements and modify the audit procedures accordingly. For those Federal programs not covered in the compliance supplement, the auditor should use the types of compliance requirements contained in the compliance supplement as guidance for identifying the types of compliance requirements to test, and determine the requirements governing the Federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.
  - (4) The compliance testing shall include tests of transactions and such other auditing procedures necessary to provide the auditor sufficient evidence to support an opinion on compliance.
- (e) *Audit follow-up.* The auditor shall follow-up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee in accordance with §\_\_\_.315(b), and report, as a current year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. The auditor shall perform audit follow-up procedures regardless of whether a prior audit finding relates to a major program in the current year.
- (f) *Data Collection Form.* As required in §\_\_\_.320(b)(3), the auditor shall complete and sign specified sections of the data collection form.

**§\_\_.505 Audit reporting.**

The auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in this section. The auditor's report(s) shall state that the audit was conducted in accordance with this part and include the following:

- (a) An opinion (or disclaimer of opinion) as to whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles and an opinion (or disclaimer of opinion) as to whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole.
- (b) A report on internal control related to the financial statements and major programs. This report shall describe the scope of testing of internal control and the results of the tests, and, where applicable, refer to the separate schedule of findings and questioned costs described in paragraph (d) of this section.
- (c) A report on compliance with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements. This report shall also include an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements which could have a direct and material effect on each major program, and, where applicable, refer to the separate schedule of findings and questioned costs described in paragraph (d) of this section.
- (d) A schedule of findings and questioned costs which shall include the following three components:
  - (1) A summary of the auditor's results which shall include:
    - (i) The type of report the auditor issued on the financial statements of the auditee (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion);
    - (ii) Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses;
    - (iii) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee;
    - (iv) Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses;
    - (v) The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion);
    - (vi) A statement as to whether the audit disclosed any audit findings which the auditor is required to report under §\_\_.510(a);
    - (vii) An identification of major programs;



- (viii) The dollar threshold used to distinguish between Type A and Type B programs, as described in § \_\_.520(b); and
  - (ix) A statement as to whether the auditee qualified as a low-risk auditee under § \_\_.530.
- (2) Findings relating to the financial statements which are required to be reported in accordance with GAGAS.
  - (3) Findings and questioned costs for Federal awards which shall include audit findings as defined in § \_\_.510(a).
    - (i) Audit findings (e.g., internal control findings, compliance findings, questioned costs, or fraud) which relate to the same issue should be presented as a single audit finding. Where practical, audit findings should be organized by Federal agency or pass-through entity.
    - (ii) Audit findings which relate to both the financial statements and Federal awards, as reported under paragraphs (d)(2) and (d)(3) of this section, respectively, should be reported in both sections of the schedule. However, the reporting in one section of the schedule may be in summary form with a reference to a detailed reporting in the other section of the schedule.

#### **§ \_\_.510 Audit findings.**

(a) *Audit findings reported.* The auditor shall report the following as audit findings in a schedule of findings and questioned costs:

- (1) Reportable conditions in internal control over major programs. The auditor's determination of whether a deficiency in internal control is a reportable condition for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the compliance supplement. The auditor shall identify reportable conditions which are individually or cumulatively material weaknesses.
- (2) Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the compliance supplement.
- (3) Known questioned costs which are greater than \$10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of total costs questioned (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). The auditor shall also report known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement for a major program. In reporting questioned costs, the auditor shall include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

- (4) Known questioned costs which are greater than \$10,000 for a Federal program which is not audited as a major program. Except for audit follow-up, the auditor is not required under this part to perform audit procedures for such a Federal program; therefore, the auditor will normally not find questioned costs for a program which is not audited as a major program. However, if the auditor does become aware of questioned costs for a Federal program which is not audited as a major program (e.g., as part of audit follow-up or other audit procedures) and the known questioned costs are greater than \$10,000, then the auditor shall report this as an audit finding.
- (5) The circumstances concerning why the auditor's report on compliance for major programs is other than an unqualified opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs for Federal awards.
- (6) Known fraud affecting a Federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for Federal awards. This paragraph does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of GAGAS.
- (7) Instances where the results of audit follow-up procedures disclosed that the summary schedule of prior audit findings prepared by the auditee in accordance with § \_\_.315(b) materially misrepresents the status of any prior audit finding.

(b) *Audit finding detail.* Audit findings shall be presented in sufficient detail for the auditee to prepare a corrective action plan and take corrective action and for Federal agencies and pass-through entities to arrive at a management decision. The following specific information shall be included, as applicable, in audit findings:

- (1) Federal program and specific Federal award identification including the CFDA title and number, Federal award number and year, name of Federal agency, and name of the applicable pass-through entity. When information, such as the CFDA title and number or Federal award number, is not available, the auditor shall provide the best information available to describe the Federal award.
- (2) The criteria or specific requirement upon which the audit finding is based, including statutory, regulatory, or other citation.
- (3) The condition found, including facts that support the deficiency identified in the audit finding.
- (4) Identification of questioned costs and how they were computed.
- (5) Information to provide proper perspective for judging the prevalence and consequences of the audit findings, such as whether the audit findings represent an isolated instance or a systemic problem. Where appropriate, instances identified shall be related to the universe and the number of cases examined and be quantified in terms of dollar value.
- (6) The possible asserted effect to provide sufficient information to the auditee and Federal agency, or pass-through entity in the case of a subrecipient, to permit them to determine the cause and effect to facilitate prompt and proper corrective action.

- (7) Recommendations to prevent future occurrences of the deficiency identified in the audit finding.
- (8) Views of responsible officials of the auditee when there is disagreement with the audit findings, to the extent practical.

(c) *Reference numbers.* Each audit finding in the schedule of findings and questioned costs shall include a reference number to allow for easy referencing of the audit findings during follow-up.

**§ \_\_.515 Audit working papers.**

(a) *Retention of working papers.* The auditor shall retain working papers and reports for a minimum of three years after the date of issuance of the auditor's report(s) to the auditee, unless the auditor is notified in writing by the cognizant agency for audit, oversight agency for audit, or pass-through entity to extend the retention period. When the auditor is aware that the Federal awarding agency, pass-through entity, or auditee is contesting an audit finding, the auditor shall contact the parties contesting the audit finding for guidance prior to destruction of the working papers and reports.

(b) *Access to working papers.* Audit working papers shall be made available upon request to the cognizant or oversight agency for audit or its designee, a Federal agency providing direct or indirect funding, or GAO at the completion of the audit, as part of a quality review, to resolve audit findings, or to carry out oversight responsibilities consistent with the purposes of this part. Access to working papers includes the right of Federal agencies to obtain copies of working papers, as is reasonable and necessary.

**§ \_\_.520 Major program determination.**

(a) *General.* The auditor shall use a risk-based approach to determine which Federal programs are major programs. This risk-based approach shall include consideration of: Current and prior audit experience, oversight by Federal agencies and pass-through entities, and the inherent risk of the Federal program. The process in paragraphs (b) through (i) of this section shall be followed.

(b) *Step 1.* (1) The auditor shall identify the larger Federal programs, which shall be labeled Type A programs. Type A programs are defined as Federal programs with Federal awards expended during the audit period exceeding the larger of:

- (i) \$300,000 or three percent (.03) of total Federal awards expended in the case of an auditee for which total Federal awards expended equal or exceed \$300,000 but are less than or equal to \$100 million.
  - (ii) \$3 million or three-tenths of one percent (.003) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed \$100 million but are less than or equal to \$10 billion.
  - (iii) \$30 million or 15 hundredths of one percent (.0015) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed \$10 billion.
- (2) Federal programs not labeled Type A under paragraph (b)(1) of this section shall be labeled Type B programs.
  - (3) The inclusion of large loan and loan guarantees (loans) should not result in the exclusion of other programs as Type A programs. When

a Federal program providing loans significantly affects the number or size of Type A programs, the auditor shall consider this Federal program as a Type A program and exclude its values in determining other Type A programs.

- (4) For biennial audits permitted under § \_\_.220, the determination of Type A and Type B programs shall be based upon the Federal awards expended during the two-year period.

(c) *Step 2.* (1) The auditor shall identify Type A programs which are low-risk. For a Type A program to be considered low-risk, it shall have been audited as a major program in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and, in the most recent audit period, it shall have had no audit findings under § \_\_.510(a). However, the auditor may use judgment and consider that audit findings from questioned costs under § \_\_.510(a)(3) and § \_\_.510(a)(4), fraud under § \_\_.510(a)(6), and audit follow-up for the summary schedule of prior audit findings under § \_\_.510(a)(7) do not preclude the Type A program from being low-risk. The auditor shall consider: the criteria in § \_\_.525(c), § \_\_.525(d)(1), § \_\_.525(d)(2), and § \_\_.525(d)(3); the results of audit follow-up; whether any changes in personnel or systems affecting a Type A program have significantly increased risk; and apply professional judgment in determining whether a Type A program is low-risk.

- (2) Notwithstanding paragraph (c)(1) of this section, OMB may approve a Federal awarding agency's request that a Type A program at certain recipients may not be considered low-risk. For example, it may be necessary for a large Type A program to be audited as major each year at particular recipients to allow the Federal agency to comply with the Government Management Reform Act of 1994 (31 U.S.C. 3515). The Federal agency shall notify the recipient and, if known, the auditor at least 180 days prior to the end of the fiscal year to be audited of OMB's approval.

(d) *Step 3.* (1) The auditor shall identify Type B programs which are high-risk using professional judgment and the criteria in § \_\_.525. However, should the auditor select Option 2 under Step 4 (paragraph (e)(2)(i)(B) of this section), the auditor is not required to identify more high-risk Type B programs than the number of low-risk Type A programs. Except for known reportable conditions in internal control or compliance problems as discussed in § \_\_.525(b)(1), § \_\_.525(b)(2), and § \_\_.525(c)(1), a single criteria in § \_\_.525 would seldom cause a Type B program to be considered high-risk.

- (2) The auditor is not expected to perform risk assessments on relatively small Federal programs. Therefore, the auditor is only required to perform risk assessments on Type B programs that exceed the larger of:
  - (i) \$100,000 or three-tenths of one percent (.003) of total Federal awards expended when the auditee has less than or equal to \$100 million in total Federal awards expended.
  - (ii) \$300,000 or three-hundredths of one percent (.0003) of total Federal awards expended when the auditee has more than \$100 million in total Federal awards expended.

(e) *Step 4.* At a minimum, the auditor shall audit all of the following as major programs:

- (1) All Type A programs, except the auditor may exclude any Type A programs identified as low-risk under Step 2 (paragraph (c)(1) of this section).
  - (2)(i) High-risk Type B programs as identified under either of the following two options:
    - (A) *Option 1.* At least one half of the Type B programs identified as high-risk under Step 3 (paragraph (d) of this section), except this paragraph (e)(2)(i)(A) does not require the auditor to audit more high-risk Type B programs than the number of low-risk Type A programs identified as low-risk under Step 2.
    - (B) *Option 2.* One high-risk Type B program for each Type A program identified as low-risk under Step 2.
  - (ii) When identifying which high-risk Type B programs to audit as major under either Option 1 or 2 in paragraph (e)(2)(i)(A) or (B) of this section, the auditor is encouraged to use an approach which provides an opportunity for different high-risk Type B programs to be audited as major over a period of time.
  - (3) Such additional programs as may be necessary to comply with the percentage of coverage rule discussed in paragraph (f) of this section. This paragraph (e)(3) may require the auditor to audit more programs as major than the number of Type A programs.
- (f) *Percentage of coverage rule.* The auditor shall audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 50 percent of total Federal awards expended. If the auditee meets the criteria in §\_\_\_\_.530 for a low-risk auditee, the auditor need only audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 25 percent of total Federal awards expended.
- (g) *Documentation of risk.* The auditor shall document in the working papers the risk analysis process used in determining major programs.
- (h) *Auditor's judgment.* When the major program determination was performed and documented in accordance with this part, the auditor's judgment in applying the risk-based approach to determine major programs shall be presumed correct. Challenges by Federal agencies and pass-through entities shall only be for clearly improper use of the guidance in this part. However, Federal agencies and pass-through entities may provide auditors guidance about the risk of a particular Federal program and the auditor shall consider this guidance in determining major programs in audits not yet completed.
- (i) *Deviation from use of risk criteria.* For first-year audits, the auditor may elect to determine major programs as all Type A programs plus any Type B programs as necessary to meet the percentage of coverage rule discussed in paragraph (f) of this section. Under this option, the auditor would not be required to perform the procedures discussed in paragraphs (c), (d), and (e) of this section.
- (1) A first-year audit is the first year the entity is audited under this part or the first year of a change of auditors.
  - (2) To ensure that a frequent change of auditors would not preclude audit of high-risk Type B programs, this election for first-year audits may not be used by an auditee more than once in every three years.

**§ \_\_.525 Criteria for Federal program risk.**

(a) *General.* The auditor's determination should be based on an overall evaluation of the risk of noncompliance occurring which could be material to the Federal program. The auditor shall use auditor judgment and consider criteria, such as described in paragraphs (b), (c), and (d) of this section, to identify risk in Federal programs. Also, as part of the risk analysis, the auditor may wish to discuss a particular Federal program with auditee management and the Federal agency or pass-through entity.

(b) *Current and prior audit experience.* (1) Weaknesses in internal control over Federal programs would indicate higher risk. Consideration should be given to the control environment over Federal programs and such factors as the expectation of management's adherence to applicable laws and regulations and the provisions of contracts and grant agreements and the competence and experience of personnel who administer the Federal programs.

- (i) A Federal program administered under multiple internal control structures may have higher risk. When assessing risk in a large single audit, the auditor shall consider whether weaknesses are isolated in a single operating unit (e.g., one college campus) or pervasive throughout the entity.
  - (ii) When significant parts of a Federal program are passed through to subrecipients, a weak system for monitoring subrecipients would indicate higher risk.
  - (iii) The extent to which computer processing is used to administer Federal programs, as well as the complexity of that processing, should be considered by the auditor in assessing risk. New and recently modified computer systems may also indicate risk.
- (2) Prior audit findings would indicate higher risk, particularly when the situations identified in the audit findings could have a significant impact on a Federal program or have not been corrected.
- (3) Federal programs not recently audited as major programs may be of higher risk than Federal programs recently audited as major programs without audit findings.

(c) *Oversight exercised by Federal agencies and pass-through entities.* (1) Oversight exercised by Federal agencies or pass-through entities could indicate risk. For example, recent monitoring or other reviews performed by an oversight entity which disclosed no significant problems would indicate lower risk. However, monitoring which disclosed significant problems would indicate higher risk.

- (2) Federal agencies, with the concurrence of OMB, may identify Federal programs which are higher risk. OMB plans to provide this identification in the compliance supplement.

(d) *Inherent risk of the Federal program.* (1) The nature of a Federal program may indicate risk. Consideration should be given to the complexity of the program and the extent to which the Federal program contracts for goods and services. For example, Federal programs that disburse funds through third party contracts or have eligibility criteria may be of higher risk. Federal programs primarily involving staff payroll costs may have a high-risk for time and effort reporting, but otherwise be at low-risk.

- (2) The phase of a Federal program in its life cycle at the Federal agency may indicate risk. For example, a new Federal program with new or inter-

im regulations may have higher risk than an established program with time-tested regulations. Also, significant changes in Federal programs, laws, regulations, or the provisions of contracts or grant agreements may increase risk.

- (3) The phase of a Federal program in its life cycle at the auditee may indicate risk. For example, during the first and last years that an auditee participates in a Federal program, the risk may be higher due to start-up or closeout of program activities and staff.
- (4) Type B programs with larger Federal awards expended would be of higher risk than programs with substantially smaller Federal awards expended.

**§ \_\_.530 Criteria for a low-risk auditee.**

An auditee which meets all of the following conditions for each of the preceding two years (or, in the case of biennial audits, preceding two audit periods) shall qualify as a low-risk auditee and be eligible for reduced audit coverage in accordance with § \_\_.520:

- (a) Single audits were performed on an annual basis in accordance with the provisions of this part. A non-Federal entity that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.
- (b) The auditor's opinions on the financial statements and the schedule of expenditures of Federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of Federal awards and provide a waiver.
- (c) There were no deficiencies in internal control which were identified as material weaknesses under the requirements of GAGAS. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of Federal awards and provide a waiver.
- (d) None of the Federal programs had audit findings from any of the following in either of the preceding two years (or, in the case of biennial audits, preceding two audit periods) in which they were classified as Type A programs:
  - (1) Internal control deficiencies which were identified as material weaknesses;
  - (2) Noncompliance with the provisions of laws, regulations, contracts, or grant agreements which have a material effect on the Type A program; or
  - (3) Known or likely questioned costs that exceed five percent of the total Federal awards expended for a Type A program during the year.

**Appendix A to Part \_\_—Data Collection Form (Form SF-SAC)**

[Insert SF-SAC after finalized]

**Appendix B to Part \_\_—Circular A-133 Compliance Supplement**

**Note:** Provisional OMB Circular A-133 Compliance Supplement is available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503.

[FR Doc. 97-16965 Filed 6-27-97; 8:45 am]

**BILLING CODE 3110-01-P**

## Appendix C

## Illustrative Schedules of Expenditures of Federal Awards

**Example Entity**  
**Schedule of Expenditures of Federal Awards<sup>1</sup>**  
**For the Year Ended June 30, 19X1<sup>2</sup>**

<i>Federal Grantor / Pass-Through Grantor / Program or Cluster Title</i>	<i>Federal CFDA Number<sup>3</sup></i>	<i>Pass-Through Entity Identifying Number<sup>4</sup></i>	<i>Federal Expenditures<sup>5</sup></i>
U.S. Department of Agriculture:			
Summer Food Service Program for Children—Commodities	10.559		\$ 46,000
<i>Total U.S. Department of Agriculture</i>			\$ 46,000
U.S. Department of Housing and Urban Development:			
Community Development Block Grant—Entitlement Grants (note 2)	14.218		\$1,235,632
Section 8 Rental Voucher Program	14.855		800,534
<i>Total U.S. Department of Housing and Urban Development</i>			\$2,036,166
U.S. Department of Education:			
Impact Aid	84.041		\$ 372,555
Bilingual Education	84.288		28,655
<i>Subtotal Direct Programs</i>			\$ 401,210
Pass-Through Program From:			
State Department of Education— Title I Grants to Local Educational Agencies	84.010	23-8345-7612	\$1,239,398
<i>Total U.S. Department of Education</i>			\$1,640,608
<i>Total Expenditures of Federal Awards</i>			<u>\$3,722,774</u>

The accompanying notes are an integral part of this schedule.

<sup>1</sup> To meet state or other requirements, auditees may decide to include certain nonfederal awards (for example, state awards) in this schedule. If such nonfederal data are presented, they should be segregated and clearly designated as nonfederal. The title of the schedule should also be modified to indicate that nonfederal awards are included.

<sup>2</sup> Additional guidance on the schedule is provided in chapter 5 which includes a discussion of the identification of federal awards, the general presentation requirements governing the schedule, pass-through awards, noncash awards, and endowment funds. Chapter 5 also includes a discussion of the auditor's responsibility for reporting on the schedule.

<sup>3</sup> When the CFDA number is not available, the auditee should indicate that the CFDA number is not available and include in the schedule the program's name and, if available, other identifying number.

<sup>4</sup> When awards are received as a subrecipient, the identifying number assigned by the pass-through entity should be included in the schedule.

<sup>5</sup> Circular A-133 requires that the value of federal awards expended in the form of noncash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end be included in either the schedule or a note to the schedule. Although it is not required, Circular A-133 states that it is preferable to present this information in the schedule (versus the notes to the schedule). If the auditee presents noncash assistance in the notes to the schedule, the auditor should be aware that such amounts must still be included in part III of the data collection form.



**Example Entity**  
**Notes to the Schedule of Expenditures of Federal Awards**  
**For the Year Ended June 30, 19X1**

**Note 1. Basis of Presentation<sup>6</sup>**

The accompanying schedule of expenditures of federal awards includes the federal grant activity of Example Entity and is presented on the [identify basis of accounting]. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the [general-purpose or basic] financial statements.

**Note 2. Subrecipients<sup>7</sup>**

Of the federal expenditures presented in the schedule, Example Entity provided federal awards to subrecipients as follows:

<i>Program Title</i>	<i>Federal CFDA Number</i>	<i>Amount Provided to Subrecipients</i>
Community Development Block Grant—Entitlement Grants	14.218	\$423,965

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<sup>6</sup> This note is included to meet the Circular A-133 requirement that the schedule include notes that describe the significant accounting policies used in preparing the schedule.

<sup>7</sup> Circular A-133 requires the schedule of expenditures of federal awards to include, to the extent practical, an identification of the total amount provided to subrecipients from each federal program. Although this example includes the required subrecipient information in the notes to the schedule, the information may be included on the face of the schedule as a separate column or section, if that is preferred by the auditee.

**Example Entity University**  
**Schedule of Expenditures of Federal Awards<sup>8</sup>**  
**For the Year Ended June 30, 19X1<sup>9</sup>**

<i>Federal Grantor/Pass-Through Grantor/Program or Cluster Title</i>	<i>Federal CFDA Number<sup>10</sup></i>	<i>Pass-Through Entity Identifying Number<sup>11</sup></i>	<i>Federal Expenditures<sup>12</sup></i>
<i>Student Financial Aid—Cluster:</i>			
U.S. Department of Education:			
Federal Pell Grant Program	84.063		\$ 8,764,943
Federal Supplemental Educational Opportunity Grant	84.007		974,873
Federal Work-Study Program	84.033		575,417
Federal Perkins Loan Program (note 2)	84.038		<u>1,548,343</u>
<i>Total U.S. Department of Education</i>			<u>\$11,863,576</u>
U.S. Department of Health and Human Services:			
Nursing Student Loans (note 2)	93.364		\$ 823,582
<i>Total U.S. Department of Health and Human Services</i>			\$ 823,582
<i>Total Student Financial Aid</i>			<u>\$12,687,158</u>
<i>Research and Development—Cluster:<sup>13</sup></i>			
U.S. Department of Defense:			
Department of Army	N.A.		\$ 87,403
Office of Naval Research	N.A.		<u>73,107</u>
Subtotal Direct Programs			\$ 160,510
Pass-Through Programs From:			
XYZ Labs—Effects of Ice on Radar Images	N.A.	4532	\$ <u>11,987</u>
<i>Total U.S. Department of Defense</i>			\$ 172,497
National Science Foundation:			
National Science Foundation (note 3)	N.A.		\$ 432,111
Pass-Through Programs From:			
ABC University—Atmospheric Effects of Volcano Eruptions	N.A.	Abc97-8	\$ <u>25,987</u>
<i>Total National Science Foundation</i>			\$ 458,098
U.S. Department of Health and Human Services:			
National Institutes of Health	N.A.		\$ 675,321
Administration on Aging (note 3)	N.A.		<u>234,987</u>
Subtotal Direct Programs			\$ 910,308

<sup>8</sup> See footnote 1.<sup>9</sup> See footnote 2.<sup>10</sup> See footnote 3.<sup>11</sup> See footnote 4.<sup>12</sup> See footnote 5.<sup>13</sup> For R&D, Circular A-133 requires that total federal awards expended must be shown either by individual award or by federal agency and major subdivision within the federal agency. This example illustrates the federal agency and major subdivision option.

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<i>Federal Grantor/Pass-Through Grantor/Program or Cluster Title</i>	<i>Federal CFDA Number<sup>10</sup></i>	<i>Pass-Through Entity Identifying Number<sup>11</sup></i>	<i>Federal Expenditures<sup>12</sup></i>
<b>Pass-Through Programs From:</b>			
ABC Hospital—Heart Research	N.A.	5489-5	\$ 432,765
State Health Department—Food Safety Research	N.A.	SG673-45	123,987
Subtotal Pass-Through Programs			\$ 556,752
<i>Total U.S. Department of Health and Human Services</i>			\$ 1,467,060
<i>Total Research and Development</i>			\$ 2,097,655
<b>Other Programs:</b>			
<b>U.S. Department of Energy:</b>			
Educational Exchange—University Lectures and Research	82.002		\$ 17,823
<i>Total U.S. Department of Energy</i>			\$ 17,823
<b>U.S. Department of Education:</b>			
TRIO Talent Search	84.044		\$ 308,465
Safe and Drug-Free Schools and Communities	84.184		59,723
Subtotal Direct Programs			\$ 368,188
<b>Pass-Through Programs From:</b>			
State Department of Education—Vocational EducationBasic Grant	84.048	874-90-5473	\$ 3,115
State Department of Education— Tech-Prep Education	84.243	25-8594-2167	176,885
Subtotal Pass-Through Programs			\$ 180,000
<i>Total U.S. Department of Education</i>			\$ 548,188
<i>Total Other Programs</i>			\$ 566,011
<i>Total Expenditures of Federal Awards</i>			<u>\$15,350,824</u>
N.A. = Not Available			

The accompanying notes are an integral part of this schedule.

**Example Entity University**  
**Notes to the Schedule of Expenditures of Federal Awards**  
**For the Year Ended June 30, 19X1**

**Note 1. Basis of Presentation<sup>14</sup>**

The accompanying schedule of expenditures of federal awards includes the federal grant activity of Example Entity University and is presented on the [identify basis of accounting]. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the [general-purpose or basic] financial statements.

**Note 2. Loans Outstanding<sup>15</sup>**

Example Entity University had the following loan balances outstanding at June 30, 19X1. These loan balances outstanding are also included in the federal expenditures presented in the schedule.

<i>Cluster / Program Title</i>	<i>Federal CFDA Number</i>	<i>Amount Outstanding</i>
Federal Perkins Loan Program	84.038	\$1,268,236
Nursing Student Loans	93.364	\$ 763,127

**Note 3. Subrecipients<sup>16</sup>**

Of the federal expenditures presented in the schedule, Example Entity University provided federal awards to subrecipients as follows:

<i>Program Title</i>	<i>Federal CFDA Number</i>	<i>Amount Provided to Subrecipients</i>
National Science Foundation	N.A.	\$236,403
Administration on Aging	N.A.	\$138,095

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<sup>14</sup> See footnote 6.  
<sup>15</sup> This note is intended to meet the Circular A-133 requirement that loans or loan guarantees outstanding at year end be included in the schedule.  
<sup>16</sup> See footnote 7.

## Appendix D

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

### Illustrative Auditor's Reports

**D.1.** This appendix contains examples of the reports issued under GAAS, *Government Auditing Standards*, and Circular A-133 in various circumstances for a single audit. Also included are examples of the reports issued for a program-specific audit.

**D.2.** As discussed in chapter 10, reporting on a financial statement audit and on the compliance requirements applicable to each major program involves varying levels of materiality and different forms of reporting. Circular A-133 states that the auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in the circular. In an effort to make the reports understandable and to reduce the number of reports issued, this SOP recommends that the following reports be issued for a single audit (the basic elements of each of the recommended reports are discussed in chapter 10):

- An opinion on the financial statements and on the supplementary schedule of expenditures of federal awards
- A report on compliance and on the internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*
- A report on compliance with requirements applicable to each major program and on the internal control over compliance in accordance with Circular A-133

**D.3.** Furthermore, as discussed in chapter 11, this SOP recommends that the following reports be issued for a program-specific audit (see paragraph 11.10 for a discussion of the possible issuance of a separate report to meet the reporting requirements of *Government Auditing Standards*): (a) an opinion on the financial statement(s) of the federal program and (b) a report on compliance with requirements applicable to the federal program and on the internal control over compliance in accordance with the program-specific audit option under Circular A-133.

**D.4.** Auditors need to understand the intended purpose of the reports and should tailor the reporting to the specific auditee's situation. Because the reports issued to comply with Circular A-133 involve varying levels of materiality and different forms of reporting, auditors should exercise care in issuing reports to ensure that they meet all of the varying reporting requirements of GAAS, *Government Auditing Standards*, and Circular A-133. Professional judgment should be exercised in any situation not specifically addressed in this SOP.

**D.5.** The following example auditor's reports illustrate the types of reports to be issued in selected situations. Chapters 10 and 11 of this SOP include discussions of certain of the situations and the resulting reports contained herein. For additional guidance the auditor should refer to SAS No. 58, *Reports on Audited Financial Statements*.

**D.6.** The following is a list of the example reports in this appendix:

<i>Example No.</i>	<i>Title</i>
1	Unqualified Opinion on General-Purpose Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Governmental Entity
1a	Unqualified Opinion on Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Not-for-Profit Organization
2	Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i> (No Reportable Instances of Noncompliance and No Material Weaknesses [No Reportable Conditions Identified])
2a	Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i> (Reportable Instances of Noncompliance and Reportable Conditions Identified)
3	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 ( <i>Unqualified Opinion on Compliance and No Material Weaknesses</i> [No Reportable Conditions Identified])
3a	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 ( <i>Qualified Opinion on Compliance and Reportable Conditions Identified</i> )
4	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 ( <i>Qualified Opinion on Compliance—Scope Limitation for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, Reportable Conditions Identified</i> )
5	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 ( <i>Adverse Opinion on Compliance for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, and Material Weaknesses Identified</i> )
6	Unqualified Opinion on the Financial Statement of a Federal Program in Accordance With the Program-Specific Audit Option Under OMB Circular A-133
6a	Report on Compliance With Requirements Applicable to the Federal Program and on Internal Control Over Compliance in Accordance With the Program-Specific Audit Option Under OMB Circular A-133 ( <i>Unqualified Opinion on Compliance and No Material Weaknesses</i> [No Reportable Conditions Identified])

## Example 1

# Unqualified Opinion on General-Purpose Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Governmental Entity<sup>1</sup>

## Independent Auditor's Report

### [Addressee]

We have audited the accompanying general-purpose financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>2</sup> issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of the City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of the City of Example's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.<sup>3</sup>

The accompanying schedule of expenditures of federal awards<sup>4</sup> is presented for purposes of additional analysis as required by U.S. Office of Management and

<sup>1</sup> Auditors may also refer to the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* for additional guidance on reporting on the general-purpose financial statements of a government.

<sup>2</sup> The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

<sup>3</sup> The following paragraph should be deleted if the schedule of expenditures of federal awards is not presented with the general-purpose financial statements (that is, a separate single audit package is issued). In such a circumstance, the required reporting on the schedule may be incorporated in the report issued to meet the requirements of Circular A-133. See footnotes 34 and 40 for additional guidance.

<sup>4</sup> If the auditor is reporting on additional supplementary information (for example, combining and individual fund and account group financial statements and schedules), this paragraph should be modified to describe the additional supplementary information. The example reports in appendix A of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), provide useful guidance.

Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the general-purpose financial statements. Such information has been subjected to the auditing procedures applied in the audit of the general-purpose financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the general-purpose financial statements taken as a whole.<sup>5</sup>

[Signature]

[Date]

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<sup>5</sup> When reporting on the supplementary information, the auditor should consider the effect of any modifications to the report on the general-purpose financial statements. Furthermore, if the report on supplementary information is other than unqualified, this paragraph should be modified. Guidance for reporting in these circumstances is described in paragraphs 9 through 11, 13, and 14 of SAS No. 29 (AICPA, *Professional Standards*, vol. 1, AU sec. 551.09-.11, .13, and .14).



## Example 1a

## Unqualified Opinion on Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Not-for-Profit Organization<sup>6</sup>

### Independent Auditor's Report

[Addressee]

We have audited the accompanying statement of financial position of Example NFP as of June 30, 19X1, and the related statements of activities and cash flows<sup>7</sup> for the year then ended. These financial statements are the responsibility of Example NFP's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>8</sup> issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Example NFP as of June 30, 19X1, and the changes in its net assets and its cash flows for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of Example NFP's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.<sup>9</sup>

The accompanying schedule of expenditures of federal awards<sup>10</sup> is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.<sup>11</sup>

[Signature]

[Date]

<sup>6</sup> Auditors may also refer to the AICPA Audit and Accounting Guide *Not-For-Profit Organizations* for additional guidance on reporting on the financial statements of a not-for-profit organization.

<sup>7</sup> If the not-for-profit organization is a voluntary health and welfare organization, this phrase should be modified to state "and the related statements of activities, functional expenses and cash flows."

<sup>8</sup> See footnote 2.

<sup>9</sup> See footnote 3.

<sup>10</sup> If the auditor is reporting on additional supplementary information (for example, a comparison of actual and budgeted expenses), this paragraph should be modified to describe the additional supplementary information. SAS No. 29 provides useful guidance.

<sup>11</sup> See footnote 5.

## Example 2

**Report on Compliance and on Internal Control Over  
Financial Reporting<sup>12</sup> Based on an Audit of Financial  
Statements Performed in Accordance With Government  
Auditing Standards (No Reportable Instances of  
Noncompliance and No Material Weaknesses [No  
Reportable Conditions Identified])<sup>13</sup>**

[Addressee]

We have audited the financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>14</sup> We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>15</sup> issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.<sup>16, 17</sup>

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Example Entity's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the

<sup>12</sup> See paragraph 4.12 for a description of internal control over financial reporting.

<sup>13</sup> The auditor should use the portions of examples 2 and 2a that apply to a specific auditee situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified reportable conditions, the compliance section of this report would be used along with the internal control section of example 2a. Alternatively, if the auditor will be giving a qualified opinion on compliance but has not identified reportable conditions, the internal control section of this report would be used along with the compliance section of example 2a.

<sup>14</sup> Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors).

<sup>15</sup> See footnote 2.

<sup>16</sup> See paragraphs 5.18 and 5.19 of *Government Auditing Standards* for the criteria for reporting.

<sup>17</sup> If the auditor has issued a separate letter to management to communicate matters that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following: "However, we noted certain immaterial instances of noncompliance, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference to management is intended to be consistent with paragraph 5.20 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.<sup>18</sup>

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>19, 20</sup>

[Signature]

[Date]

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<sup>18</sup> If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "However, we noted other matters involving the internal control over financial reporting, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

<sup>19</sup> If this report is issued for an audit that is not subject to Circular A-133, this sentence should be modified as follows: "This report is intended solely for the information and use of the audit committee, management, and [*specify legislative or regulatory body*] and is not intended to be and should not be used by anyone other than these specified parties."

<sup>20</sup> This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports.

## Example 2a

**Report on Compliance and on Internal Control Over  
Financial Reporting<sup>21</sup> Based on an Audit of Financial  
Statements Performed in Accordance With Government  
Auditing Standards (Reportable Instances of  
Noncompliance and Reportable Conditions Identified)<sup>22</sup>**

[Addressee]

We have audited the financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>23</sup> We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>24</sup> issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*<sup>25</sup> and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-2 and 97-5].<sup>26</sup>

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Example Entity's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect Example Entity's ability to record, process, summarize, and report financial data consistent with the

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<sup>21</sup> See footnote 12.

<sup>22</sup> See footnote 13.

<sup>23</sup> See footnote 14.

<sup>24</sup> See footnote 2.

<sup>25</sup> See footnote 16.

<sup>26</sup> If the auditor has issued a separate letter to management to communicate matters that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following: "We also noted certain immaterial instances of noncompliance, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference to management is intended to be consistent with chapter 5, paragraph 5.20 of *Government Auditing Standards*, which indicates that communications to "top" management should be referred to.

assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items *[list the reference numbers of the related findings, for example, 97-1, 97-4, and 97-8]*.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.<sup>27, 28</sup>

This report is intended solely for the information and use of the audit committee, management, *[specify legislative or regulatory body]*, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>29, 30</sup>

*[Signature]*

*[Date]*

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<sup>27</sup> If conditions believed to be material weaknesses are disclosed, the report should identify the material weaknesses that have come to the auditor's attention. The last sentence of this paragraph should be replaced with language such as the following: "However, of the reportable conditions described above, we consider items *[list the reference numbers of the related findings, for example, 97-1 and 97-8]* to be material weaknesses."

<sup>28</sup> If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "We also noted other matters involving the internal control over financial reporting, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

<sup>29</sup> If this report is issued for an audit that is not subject to Circular A-133, this sentence should be modified as follows: "This report is intended solely for the information and use of the audit committee, management, and *[specify legislative or regulatory body]* and is not intended to be and should not be used by anyone other than these specified parties." All references to the schedule of findings and questioned costs should also be removed, and instead, a description of the findings should be included in the report.

<sup>30</sup> See footnote 20.

## Example 3

**Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified])<sup>31</sup>**

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>32</sup> issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 19X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-3 and 97-6].<sup>33</sup>

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<sup>31</sup> The auditor should use the portions of examples 3 and 3a that apply to a specific auditee situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified reportable conditions, the compliance section of this report would be used along with the internal control section of example 3a. Alternatively, if the auditor will be giving a qualified opinion on compliance but has not identified reportable conditions, the internal control section of this report would be used along with the compliance section of example 3a.

<sup>32</sup> See footnote 2.

<sup>33</sup> When there are no such instances of noncompliance identified in the schedule of findings and questioned costs, the last sentence should be omitted.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.<sup>34</sup>

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>35</sup>

[Signature]

[Date]

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<sup>34</sup> As noted in notes 3 and 9, there may be instances in which it would be appropriate to report on the schedule of expenditures of federal awards in this report (that is, a separate single audit package is issued). In such a circumstance, a new section should be added immediately following this paragraph as follows:

Schedule of Expenditures of Federal Awards

We have audited the [*general-purpose or basic*] financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1. Our audit was performed for the purpose of forming an opinion on the [*general-purpose or basic*] financial statements taken as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the [*general-purpose or basic*] financial statements. Such information has been subjected to the auditing procedures applied in the audit of the [*general-purpose or basic*] financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the [*general-purpose or basic*] financial statements taken as a whole.

Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors). Auditors should also refer to notes 5 and 11 for additional guidance.

<sup>35</sup> See footnote 20.

## Example 3a

**Report on Compliance With Requirements Applicable to  
Each Major Program and on Internal Control Over  
Compliance in Accordance With OMB Circular A-133  
(Qualified Opinion on Compliance and Reportable  
Conditions Identified)<sup>36</sup>**

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>37</sup> issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in item [list the reference numbers of the related findings, for example, 97-10] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [identify the type(s) of compliance requirement] that are applicable to its [identify the major federal program]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with the requirements applicable to that program.

In our opinion, except for the noncompliance described in the preceding paragraph, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 19X1.<sup>38</sup>

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<sup>36</sup> See footnote 31.

<sup>37</sup> See footnote 2.

<sup>38</sup> When other instances of noncompliance are identified in the schedule of findings and questioned costs as required by Circular A-133, the following sentence should be added: "The results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-3 and 97-6]."



### Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items *[list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9]*.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.<sup>39, 40</sup>

This report is intended solely for the information and use of the audit committee, management, *[specify legislative or regulatory body]*, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>41</sup>

*[Signature]*

*[Date]*

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<sup>39</sup> See footnote 27.

<sup>40</sup> See footnote 34.

<sup>41</sup> See footnote 20.

## Example 4

**Report on Compliance With Requirements Applicable to  
Each Major Program and on Internal Control Over  
Compliance in Accordance With OMB Circular A-133  
(Qualified Opinion on Compliance—Scope Limitation for  
One Major Program, Unqualified Opinion on  
Compliance for Other Major Programs, Reportable  
Conditions Identified)**

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

Except as discussed in the following paragraph, we conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>42</sup> issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

We were unable to obtain sufficient documentation supporting the compliance of Example Entity with [identify the major federal program] regarding [identify the type(s) of compliance requirement], nor were we able to satisfy ourselves as to Example Entity's compliance with those requirements by other auditing procedures.

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding Example Entity's compliance with the requirements of [identify the major federal program] regarding [identify the type(s) of compliance requirement], Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 19X1.<sup>43</sup>

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<sup>42</sup> See footnote 2.

<sup>43</sup> See footnote 38.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as *items* [list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.<sup>44, 45</sup>

This report is intended solely for the information and use of the audit committee, management, [specify legislative or regulatory body], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>46</sup>

[Signature]

[Date]

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<sup>44</sup> See footnote 27.

<sup>45</sup> See footnote 34.

<sup>46</sup> See footnote 20.

## Example 5

**Report on Compliance With Requirements Applicable to  
Each Major Program and on Internal Control Over  
Compliance in Accordance With OMB Circular A-133  
(Adverse Opinion on Compliance for One Major Program,  
Unqualified Opinion on Compliance for Other Major  
Programs, and Material Weaknesses Identified)**

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>47</sup> issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in items [list the reference numbers of the related findings, for example, 97-10, 97-11, and 97-12] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [identify the types of compliance requirements] that are applicable to its [identify the major federal program]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with requirements applicable to that program.

In our opinion, because of the effects of the noncompliance described in the preceding paragraph, Example Entity did not comply in all material respects, with the requirements referred to above that are applicable to [identify the major federal program]. Also, in our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 19X1.<sup>48</sup>

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<sup>47</sup> See footnote 2.

<sup>48</sup> See footnote 38.

**Internal Control Over Compliance**

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items *[list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9]*.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider items *[list the reference numbers of the related findings, for example 97-8 and 97-9]* to be material weaknesses.<sup>49</sup>

This report is intended solely for the information and use of the audit committee, management, *[specify legislative or regulatory body]*, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>50</sup>

*[Signature]*

*[Date]*

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<sup>49</sup> See footnote 34.

<sup>50</sup> See footnote 20.

## Example 6

## Unqualified Opinion on the Financial Statement of a Federal Program in Accordance With the Program-Specific Audit Option Under OMB Circular A-133

### Independent Auditor's Report

We have audited the accompanying schedule of expenditures of federal awards for the [identify the federal program] of Example Entity for the year ended June 30, 19X1. This financial statement is the responsibility of Example Entity's management. Our responsibility is to express an opinion on the financial statement of the program based on our audit.<sup>51</sup>

We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>52</sup> issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of expenditures of federal awards referred to above<sup>53</sup> presents fairly, in all material respects, the expenditures of federal awards under the [identify the federal program] in conformity with generally accepted accounting principles.<sup>54, 55</sup>

[Signature]

[Date]

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<sup>51</sup> In many cases, the financial statements of the program will consist only of the schedule of expenditures of federal awards (and notes to the schedule), which is the minimum financial statement presentation required by section 235 of Circular A-133. If the auditee issues financial statements that consist of more than the schedule, this paragraph should be modified to describe the financial statements. Also refer to paragraph 11.10 for a discussion of the possible necessity to issue a separate report to meet the reporting requirements of *Government Auditing Standards*.

<sup>52</sup> See footnote 2.

<sup>53</sup> If the auditee issues financial statements that consist of more than the schedule, this sentence should be modified to identify the results displayed in the financial presentation.

<sup>54</sup> The auditor should follow the guidance in SAS No. 62, *Special Reports* when the auditee prepares the financial statement of the program in conformity with a basis of accounting other than GAAP.

<sup>55</sup> If a separate report is issued to meet the reporting requirements of *Government Auditing Standards* (see paragraph 11.10), an additional paragraph should be added as follows: "In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of Example Entity's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants."

## Example 6a

**Report on Compliance With Requirements Applicable to the Federal Program and on Internal Control Over Compliance in Accordance With the Program-Specific Audit Option Under OMB Circular A-133<sup>56</sup> (Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified])<sup>57</sup>**

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to [identify the federal program] for the year ended June 30, 19X1. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>58</sup> issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on [identify the federal program] occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to its [identify the federal program] for the year ended June 30, 19X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-1 and 97-2].<sup>59</sup>

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<sup>56</sup> This is an example of a report on a program-specific audit under Circular A-133 when no federal audit guide applicable to the program being audited is available. When a federal audit guide applicable to the program is available, Circular A-133 requires that the auditor follow the reporting requirements of that federal audit guide (see paragraph 11.4 for a discussion of the auditor's responsibility when a program-specific audit guide is not current).

<sup>57</sup> If issuing a qualified or adverse opinion on compliance, the auditor should modify the compliance section of this report to be consistent with the wording used in examples 3a or 5, accordingly. If reporting reportable conditions, including material weaknesses, the auditor should modify the internal control section of this report to be consistent with the wording used in example 3a.

<sup>58</sup> See footnote 2.

<sup>59</sup> See footnote 33.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on its *[identify the federal program]* in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the audit committee, management, *[specify legislative or regulatory body]*, and the federal awarding agency and pass-through entity and is not intended to be and should not be used by anyone other than these specified parties.<sup>60</sup>

*[Signature]*

*[Date]*

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<sup>60</sup> See footnote 20.



## Appendix E

### Illustrative Schedule of Findings and Questioned Costs

#### Example Entity Schedule of Findings and Questioned Costs For the Year Ended June 30, 19X1

##### Section I—Summary of Auditor's Results

###### *Financial Statements*

Type of auditor's report issued [*unqualified, qualified, adverse, or disclaimer*]:

Internal control over financial reporting:

- Material weakness(es) identified? \_\_\_\_\_ yes \_\_\_\_\_ no
- Reportable condition(s) identified that are not considered to be material weaknesses? \_\_\_\_\_ yes \_\_\_\_\_ none reported

Noncompliance material to financial statements noted?

\_\_\_\_\_ yes \_\_\_\_\_ no

###### *Federal Awards*

Internal control over major programs:

- Material weakness(es) identified? \_\_\_\_\_ yes \_\_\_\_\_ no
- Reportable condition(s) identified that are not considered to be material weakness(es)? \_\_\_\_\_ yes \_\_\_\_\_ none reported

Type of auditor's report issued on compliance for major programs [*unqualified, qualified, adverse, or disclaimer*]:<sup>1</sup>

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133?

\_\_\_\_\_ yes \_\_\_\_\_ no

Identification of major programs:<sup>2</sup>

CFDA Number(s)<sup>3</sup>

Name of Federal Program or Cluster<sup>4</sup>

<sup>1</sup> If the audit report for one or more major programs is other than unqualified, indicate the type of report issued for each program. For example, if the audit report on major program compliance for an auditee having five major programs includes an unqualified opinion for three of the programs, a qualified opinion for one program, and a disclaimer of opinion for one program, the response to this question could be as follows: "Unqualified for all major programs except for [name of program], which was qualified and [name of program], which was a disclaimer."

<sup>2</sup> Major programs should generally be identified in the same order as reported on the schedule of expenditures of federal awards.

<sup>3</sup> When the CFDA number is not available, include other identifying number, if applicable.

<sup>4</sup> The name of the federal program or cluster should be the same as that listed in the schedule of expenditures of federal awards. For clusters, auditors are only required to list the name of the cluster and not each individual program within the cluster.

Dollar threshold used to distinguish  
between type A and type B programs: \$ \_\_\_\_\_  
Auditee qualified as low-risk auditee? \_\_\_\_\_ yes \_\_\_\_\_ no

---

### Section II—Financial Statement Findings

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*[This section identifies the reportable conditions, material weaknesses, and instances of noncompliance related to the financial statements that are required to be reported in accordance with paragraphs 5.18 through 5.20 of Government Auditing Standards. Auditors should refer to those paragraphs, as well as the reports content section of chapter 7 of Government Auditing Standards, for additional guidance on preparing this section of the schedule.]*

*Identify each finding with a reference number.<sup>5</sup> If there are no findings, state that no matters were reported. Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a material weakness in internal control that effects an entity as a whole, including its federal awards, would generally be reported in detail in this section. Section III would then include a summary identification of the finding and a reference back to the specific finding in this section. Each finding should be presented in the following level of detail, as applicable:*

- *Criteria or specific requirement*
- *Condition*
- *Questioned costs*
- *Context<sup>6</sup>*
- *Effect*
- *Cause*
- *Recommendation*
- *Management's response<sup>7</sup>*

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### Section III—Federal Award Findings and Questioned Costs

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*[This section identifies the audit findings required to be reported by section 510(a) of Circular A-133 (for example, reportable conditions, material weaknesses, and instances of noncompliance, including questioned costs). Where practical, findings should be organized by federal agency or pass-through entity.]*

*Identify each finding with a reference number.<sup>8</sup> If there are no findings, state that no matters were reported. Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section*

---

<sup>5</sup> A suggested format for assigning reference numbers is to use the last two digits of the fiscal year being audited, followed by a numeric sequence of findings. For example, findings identified and reported in the audit of fiscal year 1997 would be assigned reference numbers of 97-1, 97-2, etc.

<sup>6</sup> Provide sufficient information for judging the prevalence and consequences of the finding, such as the relation to the universe of costs and/or the number of items examined and quantification of audit findings in dollars.

<sup>7</sup> See paragraphs 5.18 through 5.20 and 7.38 through 7.42 of *Government Auditing Standards* for additional guidance on reporting management's response.

<sup>8</sup> See footnote 5.

*III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a finding of noncompliance with a federal program law that is also material to the financial statements would generally be reported in detail in this section. Section II would then include a summary identification of the finding and a reference back to the specific finding in this section. Each finding should be presented in the following level of detail, as applicable:*

- *Information on the federal program*<sup>9</sup>
- *Criteria or specific requirement (including statutory, regulatory, or other citation)*
- *Condition*<sup>10</sup>
- *Questioned costs*<sup>11</sup>
- *Context*<sup>12</sup>
- *Effect*
- *Cause*
- *Recommendation*
- *Management's response*<sup>13]</sup>

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<sup>9</sup> Provide the federal program (CFDA number and title) and agency, the federal award's number and year, and the name of the pass-through entity, if applicable. When this information is not available, the auditor should provide the best information available to describe the federal award.

<sup>10</sup> Include facts that support the deficiency identified in the audit finding.

<sup>11</sup> Identify questioned costs as required by sections 510(a)(3) and 510(a)(4) of Circular A-133.

<sup>12</sup> See footnote 6.

<sup>13</sup> To the extent practical, indicate when management does not agree with the finding, questioned cost, or both.

**AICPA Single Audit Working Group**

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The Single Audit Working Group gratefully acknowledges the significant contributions of Norwood J. Jackson, Jr. and Terrill W. Ramsey of the U.S. Office of Management and Budget, James E. Brown, J. Michael Inzina, and the members of the AICPA Government Accounting and Auditing Committee, Health Care Committee, Not-for-Profit Organizations Committee, and the Private Companies Practice Section (PCPS) Technical Issues Committee.

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**[The next page is 31,285.]**

## Section 11,330

# **Statement of Position 98-6 Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association**

April 9, 1998

### **NOTE**

This Statement of Position presents the recommendations of the AICPA Insurance Companies Committee regarding the application of Statements on Standards for Attestation Engagements to engagements to report on management's assessment pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

## **Summary**

This Statement of Position (SOP) provides guidance to practitioners in conducting and reporting on an independent examination performed pursuant to the AICPA Statement on Standards for Attestation Engagements to assist an entity in meeting the requirements of the Insurance Marketplace Standards Association (IMSA) program (the IMSA program). IMSA requires that such engagements use the criteria it sets forth; consequently, users of this SOP should be familiar with the IMSA program and its *Assessment Handbook* and requirements.

The SOP amends chapter 9, "Auditor's Reports," of the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* and chapter 11, "Auditors' Reports," of the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*. It is effective for independent assessments with IMSA report dates after January 31, 1998.

## **Introduction and Background**

.01 Within the past several years, the life insurance industry has experienced allegations of improper market conduct practices such as questionable sales practices and potentially misleading policyholder illustrations. These allegations have triggered regulatory scrutiny, class action litigation, significant monetary settlements, and negative publicity related to market conduct issues. As a result, the industry is taking steps to promote a higher standard of ethical behavior that it hopes will reverse the negative perceptions held by many customers. In that regard, the American Council of Life Insurers (ACLI),

the largest life insurance trade organization, has established the Insurance Marketplace Standards Association (IMSA) as a nonaffiliated membership organization with its own board of directors composed of chief executives of life insurance companies. IMSA seeks to encourage and assist participating life insurance entities (hereinafter referred to as entities) in the design and implementation of sales and marketing policies and procedures that are intended to benefit and protect the consumer. Entities that desire to join IMSA will be required to adopt the IMSA Principles of Ethical Market Conduct (the Principles) and the Code of Ethical Market Conduct (the Code) and Accompanying Comments and respond affirmatively to an assessment questionnaire (the Questionnaire). Each prospective member also will be required to conduct a self-assessment to determine that it has policies and procedures in place that will enable it to respond affirmatively to the Questionnaire. An entity's self-assessment responses to the Questionnaire will need to be validated by an independent examination of the self-assessment. On obtaining an unqualified third-party assessment report, entities will be eligible for IMSA membership. Membership in IMSA is valid for a three-year period. Members are permitted to use IMSA's logo subject to rules set forth by IMSA for advertising and other promotional activities. The assessment process is intended to encourage entities and help them continually review and modify their policies and procedures in order to improve their market conduct practices and those of the industry and to strengthen consumer confidence in the life insurance business.

.02 Certified public accountants in the practice of public accounting (herein referred to as practitioners as defined by Statement on Standards for Attestation Engagements [SSAE] No. 1, *Attestation Standards* [AICPA, *Professional Standards*, vol. 1, AT sec. 100, "Attestation Engagements"]), may be engaged to examine and/or provide various consulting services related to the entity's self-assessment. This Statement of Position (SOP) provides guidance to practitioners in conducting and reporting on an independent examination performed pursuant to the American Institute of Certified Public Accountants (AICPA) SSAEs to assist an entity in meeting the requirements of the IMSA Life Insurance Ethical Market program (the IMSA program). As described herein, IMSA requires that such engagements use the criteria it sets forth; consequently, users of this SOP should be familiar with the IMSA program and its *Assessment Handbook* and requirements.

## Scope

.03 This SOP applies to engagements to report on an entity's assertion that the affirmative responses to the Questionnaire relating to the IMSA Principles and Code and Accompanying Comments are based on policies and procedures in place at the IMSA report date. Reporting on assertions made in connection with the IMSA program are examination engagements that should be performed under SSAE No. 1 (AT sec. 100).

## Overview of the IMSA Life Insurance Ethical Market Conduct Program

### Principles of Ethical Market Conduct

.04 The Principles consist of six statements that set certain standards with respect to the sale and service of individually sold life and annuity products. The Principles that the entity is required to adopt are as follows:

**Principle 1**

To conduct business according to high standards of honesty and fairness and to render that service to its customers which, in the same circumstances, it would apply to or demand for itself.

**Principle 2**

To provide competent and customer-focused sales and service.

**Principle 3**

To engage in active and fair competition.

**Principle 4**

To provide advertising and sales materials that are clear as to purpose and honest and fair as to content.

**Principle 5**

To provide for fair and expeditious handling of customer complaints and disputes.

**Principle 6**

To maintain a system of supervision and review that is reasonably designed to achieve compliance with these Principles of Ethical Market Conduct.

.05 IMSA developed the Code of Ethical Market Conduct to expand the Principles of Ethical Market Conduct to the operating level and to identify the attributes of the sales, marketing, and compliance systems that IMSA believes should support each of the Principles.

.06 To further expand on the Principles and Code, IMSA developed Accompanying Comments, which further define the intention of the Principles and Code and, in some instances, provide examples of implementation.

**IMSA Assessment Questionnaire**

.07 As noted above, IMSA developed the Questionnaire to provide prospective members with uniform criteria to demonstrate for self-assessment purposes that they have policies and procedures in place that meet the objective of the questions in the Questionnaire.

**Insurance Marketplace Standards Association Membership and Certification Process**

.08 Participation in the IMSA program requires an entity to adopt the Principles and Code and to undertake a two-step assessment process. First, an entity conducts a self-assessment, using the Questionnaire and *Assessment Handbook*, with the objective of concluding that it can respond affirmatively to every question in the Questionnaire in conformity with the criteria set forth in IMSA's Principles, Code, and Accompanying Comments. Second, an independent assessor from a list of IMSA-approved assessors examines the self-assessment materials to determine whether the entity has a reasonable basis for its affirmative responses to the Questionnaire.

.09 Once the assessment process is complete, the entity submits its IMSA Membership Application (the application) and Self-Assessment Report. The Self-Assessment Report states that the entity has adopted the Principles and

Code, has conducted a self-assessment of its policies and procedures, and has determined that the answer to each of the questions in the Questionnaire is “yes” in conformity with the *Assessment Handbook*. The entity also submits an unqualified examination report from an IMSA-approved independent assessor.

## **IMSA Independent Assessor Application Process and Required Training**

.10 IMSA will accept independent assessor reports only from those assessors that have been preapproved by IMSA. To become an independent assessor, a candidate is required to submit an IMSA Independent Assessor Application that requires that the candidate meet specific educational and professional requirements established by the IMSA board of directors. IMSA also requires that all independent assessors attend IMSA training as outlined by the board of IMSA. Independent assessors may be of various occupations or professional disciplines, including certified public accountants.

## **IMSA Assessment Handbook**

.11 IMSA developed an *Assessment Handbook* (the Handbook or the IMSA Handbook) to assist companies in the implementation of the IMSA program and provide guidance to independent assessors. Entity personnel and independent assessors should use the Handbook to gain an understanding of the assessment process and as a source of information for performing an assessment. The Handbook is intended for companies of all sizes regardless of the means by which they distribute individually sold life and annuity products. IMSA acknowledges that this is a new program that will evolve over time. Therefore, the Handbook may be revised as companies and independent assessors provide IMSA with suggestions for improvement. Practitioners should ensure that they are utilizing the most current version of the Handbook in planning and performing their work.

## **Conclusions**

### **Planning the Engagement**

.12 To satisfy IMSA program requirements, practitioners need to perform an examination engagement pursuant to SSAE No. 1 (AT sec. 100), which states that planning an attest engagement involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners should have adequate technical training and proficiency in the attest function and have adequate knowledge in life insurance market conduct and the IMSA program to enable them to sufficiently understand the events, transactions, and practices that, in their judgment, have a significant effect on the presentation of the assertions.

.13 The examination should be made in accordance with standards established by the AICPA, including obtaining an understanding of the policies and procedures in place upon which the affirmative responses to the Questionnaire are based. To be acceptable to IMSA, the engagement also should be performed in accordance with the criteria set forth in the IMSA Handbook. This SOP is intended to provide neither all the required criteria set forth in the IMSA Handbook nor all the applicable standards established by the AICPA.



.14 In accordance with SSAE No. 1 (AT sec. 100.33–35) and the Handbook, a practitioner performing the examination should supervise the engagement team, which involves directing the efforts of the engagement team in accomplishing the objectives of the engagement and determining whether the engagement objectives were met. If the practitioner is not an IMSA-approved independent assessor, such an assessor should be a member of the engagement team with responsibility for, among other things, assisting the practitioner in performing these functions.

.15 The engagement team should be informed of its responsibilities, including the objectives of the procedures that they are to perform and matters that may affect the nature, extent, and timing of such procedures. The work performed by each member of the engagement team should be reviewed to determine if it was adequately performed.

.16 IMSA, through its Handbook, has adopted a methodology to foster a uniform determination by entities and their independent assessor on whether policies and procedures are in place. The Handbook requires the following three aspects be present: approach, deployment, and monitoring. (See appendix B, paragraph B-2 [paragraph .38], for further discussion.)

### **Establishing an Understanding With the Client**

.17 The practitioner should consider the risks associated with accepting an engagement to examine and report on an entity's assertion about its responses to the IMSA Questionnaire. The practitioner should establish an understanding with the client regarding the services to be performed. The understanding should include the objectives of the engagement, management's responsibilities, the practitioner's responsibilities, limitations of the engagement, provision for changes in the scope of the engagement, and the expected form of the report. The practitioner should document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter. Appendix C [paragraph .39] contains a sample engagement letter that may be used for this type of engagement.

### **Assessments of Attestation Risk**

.18 The practitioner should evaluate the attestation risk that policies and procedures may not be in place to support affirmative responses to the Questionnaire and should consider this risk in designing the attest procedures to be performed. In examining whether policies and procedures are in place, the practitioner determines whether the policies and procedures have been adopted and are in operation and whether such policies and procedures satisfy the six components required by IMSA for the entity to respond affirmatively to each question, as discussed in appendix B [paragraph .38]. Whether an entity has policies and procedures in place does not encompass whether those policies and procedures operated effectively as of a particular date, or over any period of time, to ensure compliance with the Principles, Code, and Accompanying Comments or about whether the entity or its employees have complied with applicable laws and regulations.

.19 Examples of risk considerations that may affect the nature, timing, and extent of testing procedures are listed in appendix A [paragraph .37]. Not all the examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, distribution channels, product lines, or sales volume. In determining the examination procedures to be performed, practitioners should assess the impact that those risk considerations, individually and in combination, may have on attestation risk.

.20 Before performing attestation procedures, the practitioner should be adequately trained and should obtain an understanding of the entity's overall operations and market conduct practices, as well as its policies and procedures that have been identified in the self-assessment as supporting its affirmative responses to the Questionnaire. In addition, the practitioner should obtain an understanding of the operation and history of the entity's distribution systems and products sold and of sales volume by product and distribution system. The practitioner should also obtain an understanding of the entity's past market conduct issues and related corrective measures.

## Evidential Matter

.21 In an examination engagement performed under the attestation standards, the practitioner's objective is to accumulate sufficient evidence to limit attestation risk to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be imparted by his or her report. In such an engagement, the practitioner should select from all available procedures any combination that can limit attestation risk to such an appropriately low level. Accordingly, in an examination engagement it is necessary for a practitioner's procedures to go beyond reading relevant policies and procedures and making inquiries of appropriate members of management to determine whether the policies and procedures supporting affirmative responses to the Questionnaire were in place. Examination procedures should also include verification procedures, such as inspecting documents and records, confirming assertions with employees or agents, and observing activities. See appendix B [paragraph .38] for examples of illustrative procedures.

.22 As outlined in the Handbook, the entity should provide the practitioner with adequate information for the practitioner to obtain reasonable assurance that there is a basis for an affirmative response to each of the questions in the Questionnaire. The AICPA's concept of reasonable assurance in the context of an attestation engagement is set forth in SSAE No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1, AT sec. 400.13), and SSAE No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500.30). These concepts are consistent with IMSA's concept of reasonable assurance as defined in the Handbook.<sup>1</sup>

.23 In an examination of management's assertion about an entity's affirmative responses to the Questionnaire, the practitioner's evaluation of sufficiency and competency of evidential matter should include consideration of (a) the nature of management's assertion and the related indicators used to support such assertions, (b) the nature and frequency of deviations from expected results of applying examination procedures, and (c) qualitative considerations, including the needs and expectations of the report's users.

## Reporting Considerations

.24 SSAE No. 1 (AT sec. 100) defines an attest engagement as one in which a practitioner is engaged to issue a written communication that expres-

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<sup>1</sup> *Reasonable (assurance)* is defined in the Handbook as follows: "In the context of the IMSA program documents, the term *reasonable* is used to modify assurance, as an acknowledgment that it is virtually impossible to provide absolute and certain assurance that an event will happen (e.g., that a policy will address every possible circumstance, or that procedures will be applied without exception). *Reasonable*, as a qualifier, suggests that there exists a standard in both design and performance, and that such a standard, while conforming to the judgment or discernment of a knowledgeable person, is neither excessive nor extreme."

ses a conclusion about the reliability of a written assertion that is the responsibility of another party. The accompanying affirmative responses to the questions in the Questionnaire are written assertions of the entity. When a practitioner is engaged by an entity to express a written conclusion about management's assertions about its policies and procedures, such an engagement involves a written conclusion about the reliability of an assertion that is the responsibility of the entity. The entity is responsible for the design, implementation, and monitoring of the policies and procedures upon which the responses to the Questionnaire are based.

.25 Self-assessment is based in part on criteria set forth in the IMSA Handbook, which is prepared by an industry organization for the specific use of its members. Such criteria are not suitable for general distribution reporting. Accordingly, the independent accountant's report should contain a statement that it is intended solely for the information and use of the entity's board of directors and management as well as IMSA.

.26 IMSA has adopted a uniform assessment report that all independent assessors (regardless of professional discipline) are required to use when reporting on the results of an independent assessment. IMSA has indicated that deviations from its standard report format, except as discussed below, will not be accepted. The following is an illustration of an independent accountant's report on a company's assertion relating to its affirmative responses to the IMSA Questionnaire. The third paragraph in the following report deviates from the IMSA format, where the practitioner specifies that the examination was made in accordance with standards established by the AICPA, and refers to those standards before referring to the criteria set forth in the IMSA Handbook. The other deviation is that the report is titled "Independent Accountant's Report" rather than "Independent Assessor Report." Representatives of IMSA have indicated that they will accept only these deviations for reports issued by practitioners.

#### Independent Accountant's Report

To [name of insurer] Board of Directors and the Insurance Marketplace Standards Association:

We have examined management's assertion that the affirmative responses of [name of insurer] to the Questionnaire relating to the Principles of Ethical Market Conduct and the Code of Ethical Market Conduct and Accompanying Comments for individually sold life and annuity products, adopted by the Insurance Marketplace Standards Association ("IMSA"), are based on policies and procedures in place as of [the IMSA report date]. The Company is responsible for the design, implementation, and monitoring of the policies and procedures in place upon which the responses to the Questionnaire are based.

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and in accordance with the criteria set forth in the *IMSA Assessment Handbook*, and included obtaining an understanding of the policies and procedures in place upon which the affirmative responses to the Questionnaire are based and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination was not designed to evaluate whether the policies and procedures, upon which the Company's responses to the Questionnaire are based, have or will operate effectively, nor have we evaluated whether or not the Company has or will comply with applicable laws or regulations. Accordingly, we do not express an opinion or any other form of assurance thereon.

In our opinion, management's assertion that the affirmative responses to the Questionnaire are based on policies and procedures in place as of [the *IMSA report date*] is fairly stated, in all material respects, based upon the criteria set forth in the Principles of Ethical Market Conduct, the Code of Ethical Market Conduct and Accompanying Comments, and the *Assessment Handbook*.

This report is intended solely for the information and use of the board of directors and management of the Company and the Insurance Marketplace Standards Association and should not be used for any other purpose.

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[*IMSA Report Date*; see paragraph .28]

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[*Company (Insurer)*]

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[*Name of Independent Assessor*; see paragraph .27]

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[*Signature of Independent Accountant or Firm*]

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[*Date of Signature*; see paragraph .29]

**Note:** In any instance where an alternative indicator is used to support an affirmative answer to any question in the Questionnaire, such alternative indicator must be fully set forth in an attachment to this Assessor Report (see paragraph .30).

## Elements of the Report

**.27 Signatures and Identification of the Independent Assessor.** IMSA prefers that the independent assessor sign his or her name on the report. However, many AICPA member firms require that a manual or printed signature of the firm name be presented on the face of the report and prohibit a member of the firm from signing the report as an individual. Although IMSA will accept this practice, it requires the identification on the face of the independent accountant's report of the IMSA-approved independent assessor who actively participated in and supervised relevant portions of the engagement on behalf of the firm. In addition, in circumstances where the IMSA-approved independent assessor does not sign the report as an individual, IMSA requires an affirmation from the independent assessor to be attached to the independent accountant's report. A sample affirmation follows:

### Affirmation of Independent Assessor

I, [print name], affirm that I have reviewed the attached Independent Accountant's Report on management's assertions regarding the IMSA program for [insurer] as of [IMSA report date] and that I was the Independent Assessor responsible for supervising relevant portions of the assessment identified herein.

[Signature]

[Date of Signature]

**.28 IMSA Report Date.** The IMSA report date referred to in the independent accountant's report is the date of the self-assessment and the date to which the entity and the independent assessor have agreed as the point in time which the policies and procedures supporting the affirmative response to the Questionnaire are in place. Due care should be taken to ensure that representations made by management on the basis of a self-assessment are current as of the IMSA report date. If a significant amount of time has elapsed between the date of the performance of the practitioner's procedures on certain questions and the IMSA report date, due care should be taken to ensure that policies and procedures were in place as of the IMSA report date.

**.29 Date of Signature.** The date of signature is the date fieldwork is completed. Changes in the policies and procedures, personnel changes, or other considerations that might significantly affect responses to the Questionnaire may occur subsequent to the IMSA report date but before the date of signature or the date when the report is issued. The practitioner should obtain management's representations relating to such matters and perform such other procedures regarding subsequent events considered necessary in the circumstances. The practitioner has no responsibility to perform examination procedures or update his or her report for events subsequent to the date when the report is issued; however, the practitioner may later become aware of conditions that existed at that date that might have affected the practitioner's opinion had he or she been aware of them. The practitioner's consideration of such subsequent information is similar to an auditor's consideration of information discovered subsequent to the date of a report on an audit of financial statements described in SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report").

**.30 Alternative Indicators.** A list of indicators in the Handbook corresponds to each of the questions in the Questionnaire and lists possible policies and procedures identified by IMSA that an entity can have in place to be able to respond affirmatively to a question. A company must support each "yes" response to a question by the selection of indicators sufficient to meet the six required components and to meet the objective of each question. IMSA has established limitations on the use of indicators other than those contained in the Handbook. Alternative indicators that are used as support for an affirmative response to a question in the Questionnaire may require preapproval by IMSA in certain situations, as noted in the Handbook. It will be necessary for the practitioner to evaluate whether an alternative indicator used by the entity supports an affirmative response to the question. The alternative indicators should be disclosed by the practitioner to IMSA in the basic independent accountant's report as an attached appendix, and an explanatory paragraph should be added to the standard independent accountant's report in paragraph .26. The following is an example of a paragraph that should be included in the examination report when alternative indicators are used by management. The paragraph should precede the opinion paragraph.

Management's assertion supporting an affirmative response to certain questions is supported by the use of alternative indicators, as that term is defined in the IMSA Handbook. The attached appendix to this report lists the questions and alternative indicators used by management.

**.31 Negative Responses.** IMSA will not grant membership applications to an entity whose application contains a "no" response to any question. In circumstances where no report will be issued to IMSA, management may request the practitioner to report findings to management or the board of dir-

ectors. In this situation, the practitioner and management should agree on the means and format of such communication and document this understanding in writing.

**.32 Working Papers.** The practitioner should prepare and maintain working papers in connection with an engagement under the attestation standards; such working papers should be appropriate to the circumstances and the practitioner's needs on the engagement to which they apply. Although it is not possible to specify the form or content of the working papers that a practitioner should prepare in connection with an assessment because circumstances vary in individual engagements, the practitioner's working papers ordinarily should indicate that—

- a. The work was adequately planned and supervised.
- b. Evidential matter (SSAE No. 1 [AT sec. 100.36–.39]) was obtained to provide a reasonable basis for the conclusion that the policies and procedures underlying the affirmative responses contained in the Questionnaire are in place.

In its required training, IMSA has advised IMSA-approved independent assessors to appreciate the sensitivity of insurers to litigation risks and the production of documents that litigation typically requires. IMSA has reminded assessors and insurers alike that the self-assessment process is designed to demonstrate compliance currently with IMSA assessment criteria and that reports will not be accepted by IMSA unless all questions are answered in the affirmative. Accordingly, IMSA has stated its belief that IMSA-approved assessors will have no need, at least for IMSA's purposes, to maintain documentation of noncompliance with the IMSA assessment criteria currently or in the past.

**.33 Concern over access to the practitioner's working papers** might cause some clients to inquire about working paper requirements. In situations where the practitioner is requested to not maintain copies of certain client documentation, or to not prepare and maintain documentation similar to client documents, the practitioner may refer to the auditing Interpretation "The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals" (AICPA, *Professional Standards*, vol. 1, AU sec. 9326.06–.17) for guidance. See the attest Interpretation "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards*, vol. 1, AT sec. 9100.58) for guidance related to providing access to or photocopies of working papers to a regulator in connection with work performed on an attestation engagement.

**.34 Management's Representations.** The practitioner should obtain written representation from management—

- a. Acknowledging management's responsibility for the design, implementation, and monitoring of the policies and procedures in place upon which the responses to the Questionnaire are based and that the affirmative responses to the Questionnaire are based on such policies and procedures in place as of a specific point in time.
- b. Stating that management has adopted the Principles and Code, and has performed and made available to the practitioners all documentation related to a self-assessment of the policies and procedures in place as of the IMSA report date upon which the affirmative responses to the Questionnaire are based.

- c. Stating that management has disclosed to the practitioner all matters regarding the design, implementation, and monitoring of policies and procedures that could adversely affect the entity's ability to answer affirmatively the questions in the Questionnaire.
- d. Describing any related material fraud or other fraud or illegal acts that, whether or not material, involve management or other employees who have a significant role in the entity's design, implementation, and monitoring of the policies and procedures in place upon which the responses to the Questionnaire were made.
- e. Stating whether there were, subsequent to the date of management's self-assessment (that is, the IMSA report date), any known changes or deficiencies in the design, implementation, and monitoring of the policies and procedures in place, including any personnel changes or other considerations of reference to the IMSA Questionnaire subject matter.
- f. Stating that management has disclosed any communication from regulatory agencies, internal auditors, and other parties concerning matters regarding the design, implementation, and monitoring of the policies and procedures in place, including communication received between the IMSA report date (the date of management's assertion) and the date of the practitioner's report (the date of signature).
- g. Stating that management has disclosed to the practitioners, orally or in writing, information about past market conduct issues (for example, policyholder complaints or litigation) of relevance to the IMSA Questionnaire subject matter and the related corrective measures taken to support affirmative responses in those areas.

.35 Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the examination sufficient to preclude an unqualified report suitable for submission to IMSA. Further, the practitioner should consider the effects of management's refusal on his or her ability to rely on other management representations.

## Effective Date

.36 This SOP is effective for independent assessments with IMSA report dates after January 31, 1998. Early application is permissible.

## Appendix A

### Assessment of Attestation Risk

**A.1.** The following are examples of considerations that may influence the nature, timing, and extent of a practitioner's testing procedures relating to an entity's assertion of its affirmative responses to the Questionnaire. The considerations may also affect a practitioner's decision to accept such an engagement. The examples are not intended to be a complete list.

#### ***Management Characteristics and Influence Over the Control Environment***

- Management's attitude regarding internal control over sales and marketing practices, which may affect its ability to foster a more comprehensive and effective compliance program
- Management's financial support of the internal resources allocated to the development and maintenance of compliance with the IMSA program through adequate funding, resources, time, etc.
- Management's history of ensuring that sales personnel are qualified, trained, licensed, and supervised
- Management's history and systems for tracking complaint and replacement trends
- Management's ability to generate timely, complete, and accurate information on issues of regulatory concern regarding sales and marketing practices
- The entity's relationship with its current independent assessor, regulatory authorities, or both (The practitioner should gain an understanding of the circumstances surrounding the disengagement of predecessor independent assessors, any issues identified in prior self-assessments or independent assessments, and consider making inquiries of predecessor assessors.)
- Consistent application of policies and procedures across product lines and distribution channels (If the entity did not address each distribution channel, product line, or both because it deemed certain ones to be immaterial in terms of premiums earned or in force, or because of low volume of production, the practitioner will need to use his or her professional judgment to assess whether the omitted product lines or distribution channels should have been considered in the entity's self-assessment and assess the impact on his or her ability to opine on management's assertions by exercising that judgment. The definition of the term *appropriate to its size* in the Handbook may also apply.)
- Whether the entity's approach to its self-assessment includes validation of the information it collected to support that policies and procedures are in place

#### ***Industry Conditions***

- Changes in regulations or laws, such as those governing various products, sales methods and materials, agent compensation, and customer disclosure



- Publicity about sales and marketing practices and increased litigation to seek remedy
- Rapid changes in the industry, such as the introduction of new and complex product offerings or information technology
- The degree of competition or market saturation

***Distribution, Sales Volume, and Products***

- The diversity of distribution systems
- The relative volume of business for different products and distribution systems
- The length of time that products, distribution systems, or both have been available, used, or both
- Limitations of an entity's ability to assert control over producers
- Compliance training provided by management to its producers and employees involved in the sales process
- The complexity of product offerings
- The targeted markets for various products
- Whether the entity is applying for IMSA membership as a fleet of entities or as an individual entity (If the entity is applying for fleet membership, the independent assessor should plan the engagement to address whether the policies and procedures are in place at each company within the fleet, including newly acquired subsidiaries or affiliates in the fleet.)

***Other Considerations***

- Issues identified in prior self-assessments, independent assessments, and other services provided
- Findings from recent market conduct examinations conducted by regulatory authorities or internal auditors
- Policyholder concerns expressed through complaints or litigation
- Ratings received from rating agencies

## Appendix B

### Illustrative Procedures

**B.1.** Examples of illustrative procedures are provided in this appendix. The procedures are organized by the three aspects of each question. Many of these procedures can be used for more than one question. The illustrative procedures are intended to be used as a guide and are not to be considered all-inclusive. Because the objective and the types of policies and procedures for each question will differ according to the methods for establishing, maintaining, communicating, deploying, and monitoring as they differ by entity and for each question, no single methodology for testing can be suggested. Practitioners should use judgment to determine the procedures necessary to be performed to render an opinion. It will be more difficult to obtain objective evidence about some indicators than others. Accordingly, the practitioner should adjust the procedures selected for testing. A challenging aspect of the IMSA program is its application to various distribution channels, including independent producers, and how entities will satisfy questions relating to these various channels. This is because an entity's ability to enforce or encourage producers to use its policies and procedures varies by channel. The practitioner needs to clearly understand how an entity manages each significant distribution channel.

**B.2.** IMSA has identified three aspects of each question: approach, deployment, and monitoring. The aspects are defined in the glossary of the Handbook as follows:

*Approach*—A systematic method or means used by the entity to address the requirements of the Principles and Code, as queried by the specific question.

*Deployment*—Refers to the extent to which the entity's approach is actually being applied to the provisions of the Principles and Code.

*Monitoring*—To check routinely and systematically with a view to collecting certain specified categories of information, to investigate and resolve questions concerning anomalous or unexpected information, and to identify the need for or to make recommendations designed to reduce the probability of future anomalies. The Principles, Code, Accompanying Comments, and Questionnaire require that monitoring be performed to provide reasonable assurance that policies accurately reflect management's (or other applicable governing bodies') point of view, that procedures are designed to support those policies, and that procedures are appropriately executed.

### Approach

**B.3.** The two components underlying the first aspect, *approach*, as defined by the Handbook are as follow:

- a. Does the insurer have in place policies and procedures that address the objective of the question?
- b. Is someone (an individual or a team) responsible for establishing, maintaining, communicating, deploying, and monitoring these policies and procedures?

**B.4.** The following are examples of procedures the practitioner and engagement team may employ to test the affirmative responses for the *approach* aspect:

## Examine Documentation

- Obtain and read written policies and procedures to obtain an understanding of—
  - a. The policies and procedures that are supposed to be in place and to which distribution systems, products, and markets those policies and procedures apply.
  - b. How the policies and procedures respond to the objective of the question.
  - c. Who (a person or department) is responsible for establishing, maintaining, communicating, deploying, and monitoring those policies and procedures.
- Examine job descriptions, titles, organization charts, and other communications for those identified as being responsible for the policies and procedures to support the assignment of those responsibilities.

## Inquiry

- Through inquiry, obtain an understanding of—
  - a. How the policies and procedures are being used in practice.
  - b. Who is responsible for the policies and procedures being addressed.
  - c. The responsibilities of management and employees who oversee the policies and procedures.
  - d. Evidence that supports that the policies and procedures exist.
  - e. Evidence that policies and procedures have been in place for a sufficient period.
  - f. The distribution systems, products, and markets to which the policies and procedures apply.
  - g. How the policies and procedures respond to the selected indicator.

## Deployment

**B.5.** The two components underlying the second aspect, *deployment*, as defined by the Handbook are as follow:

- a. Are the policies and procedures communicated?
- b. Does the insurer consistently use these policies and procedures?

**B.6.** The following are examples of procedures the practitioner and engagement team may employ to test the affirmative responses for the *deployment* aspect:

## Examine/Inspect Documentation

- Obtain and read internal documents—including memos, email, handbooks, policy manuals, and contracts—to verify that communications have been made.
- Obtain and read written confirmation or other evidence that the intended audience of the policies and procedures has received and read the communication.

- Obtain independent confirmation that policies and procedures are being used.

### Observation

- Observe that reference materials (internal or external) that may be required for personnel to adequately perform the policies and procedures are reasonably accessible.
- For a sample of items, perform a walkthrough of the policies and procedures deemed to be in place in the *approach* aspect to support that those policies and procedures are being consistently applied for distribution channels and product lines that use those policies and procedures. Determine that the policies and procedures have also been consistently applied for a sufficient time by including transactions for various dates in the sample of transactions for the walkthrough.

### Inquiry

- Interview personnel who perform the activities described in the policies and procedures documents to support that policies and procedures have been communicated to them.

### Monitoring

**B.7.** The two components underlying the third aspect, *monitoring*, as defined by the Handbook are as follow:

- a. Does the insurer routinely monitor the operation of these policies and procedures with a view toward achieving the intended result?
- b. Does the insurer act upon the information received?

**B.8.** The following are examples of procedures the practitioner and engagement team may employ to test the affirmative responses for the *monitoring* aspect:

### Examine Documentation

- Obtain and examine documents prepared by entity personnel that provide the responsible party with appropriate monitoring tools (for example, management reports, trend analyses, and tracking logs).
- Examine monitoring tools to identify deviations from the expected results, provide analysis of these deviations, and demonstrate investigation has occurred.
- Examine documentation of the corrective actions taken in response to information received by the responsible parties.
- Examine monitoring documents subsequent to corrective action taking place to ascertain whether the incidence of an identified problem or complaint has decreased in frequency because of the corrective action.

### Inquiry

- Interview the personnel responsible for preparing reports used as monitoring tools to determine that the appropriate information is being gathered in a reasonable manner.

- Interview the personnel responsible for acting on the information provided and identify the procedures in place to perform corrective actions.

## **Observation**

- Examine monitoring reports to ascertain whether they are prepared and distributed on a regular basis to the responsible personnel.
- Perform a walkthrough for a selection of transactions in which the action described by the identified responsible party should have occurred and ascertain whether the procedure was put in place.
- Observe changes in policies and procedures or communications to entity personnel that have occurred because of the recurrence of an identified problem or complaint.

## Appendix C

### Sample Engagement Letter

The following is an illustration of a sample engagement letter that may be used for this type of engagement.

[CPA Firm Letterhead]

[Client's Name and Address]

Dear \_\_\_\_\_:

This will confirm our understanding of the arrangements for our examination of management's assertion that the affirmative responses of [name of client entity] to the Insurance Marketplace Standards Association ("IMSA") questionnaire (the "Questionnaire") relating to the Principles of Ethical Market Conduct and the Code of Ethical Market Conduct and Accompanying Comments for individually sold life and annuity products, are based on policies and procedures in place as of [the IMSA report date].

We will examine management's assertion that the affirmative responses to the Questionnaire are based on policies and procedures in place as of the IMSA report date for the purpose of expressing an opinion as to whether management's assertion is fairly stated, in all material respects, based upon the criteria set forth in the Principles of Ethical Market Conduct, Code of Ethical Market Conduct and Accompanying Comments, and Assessment Handbook. The Company is responsible for the design, implementation, and monitoring of the policies and procedures in place upon which the responses are based. Our responsibility is to express an opinion on management's assertion based on our examination.

We will conduct our examination in accordance with standards established by the American Institute of Certified Public Accountants and in accordance with the criteria set forth in the IMSA Assessment Handbook. Our examination will include obtaining an understanding of the policies and procedures in place upon which the affirmative responses to the Questionnaire are based and such other procedures as we consider necessary in the circumstances. Our examination will not be designed to evaluate whether the policies and procedures, upon which [the entity's] responses to the Questionnaire are based, operate effectively, nor will we evaluate whether [the entity] has complied with applicable laws or regulations. Accordingly, we will not express an opinion or any other form of assurance thereon.<sup>2</sup>

Working papers that are prepared in connection with this engagement are the property of the independent accountant. The working papers are prepared for the purpose of providing the principal support for the independent accountant's report.

At the completion of our work we expect to issue an examination report in a form acceptable to IMSA (example attached). If, however, we are not able to conclude that management's assertion that the affirmative responses to the

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<sup>2</sup> The independent accountant may wish to include an understanding with the client about any limitation or other arrangements regarding liability of the practitioner or the client in the engagement letter.

Questionnaire are based on policies and procedures in place as of the IMSA report date, we will so advise you. At that time we will discuss with you the form of communication, if any, that you desire for our findings. We will ask you to confirm your request in writing at that time. If no report is requested, we understand that our engagement will be terminated, our working papers will be destroyed (at your request), our professional fees will be payable in full, and our professional responsibilities to you will be complete. We will have no responsibility to report in writing at a later date. If you request written or oral communication of our findings, we will do so and our working papers will be retained in accordance with our firm's working paper retention policy. Our professional fees will be subject to adjustment. If you request that we delay issuance of our report until corrective action is taken that will result in affirmative answers to all questions, we will do so only at your written request. Our working papers will be retained in accordance with our firm's working paper retention policy. Again, our fees will be subject to adjustment. If we conclude that we are unable to issue an unqualified report, we reserve the right to bring the matter to the attention of an appropriate level of management or the board of directors.

The distribution of the independent accountant's report will be restricted to the board of directors and management of *[the entity]* and IMSA. *[The entity]* agrees that it will not use the CPA firm's name in advertising materials referring to *[the entity's]* membership in IMSA.

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees.

If this letter correctly expresses your understanding of this engagement, please sign the enclosed copy where indicated and return it to us.

We appreciate the opportunity to serve you.

Sincerely,

\_\_\_\_\_  
*[Partner's Signature]*

*[Firm Name or Firm Representative]*

Accepted and agreed to:

\_\_\_\_\_  
*[Client Representative's Signature]*

\_\_\_\_\_  
*[Title]*

\_\_\_\_\_  
*[Date]*

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## Section 11,340

# **Statement of Position 98-8 Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934, Rule 17Ad-18 of the Securities Exchange Act of 1934, and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission**

November 16, 1998

### **NOTE**

This Statement of Position presents the recommendations of the AICPA's Securities Industry Year 2000 Agreed-Upon Procedures Task Force regarding the application of Statements on Standards for Attestation Engagements to agreed-upon procedures attestation engagements pursuant to rules 17a-5 and 17Ad-18 of the Securities Exchange Act of 1934, and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission. The Auditing Standards Board has found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departure from the recommendations in this Statement of Position.

## **Introduction and Background**

.01 The Securities and Exchange Commission (SEC) issued rules under the Securities Exchange Act of 1934 requiring reporting of specified matters with respect to year 2000 readiness by broker-dealers and certain transfer agents.<sup>1</sup> These rules also require broker-dealers meeting specific thresholds and certain transfer agents to file a report prepared by an independent public accountant regarding the broker-dealer or transfer agent's process for addressing year 2000 problems as of March 15, 1999. In SEC Releases No. 34-40608 and 34-40587, the SEC indicated that an agreed-upon procedures engagement performed in accordance with this Statement of Position (SOP) satisfies the SEC's regulatory requirements.

.02 The Commodity Futures Trading Commission (CFTC) issued Advisory No. 17-98 indicating that a year 2000 problem, as defined therein, consti-

<sup>1</sup> SEC Release No. 34-40162 and Release No. 34-40608 amend 17 C.F.R. 240.17a-5, *Reports to Be Made by Certain Brokers and Dealers* (rule 17a-5). SEC Release No. 34-40163 and Release No. 34-40587 add and amend, respectively, 17 C.F.R. 240.17Ad-18, *Year 2000 Readiness Reports to Be Made by Certain Transfer Agents* (rule 17Ad-18).

tutes a material inadequacy within the meaning of CFTC Regulation 1.16, thus triggering certain notification requirements applicable to CFTC registrants and their accountants. In Advisory No. 42-98, the CFTC advised its registrants and their accountants that the performance by an accountant of an agreed-upon procedures attestation engagement meeting the requirements of this SOP will satisfy the CFTC's requirements with respect to the accountant's responsibility for the identification of material inadequacies resulting from a year 2000 problem.<sup>2</sup> As a result of the connection between year 2000 problems and the identification and reporting of material inadequacies, as set forth in CFTC Advisory No. 17-98, the auditor of the financial statements of a CFTC-regulated entity should be the accountant engaged to perform the agreed-upon procedures attestation engagement pursuant to this SOP. In performing the audit of the CFTC-regulated entity's financial statements, the CFTC does not require the auditor to perform procedures beyond the agreed-upon procedures set forth in this SOP in order to detect material inadequacies resulting from a year 2000 problem.<sup>3</sup>

.03 Paragraphs .05 through .09 of this SOP contain a discussion of the relevant requirements of SEC rules 17a-5 and 17Ad-18 and CFTC Advisories No. 17-98 and No. 42-98. The practitioner should refer to the original rules and advisories for a complete understanding of their requirements.

## Applicability

.04 This SOP was developed to provide practitioners with guidance in performing year 2000 agreed-upon procedures attestation engagements to meet the requirements of SEC rules 17a-5 and 17Ad-18 and CFTC Advisories No. 17-98 and No. 42-98. Practitioners should note that the engagements described in this SOP are designed only to satisfy the regulatory requirements of SEC rules 17a-5 and 17Ad-18 and CFTC Advisories No. 17-98 and No. 42-98. The procedures, as set forth in the reports illustrated in appendices A to D [paragraphs .39-.42] herein, are neither appropriate nor intended for use in other engagements.

## SEC Rules

.05 Rule 17a-5 requires broker-dealers with minimum net capital requirements of \$5,000 or greater to file with the SEC and the broker-dealer's designated examining authority (DEA) two separate reports regarding their year 2000 readiness. Similarly, rule 17Ad-18 requires certain registered non-bank transfer agents to file with the SEC two separate reports regarding their

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<sup>2</sup> As discussed in CFTC Advisory No. 42-98, CFTC registrants meeting specified criteria are exempt from the requirement to file the accountant's agreed-upon procedures report that is the subject of this SOP. It is important to note that the exemption for any registrant may be revoked at the discretion of either the CFTC or the registrant's designated self-regulatory organization. The criteria specified in CFTC No. 42-98 (all of which must be met) are as follows.

- a. The entity is not a clearing member of an exchange.
- b. The entity carries no funds, accounts or positions for customers.
- c. The entity has no mission-critical systems that interface with other registrants or major market participants.
- d. The entity's designated self-regulatory organization has not provided notice to it that its exemption has been revoked. Also, the CFTC's Division of Trading and Markets has not notified the entity that it will be required to file the agreed-upon procedures report that is the subject of this SOP.

<sup>3</sup> See CFTC Advisory No. 17-98 and paragraph .12 of this SOP for the CFTC's definition of year 2000 problem.

year 2000 readiness. The first report, which addresses the broker-dealer or transfer agent's year 2000 readiness as of July 15, 1998, was to be filed with the SEC and DEA by August 31, 1998. The second report, which addresses year 2000 readiness as of March 15, 1999, is to be filed with the SEC and DEA by April 30, 1999. Each report is divided into Part I and Part II (jointly referred to as Form BD-Y2K for broker-dealers and Form TA-Y2K for transfer agents). Part I, which is in a "check-the-box" style, is required to be filed by all entities subject to the reporting rules. Part II requires a narrative discussion of specified aspects of the broker-dealer or transfer agent's year 2000 efforts. Part II is applicable only to broker-dealers with minimum net capital requirement of \$100,000 or greater<sup>4</sup> as of March 15, 1999, and transfer agents that do not qualify for the exemption in paragraph (d) of rule 17Ad-13<sup>5</sup> under the Securities Exchange Act of 1934.

.06 With respect to the report due on April 30, 1999, addressing year 2000 readiness as of March 15, 1999, the SEC requires entities completing Part II to file a report prepared by an independent public accountant regarding the entity's process for addressing year 2000 problems. In rules 17a-5 and 17Ad-18, the SEC states that only reports on engagements performed in accordance with standards issued by a national organization that is responsible for promulgating authoritative accounting and auditing standards will meet its regulatory requirements. In Releases No. 34-40608 and 34-40587, the SEC indicated that the procedures set forth in this SOP meet its regulatory requirements. The accountant's agreed-upon procedures report is to be filed with the SEC and the broker-dealer's DEA by April 30, 1999. Although the agreed-upon procedures report is restricted to the use of certain specified parties, it will be accessible by the public.

## CFTC Rules

.07 As indicated in the preceding, the CFTC has advised its registrants and their accountants that the performance by an accountant of an agreed-upon procedures attestation engagement in accordance with this SOP will satisfy the CFTC's regulatory requirements with respect to material inadequacies resulting from a year 2000 problem as set forth in Advisory No. 17-98.<sup>6</sup>

.08 The CFTC does not require year 2000 readiness reports from its registrants; therefore, the practitioner will need to obtain from CFTC-regulated entities an assertion in the form of a representation about the absence of a material inadequacy relating to a year 2000 problem as such is defined in Advisory No. 17-98. The agreed-upon procedures will be performed on the subject matter of that assertion. (The assertion is discussed in paragraph .20 herein.)

.09 In Advisory No. 42-98, the CFTC sets forth the requirements for the timing of the agreed-upon procedures attestation engagements. The general requirements are as follows.

- a. For entities subject to Advisories No. 17-98 and No. 42-98 that also are required to engage an accountant to perform an agreed-upon pro-

<sup>4</sup> Pursuant to rule 15c3-1(a)(2).

<sup>5</sup> 17 C.F.R. 240.17Ad-13.

<sup>6</sup> See footnote number 2.

cedures engagement relating to Part II of Form BD-Y2K pursuant to SEC rule 17a-5, the agreed-upon procedures should be performed on the subject matter of an assertion as of March 15, 1999. The accountant's agreed-upon procedures report is to be filed with the CFTC and the entity's designated self-regulatory organization by April 30, 1999.<sup>7</sup>

- b. For entities other than those in item *a* above that are subject to Advisories No. 17-98 and No. 42-98 and have fiscal years ending on or after February 28, 1998, but before October 1, 1998, the agreed-upon procedures should be performed on an assertion made as of a date selected by the entity between and including November 15, 1998, and December 15, 1998. The accountant's agreed-upon procedures report is to be filed with the CFTC and the entity's designated self-regulatory organization by December 31, 1998.
- c. For entities other than those in item *a* above that are subject to Advisories No. 17-98 and No. 42-98 and have fiscal years ending on or after October 1, 1998, but before February 28, 1999, the agreed-upon procedures should be performed on an assertion as of the fiscal year-end. The accountant's agreed-upon procedures report is to be filed with the CFTC and the entity's designated self-regulatory organization within ninety days after the fiscal year-end.

## Definition of "Year 2000 Problem"

.10 SEC rules 17a-5 and 17Ad-18 and CFTC Advisory No. 17-98 include descriptions of the "year 2000 problem" to be used for purposes of reporting pursuant to their requirements; however, those descriptions differ.

.11 SEC rule 17a-5(e)(5)(i) states the following.

[T]he term [y]ear 2000 [p]roblem shall include problems arising from (a) computer software incorrectly reading the date "01/01/00" as being the year 1900 or another incorrect year; (b) computer software incorrectly identifying a date in the Year 1999 or any year thereafter; (c) computer software failing to detect that the Year 2000 is a leap year; or (d) any other computer software error that is directly or indirectly caused by the problems set forth in [(a) through (c)].

.12 CFTC Advisory No. 17-98 states that "a 'year 2000 problem', for purposes of [the] Advisory, is a failure to address year 2000 mission-critical issues in an adequate and timely manner...." The Advisory further describes the year 2000 problem and what it considers "adequate and timely manner" as follows.

A "year 2000 problem" shall be deemed to exist if there is a material failure by an entity to meet the conditions set forth below. As used herein, the term "entity" refers to any registrant covered by the reporting or disclosure requirements enumerated [in the Advisory], and the term "system" refers to any mission-critical system and related facilities and infrastructure equipment.

Planning—The entity must have identified and evaluated its mission-critical systems for year 2000 compliance, identified those systems that need modification or replacement, and determined the scope of work necessary to achieve

<sup>7</sup> These dates correspond with the requirements of rule 17a-5. See discussion in paragraphs .28 and .29 herein regarding optional combined reporting.

compliance. For systems that interface with third party systems, an entity must also have made appropriate inquiry of operators of the other third party systems and planned to participate in industry-wide testing. Testing results must be documented and reported to management. The extent and detail of any plan must be appropriate to the complexity of the entity's operations. The plan must include provision(s) for contingencies to deal with the possibility that problems might arise in achieving year 2000 compliance. The Commission notes that the Futures Industry Association is leading industry-wide year 2000 testing and also plans to issue guidance regarding contingency planning.

**Scheduling**—The entity must have identified the major steps involved in bringing each system into compliance and have established a schedule, including milestones, for accomplishing this task. The schedule must allow sufficient time for testing of new systems and system modifications prior to commencing year 2000 operations. The entity must be in compliance with its schedule. In the event of slippage in meeting the original schedule, the entity must have established a new schedule.

**Staffing**—Top management of the entity must have assigned appropriate staff to carry out the plan. If the entity does not possess the appropriate staff resources, sufficient outside expertise must have been secured or otherwise be available on a contract basis.

**Approval and Control**—The entity must have a management process in place to approve and control the execution of the plan. The plan must be approved by the board of directors (or equivalent). Senior management must monitor and control execution of the plan and report progress to the board of directors.

## Applicable Professional Standards

.13 Agreed-upon procedures attestation engagements performed to meet the requirements of SEC rules 17a-5 and 17Ad-18 and CFTC Advisories No. 17-98 and No. 42-98 are to be performed in accordance with Statement on Standards for Attestation Engagements (SSAE) No. 4, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 600). As described in SSAE No. 4, an agreed-upon procedures engagement is one in which a practitioner is engaged by a client to issue a report of findings based on specific procedures performed on the subject matter of an assertion. Not all of the provisions of SSAE No. 4 are discussed herein. Rather, this SOP includes guidance to assist the practitioner in the application of selected aspects of SSAE No. 4.

.14 SSAE No. 4 (AT sec. 600.10), states that the practitioner may perform an agreed-upon procedures attestation engagement provided that, among other things, "(a) the practitioner and the specified users agree upon the procedures performed or to be performed by the practitioner; and (b) the specified users take responsibility for the sufficiency of the agreed-upon procedures for their purposes."

.15 As discussed above, the SEC and CFTC have indicated that engagements performed in accordance with this SOP will satisfy the regulatory requirements of SEC rules 17a-5 and 17Ad-18 and CFTC Advisories No. 17-98 and No. 42-98, respectively. Therefore, the requirements of SSAE No. 4 (AT sec. 600.10) have been satisfied. For that reason, practitioners should not agree to alter the scope of the procedures set forth in the illustrative agreed-upon procedures reports that appear in the appendixes to this SOP [paragraphs .39-.43].

.16 The specified users of an accountant's agreed-upon procedures report performed in accordance with this SOP should be limited to the following:

- a. The Board of Directors and management of the entity
- b. The SEC (if the entity is subject to rule 17a-5 or rule 17Ad-18)
- c. The self-regulatory organization designated to have examining authority pursuant to rule 17d-2 of the Securities Exchange Act of 1934 (if the entity is subject to rule 17a-5)
- d. The CFTC (if the entity is subject to CFTC Regulation 1.16 and Advisories No. 17-98 and No. 42-98)
- e. The self-regulatory organization designated to have examining responsibility pursuant to CFTC rule 1.52 (if the entity is subject to CFTC Regulation 1.16 and Advisories No. 17-98 and No. 42-98)

## Establishing an Understanding With the Client

.17 In accordance with SSAE No. 4 (AT sec. 600.12), the accountant should establish and document an understanding with the client regarding the services to be performed pursuant to this SOP. Such an understanding reduces the risk that the client may misinterpret the objectives and limitations of an agreed-upon procedures attestation engagement performed to meet the regulatory requirements of SEC rules 17a-5 and 17Ad-18 and CFTC Advisories No. 17-98 and No. 42-98. Such an understanding also reduces the risk that the client misunderstands its responsibilities, the responsibilities of other specified users, and the responsibilities of the practitioner.

## Assertions

.18 The applicable assertion, if this engagement is performed for a broker-dealer, is Parts I and II of Form BD-Y2K prepared and filed pursuant to the requirements of SEC rule 17a-5.

.19 The applicable assertion, if this engagement is performed for a transfer agent, is Parts I and II of Form TA-Y2K prepared and filed pursuant to the requirements of SEC rule 17Ad-18.

.20 For entities subject to CFTC Regulation 1.16 and Advisories No. 17-98 and No. 42-98, practitioners must obtain an assertion from management in the form of a representation, dated as described in CFTC Advisory No. 42-98 (see paragraph .09 of this SOP), regarding the absence of material inadequacies relating to year 2000 problems as such are defined in CFTC Advisory No. 17-98. The agreed-upon procedures will be performed on the subject matter of that assertion. The following illustrative language is appropriate for an assertion.

We confirm to the best of our knowledge and belief that as of *[insert date]*, there were no material inadequacies relating to the year 2000 problem, as year 2000 problem is defined in the Commodity Futures Trading Commission's Advisory No. 17-98. Accordingly, we have nothing to report or disclose to the Commission pursuant to Advisory No. 17-98 or the applicable Commodity Futures Trading Commission rules.

## Procedures to Be Performed

.21 The agreed-upon procedures to be performed are directed toward the identification of selected characteristics of the process planned and implemen-

ted by each entity to assess, remediate, test and monitor the entity's year 2000 readiness. Thus, the agreed-upon procedures engagement provides no assurance as to whether an entity or the parties with which an entity does business will be year 2000 ready. For that reason the practitioner's agreed-upon procedures report should include the following disclaimer.

Our procedures also do not provide assurance that the entity is or will be year 2000 ready, that its year 2000 project plans will be successful in whole or in part, or that parties with which the entity does business will be year 2000 ready.

**.22** The procedures to be performed in connection with the agreed-upon procedures attestation engagements contemplated in this SOP are included in the illustrative reports in appendixes A to D [paragraphs .39-.42] herein.<sup>8</sup>

**.23** The procedures have been designed such that the findings resulting from the application of the procedures are to be expressed in a tabular format. The finding for each procedure should be reported as *No Exception*, *Exception*, or *N/A* for not applicable. Accordingly, if a procedure included in the illustrative reports in the appendixes [paragraphs .39-.43] is not applicable to an entity for which an engagement is performed, the procedure should be marked *N/A* rather than deleted from the report. This format is intended to provide ease of review and aggregation of results by the specified users of the agreed-upon procedures reports.

**.24** If any portion of a procedure performed results in an exception, the entire finding should be reported as an exception. A brief factual explanation is to be provided by the practitioner for all exceptions in the report. Such explanation is intended to enable the specified users to understand the nature of the finding resulting in the exception. Examples of explanations for exceptions are as follows.

#### **Exception Attributed to One Component of the Organization**

This exception relates to items *2d* and *e* in the illustrative reports in appendixes A to D [paragraphs .39-.42] of this SOP.

With respect to XYZ subsidiary, the year 2000 project plans do not include a process for identifying and the actual identification of third parties that the entity has determined to be significant in the context of the broker-dealer's potential year 2000 problems. Further, with respect to XYZ subsidiary, the year 2000 project plans do not include a process for assessing the year 2000 readiness of significant third parties.

#### **Exception Attributed to One Mission Critical System**

This exception relates to item *2i* in the illustrative reports in appendixes A to D [paragraphs .39-.42] of this SOP.

The entity has not determined a date by which a mission-critical system, the system used to assign values to fixed income portfolios, is expected to be year 2000 ready.

#### **Pervasive Exception**

These exceptions relate to items *2n* to *2o* in the illustrative reports in appendixes A to D [paragraphs .39-.42] of this SOP.

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<sup>8</sup> The footnotes in the illustrative reports are intended to be included in reports issued pursuant to this SOP.

*Item 2n—The entity's year 2000 project plans do not include a process to evaluate staffing requirements on an ongoing basis throughout the term of the project.*

*Item 2o—The entity does not have a written plan for testing changes made to its mission-critical systems intended to remedy potential year 2000 problems.*

**.25** A practitioner may perform significant portions of the agreed-upon procedures attestation engagement before the date of the entity's assertion. If, during that time, the practitioner identifies conditions that would result in an exception to one or more agreed-upon procedures, he or she should—

- a. Not report an exception in the agreed-upon procedures report if the condition is corrected on or before the date of the entity's assertion.
- b. Report an exception in the agreed-upon procedures report if the entity does not correct the condition on or before the date of the assertion. However, if the condition has been corrected by the date of the practitioner's report, the explanation for the exception should indicate, "the condition resulting in the reporting of an exception was corrected subsequent to the date of ABC Entity's assertion." In such case, no further explanation of the condition resulting in the exception is necessary.

**.26** The practitioner has no obligation to perform procedures beyond the agreed-upon procedures set forth in this SOP. However, if information contradicting management's assertion comes to the practitioner's attention by other means, such information should be included in his or her report.

**.27** The practitioner may become aware of conditions or events occurring subsequent to the date of the entity's assertion but before the date of the accountant's report that contradict the entity's assertion or would have resulted in the reporting of an exception by the practitioner if that condition or event had existed at the date of the assertion. The accountant should consider including information about such conditions or events in his or her report. However, the practitioner has no responsibility to perform procedures to detect such conditions or events.

## SEC and CFTC Combined Reporting

**.28** A number of entities will be required to engage accountants to perform agreed-upon procedures attestation engagements to satisfy the requirements of both SEC rule 17a-5 and CFTC Advisories No. 17-98 and No. 42-98. For these entities, Advisory No. 42-98 provides that the timing of the agreed-upon procedures engagements will be the same as that for agreed-upon procedure engagements performed to satisfy the requirements of SEC rule 17a-5 (see Advisory No. 42-98 and paragraph .09a of this SOP). Thus, entities subject to the requirements of both the SEC and the CFTC may file either separate agreed-upon procedures reports with the SEC and the CFTC or a combined report. An illustrative combined report is in appendix D, "Illustrative Combined Agreed-Upon Procedures Report Pursuant to CFTC Advisories No. 17-98 and No. 42-98 and SEC Rule 17a-5," [paragraph .42] of this SOP.

**.29** When reporting on a combined basis, the relevant assertions for the agreed-upon procedures engagement will include both Form BD-Y2K and the assertion required for CFTC agreed-upon procedures engagements as set forth in paragraphs .18 and .20 of this SOP.



## Restriction on the Performance of Procedures

.30 As discussed in paragraph .15 of this SOP, the practitioner should not agree to alter the scope of the procedures set forth in the illustrative agreed-upon procedures reports that appear in the appendixes [paragraphs .39–.43] to this SOP. If circumstances impose restrictions on the performance of the agreed-upon procedures as described in the sample agreed-upon procedures reports, the practitioner should describe the restriction(s) in his or her report or withdraw from the engagement.

## Dating of Report

.31 The date of completion of the agreed-upon procedures should be used as the date of the agreed-upon procedures report.

## Report on Internal Control Required by CFTC Regulation 1.16

.32 The CFTC rules require that the scope of the financial statement audit be sufficient to provide reasonable assurance that material inadequacies, as defined by the CFTC, are detected. Auditors of entities subject to CFTC Regulation 1.16 are required to file a supplemental report on the entity's internal control describing any material inadequacies found to exist or found to have existed since the date of the previous audit.

.33 Because CFTC Advisory No. 17-98 indicated that a year 2000 problem, as defined in that advisory, constitutes a material inadequacy within the meaning of CFTC Regulation 1.16, the practitioner performing the entity's audit should include the following in his or her report on internal control prepared in connection with the audit and pursuant to CFTC Regulation 1.16:

- a. A discussion of the requirements of CFTC Advisories No. 17-98 and No. 42-98 with respect to the year 2000 problem
- b. A reference to the agreed-upon procedures attestation engagement to be performed pursuant to this SOP<sup>9</sup>
- c. A description of the limitations on assurance provided by the accountant with respect to the year 2000 problem

An illustrative report on internal control required under CFTC Regulation 1.16, modified to limit the scope of the report for the Year 2000 Issue, is in appendix E, "Report on Internal Control Required by CFTC Regulation 1.16, Modified to Limit the Scope of the Report for the Year 2000 Issue," [paragraph .43] herein.

.34 In the course of performing the financial statement audit and the agreed-upon procedures attestation engagement, the accountant may become aware of matters relating to the year 2000 problem that, in the practitioner's judgment, constitute material inadequacies as those are defined by the CFTC. The practitioner should follow CFTC requirements for reporting such matters

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<sup>9</sup> As discussed in footnote number 2, certain CFTC registrants are exempt from the requirement to file this report. Therefore, this reference should be omitted from the report on internal control relating to these registrants.

to management and the CFTC. Depending on the timing of the identification of such matters, they may be included in the practitioner's report on internal control prepared in connection with the financial statement audit, or it may be necessary to make such communications separately.

## **Report on Internal Control Required by SEC Rule 17a-5**

.35 In connection with the financial statement audit of a broker-dealer, the SEC requires independent auditors to issue a report on internal accounting control. To meet this requirement, the auditor issues a report that expresses an opinion on the adequacy of specified practices and procedures in relation to the definition of a material inadequacy as stated in rule 17a-5(g)(3) and discloses material weaknesses in internal control (including controls for safeguarding securities) that are revealed through auditing procedures designed and conducted for the purpose of expressing an opinion on the financial statements. With respect to material inadequacies, the auditor also is subject to the notification requirements of SEC rules 17a-5 and 17a-11.

.36 The staff of the SEC has not issued any interpretive guidance as to whether any year 2000 problems as defined by the SEC should be considered material inadequacies. An accountant should refer to rule 17a-5(g)(3) when evaluating whether any year 2000 problems identified in performing a financial statement audit for a broker-dealer or an agreed-upon procedures attestation engagement pursuant to this SOP constitute a material inadequacy.

.37 With respect to entities subject to both SEC rule 17a-5 and CFTC Regulation 1.16, if a material inadequacy relating to a year 2000 problem is reported to the CFTC (see paragraph .34), practitioners are advised to consider including that information in the internal control report filed with the SEC. However, for reporting to the SEC, the accountant may determine that such matters do not constitute a material inadequacy.

## **Effective Date**

.38 This SOP is effective upon issuance and is applicable only to agreed-upon procedures attestation engagements relating to the assertions regarding year 2000 readiness in Part I and Part II of Form BD-Y2K, Part I and Part II of Form TA-Y2K, or a futures commission merchant or introducing broker's representation regarding the absence of material inadequacies relating to year 2000 problems as such are defined in CFTC Advisory No. 17-98.

.39

## Appendix A

### Illustrative Agreed-Upon Procedures Report Pursuant to SEC Rule 17a-5

#### Independent Accountant's Report on Applying Agreed-Upon Procedures

To the Board of Directors of ABC Broker-Dealer:

We have performed the procedures enumerated below as specified in the American Institute of Certified Public Accountants' (AICPA's) Statement of Position 98-8 [section 11,340], which were agreed to by ABC Broker-Dealer (hereinafter referred to as the *entity*) to assist the users in evaluating the entity's assertions in Parts I and II of Form BD-Y2K (Form BD-Y2K) as of March 15, 1999, prepared and filed pursuant to the requirements of SEC rule 17a-5.<sup>1</sup> Pursuant to Securities and Exchange Commission (SEC) Release No. 34-40608 these agreed-upon procedures will satisfy the SEC's regulatory requirements. This report is issued solely for these regulatory purposes.

This agreed-upon procedures engagement was performed in accordance with standards established by the AICPA. The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

Procedure	Findings		
	No Exception	Exception	N/A
1. We read the entity's written plans for preparing and testing the entity's computer systems for potential year 2000 problems <sup>2</sup> (year 2000 project plans) and—			
a. Determined, by comparison to organization charts (or similar corporate documents) and the entity's most recent net capital calculation, that the year 2000 project plans include all divisions and branches of the registered entity and any subsidiary or affiliate as to which the registered entity (1) guarantees, endorses, or assumes directly or indirectly the obligations or liabilities, or (2) receives flow-through capital treatment. <sup>3</sup>			

<sup>1</sup> See 17 C.F.R. 240.17a-5 (rule 17a-5).

<sup>2</sup> See rule 17a-5(e)(5)(i) for the SEC's definition of year 2000 problem.

<sup>3</sup> For further guidance, please refer to Appendix C to SEC rule 15c3-1.

Procedure	Findings		
	No Exception	Exception	N/A
b. Obtained written representation from the entity's chief operating officer (or equivalent) that the organization charts (or similar corporate documents) used in performing this procedure were complete, accurate, and current.			
c. Obtained written representation from the entity's chief operating officer (or equivalent) that the net capital calculation includes any subsidiary or affiliate as to which the registered entity (1) guarantees, endorses, or assumes directly or indirectly the obligations or liabilities, or (2) receives flow-through capital treatment.			
d. Compared the organizational information in the year 2000 project plans (see item 1a) with the corresponding information in Form BD-Y2K and found them to be in agreement.			
2. We read the entity's year 2000 project plans, and determined that the plans include each of the elements listed below. In performing this procedure, we did not evaluate the completeness or accuracy of the information contained within each element of the written document nor did we evaluate whether the year 2000 project plans will achieve the objectives set forth therein.			
<b>Assessment</b>			
<b>Mission-critical systems</b>			
a. The entity's definition of mission-critical systems. (In defining <i>mission-critical</i> , the entity included, as applicable, systems—whether developed and maintained in-house or by an outside service organization—related to clearing and settlement, customer segregation, net capital, financial reporting, and payroll, among other things.)			

Procedure	Findings		
	No Exception	Exception	N/A
b. Process for identifying and actual identification of systems (including affected software and hardware) that the entity has determined are mission-critical systems			
c. Process for identifying and actual identification of mission-critical systems that the entity has determined present a potential year 2000 problem (hereinafter referred to as <i>noncompliant</i> ) (See footnote 1 of this report.)			
<b>Vendors, service providers, and counterparties<sup>4</sup></b>			
d. Process for identifying and actual identification of vendors, service providers, and counter-parties (hereinafter collectively referred to as <i>third parties</i> ) that the entity has determined to be significant (as defined by the entity) in the context of the entity's potential year 2000 problems			
e. Process for identifying and actual identification of significant third parties with respect to which the entity has determined either (1) the third party's lack of year 2000 readiness is expected to result in its inability to continue to provide goods and services or perform in the time and manner required, or (2) insufficient information is available to the entity to make an assessment as to the significant third party's year 2000 readiness			
<b>Electronic Interfaces</b>			
f. Process for identifying and actual identification of internal and external electronic interfaces (hereinafter collectively referred to as <i>interfaces</i> ) that the entity has determined to be significant (as defined by the entity) in the context of the entity's potential year 2000 problems			

<sup>4</sup> For purposes of this report, vendors, service providers, and counterparties may include affiliated entities.

Procedure	Findings		
	No Exception	Exception	N/A
<i>g.</i> Process for identifying and actual identification of significant interfaces that the entity has determined are noncompliant			
<b>Remediation strategy</b>			
<b><i>Mission-critical systems</i></b>			
<i>h.</i> Plans for repairing or replacing each noncompliant mission-critical system (including affected hardware and software)			
<i>i.</i> The date by which each noncompliant mission-critical system is expected to be year 2000 ready and either (1) a determination by the entity that such date is prior to the date that the entity expects the mission-critical system to fail, or (2) plans for resolving situations where mission-critical systems are not expected to be year 2000 ready before failure			
<b><i>Third Parties</i></b>			
<i>j.</i> Plans for resolving situations in which either (1) a significant third party's assessed lack of year 2000 readiness is expected to result in its inability to provide goods and services or perform in the time and manner required, or (2) insufficient information is available to the entity to make an assessment as to the significant third party's year 2000 readiness			
<b><i>Interfaces</i></b>			
<i>k.</i> Plans for repairing or replacing each significant noncompliant interface (including affected hardware and software)			
<i>l.</i> The date by which each significant noncompliant interface is expected to be year 2000 ready and either (1) a determination by the entity that such date is prior to the date that the entity expects the significant interfaces to fail, or (2) plans for addressing situations in which significant interfaces are not expected to be year 2000 ready before failure			

Procedure	Findings		
	No Exception	Exception	N/A
<b>Staffing</b>			
m. Identification of staff resources needed, including the assignment of existing employees and/or hiring of new employees or contractors to implement the year 2000 project plans.	_____	_____	_____
n. Process to evaluate staffing requirements on an ongoing basis throughout the term of the project	_____	_____	_____
<b>Testing</b>			
o. Plans for testing year 2000 project efforts relating to each mission-critical system and significant interface (including affected hardware and software) as follows:			
(1) Internal testing	_____	_____	_____
(2) Point-to-point testing	_____	_____	_____
(3) Industry-wide testing in Securities Industry Association Tier 1	_____	_____	_____
p. Process for reporting results of testing (including exceptions) identified in item o above to members of management assigned oversight responsibility for the implementation of the year 2000 project plans (See item s below.)	_____	_____	_____
<b>Contingency plans</b>			
q. Plans for addressing unexpected failures or unsuccessful remediation efforts of mission-critical systems or significant interfaces and unexpected inability of significant third parties to continue to provide goods and services or perform in the time and manner required due to lack of year 2000 readiness	_____	_____	_____
<b>Timetable</b>			
r. Timetable with milestones for completion of the key elements (assessment, implementation of remediation strategy, staffing, testing, and contingency planning) of the entity's year 2000 project plans	_____	_____	_____

Procedure	Findings		
	No Exception	Exception	N/A
<b>Management Oversight</b>			
s. Specific identification of the member(s) of management who have been assigned oversight responsibility for the implementation of the year 2000 project plans			
<b>Monitoring</b>			
t. Procedures for reporting the progress of the year 2000 project efforts to members of management assigned oversight responsibility for the implementation of the year 2000 project plans (See items above.)			
u. Procedures for reporting the progress of the year 2000 project efforts, including the results of testing, to the board of directors <sup>5</sup>			
v. Procedures for evaluating the progress of the year 2000 project efforts, including testing thereof, and making revisions to the year 2000 project plans as necessary			
3. We compared the information described in items 2a to 2v with the corresponding information in Form BD-Y2K and found it to be in agreement.			
4. We read [minutes of meetings of the board of directors, or made inquiries of individuals in attendance at meetings of the board of directors] and noted that the board of directors of the entity approved the year 2000 project plans. We compared this information with the corresponding information in Form BD-Y2K and found it to be in agreement.			
5. We read [minutes of meetings of the board of directors, or made inquiries of individuals in attendance at meetings of the board of directors] and noted that the board of directors has approved the commitment			

<sup>5</sup> As used in this report, *board of directors* refers to the board of directors, its designee committee for addressing year 2000 matters, or group equivalent to the board of directors or designee committee.



Procedure	Findings		
	No Exception	Exception	N/A
of financial resources determined by management to be sufficient to accomplish the objectives of the entity's year 2000 project plans. We compared this information with the corresponding information in Form BD-Y2K and found it to be in agreement. In performing this procedure, we did not evaluate the adequacy of the resources determined by management to be sufficient to accomplish the objectives of the year 2000 project plans.			
6. We obtained from management a list of business units <sup>6</sup> considered by the entity to be significant, and performed the following procedures.			

Assessment

- a. We inquired of management of five randomly selected (or 100 percent if less than five) significant business units (see list below), and obtained written representation therefrom, as to whether the identification of mission-critical systems included in the entity's year 2000 project plans included all systems that they considered critical to the continuation of operations in their respective business unit (see item 2b above). An exception would be reported if, as a result of this procedure, management of a significant business unit identified systems that they considered critical to the continuation of operations in their respective business unit that are not included in the entity's year 2000 project plans.

[List the five business units here.]

<sup>6</sup> The entity's list of significant business units includes profit centers as well as support units such as treasury, accounting, payroll and human resources, order entry and trade execution, clearance and settlement, and regulatory reporting.

Procedure	Findings		
	No Exception	Exception	N/A
<p>b. We inquired of management of five randomly selected (or 100 percent if less than five) significant business units (see list below), and obtained written representation therefrom, as to whether the identification of significant third parties included in the entity's year 2000 project plans included all third parties that they considered critical to the continuation of operations in their respective business unit (see item 2d above). An exception would be reported if, as a result of this procedure, management of a significant business unit identified significant third parties that they considered critical to the continuation of operations in their respective business unit that are not included in the entity's year 2000 project plans.</p> <p>[List the five business units here.]</p>			
<p>c. We inquired of information technology management of five randomly selected (or 100 percent if less than five) significant business units (see list below), and obtained written representation therefrom, as to whether the identification of interfaces included in the entity's year 2000 project plans included all interfaces that they considered critical to the continuation of operations in their respective business unit (see item 2f above). An exception would be reported if, as a result of this procedure, information technology management of a significant business unit identified interfaces that they considered critical to the continuation of operations in their respective business unit that are not included in the entity's year 2000 project plans.</p> <p>[List the five business units here.]</p>			

Procedure	Findings		
	No Exception	Exception	N/A
<b>Staffing</b>			
d. We read <i>[reports to or summaries of meetings attended by]</i> the individual(s) of the management team with oversight responsibility for the execution of the year 2000 project plans indicating that implementation of staffing plans, as set forth in the year 2000 project plans, are being tracked and deviations from the year 2000 project plans are being identified.			
e. We read contracts or other written evidence of engagements with five randomly selected (or 100 percent if less than five) individuals (not employees) or entities that were contracted to implement year 2000 project activities. We compared this information with the corresponding information in the year 2000 project plans and found them to be in agreement.			
<b>Testing</b>			
f. We read <i>[reports to or summaries of meetings attended by]</i> the individual(s) of the management team with oversight responsibility for the execution of the year 2000 project plans indicating that the status of testing of mission-critical systems and significant interfaces is being tracked and any delays in schedule are being identified.			
g. We obtained written representation from the individual(s) of the management team with oversight responsibility for the execution of the year 2000 project plans that the status of testing of mission-critical systems and significant interfaces is being tracked and any delays in schedule are being identified.			

Procedure	Findings		
	No Exception	Exception	N/A
<b>Monitoring</b>			
h. We [read minutes of meetings of the board of directors, or made inquiries of individuals in attendance at meetings of the board of directors] and noted that, as called for in the year 2000 project plans, the board of directors is receiving periodic updates of the status of the implementation progress of the year 2000 project plans.			
i. We read [reports to or summaries of meetings attended by] the individual(s) of the management team with oversight responsibility for executing the year 2000 project plans indicating that modifications to the year 2000 project plans that they have determined are necessary, including those found to be necessary as a result of testing or delays in schedule, have been made.			
j. We obtained written representation from the individual(s) of the management team with oversight responsibility for executing the year 2000 project plans that modifications to the year 2000 project plans that they have determined are necessary, including those found to be necessary as a result of testing or delays in schedule, have been made.			
7. We compared the information described in items 6a to 6j with the corresponding information in Form BD-Y2K and found it to be in agreement.			

[Include description of any exceptions.]

We were not engaged to, and did not, perform an examination, the objective of which would be the expression of an opinion on the entity's assertions included in Form BD-Y2K referred to in the introductory paragraph of this report. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you. Our procedures also do not provide assurance that the entity is or will be year 2000 ready, that its year 2000 project plans will be successful in whole or in part, or that parties with which the entity does business will be year 2000 ready.

This report is intended solely for the information and use of the Board of Directors and Management of ABC Broker-Dealer, the Securities and Exchange Commission, and ABC Broker-Dealer's designated self-regulatory organization and is not intended to be and should not be used by anyone other than these specified parties.

[Signed]

[City]

[Date]

Appendix B

Illustrative Agreed-Upon Procedures Report Pursuant to SEC Rule 17Ad-18

Independent Accountant's Report  
on Applying Agreed-Upon Procedures

To the Board of Directors of ABC Transfer Agent:

We have performed the procedures enumerated below as specified in the American Institute of Certified Public Accountants' (AICPA's) Statement of Position 98-8 [section 11,340] which were agreed to by ABC Transfer Agent (hereinafter referred to as the *entity*) to assist the users in evaluating the entity's assertions in Parts I and II of Form TA-Y2K (Form TA-Y2K) as of March 15, 1999, prepared and filed pursuant to the requirements of SEC rule 17Ad-18.<sup>1</sup> Pursuant to Securities and Exchange Commission (SEC) Release No. 34-40587, these agreed-upon procedures will satisfy the SEC's regulatory requirements. This report is issued solely for these regulatory purposes.

This agreed-upon procedures engagement was performed in accordance with standards established by the AICPA. The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

Procedure	Findings		
	No Exception	Exception	N/A
1. We read the entity's written plans for preparing and testing the entity's computer systems for potential year 2000 problems <sup>2</sup> (year 2000 project plans) and—			
a. Determined, by comparison to organization charts (or similar corporate documents), that the year 2000 project plans include all divisions and branches of the registered entity and any subsidiary or affiliate as to which the registered entity guarantees, endorses, or assumes directly or indirectly the obligations or liabilities			

<sup>1</sup> See 17 C.F.R. 240.17Ad-18 (rule 17Ad-18).  
<sup>2</sup> See rule 17Ad-18(d) for the SEC's definition of year 2000 problem.

Procedure	Findings		
	No Exception	Exception	N/A
b. Obtained written representation from the entity's chief operating officer (or equivalent) that the organization charts (or similar corporate documents) used in performing this procedure were complete, accurate, and current.			
c. Compared the organizational information in the year 2000 project plans (see item 1a) with the corresponding information in Form TA-Y2K and found them to be in agreement.			
2. We read the entity's year 2000 project plans, and determined that the plans include each of the elements listed below. In performing this procedure, we did not evaluate the completeness or accuracy of the information contained within each element of the written document nor did we evaluate whether the year 2000 project plans will achieve the objectives set forth therein.			
<b>Assessment</b>			
<b>Mission-critical systems</b>			
a. The entity's definition of mission-critical systems (In defining <i>mission-critical</i> , the entity included, as applicable, systems—whether developed and maintained in-house or by an outside service organization—related to clearing and settlement, customer segregation, financial reporting, and payroll, among other things.)			
b. Process for identifying and actual identification of systems (including affected software and hardware) that the entity has determined are mission-critical systems			
c. Process for identifying and actual identification of mission-critical systems that the entity has determined present a potential year 2000 problem (hereinafter referred to as noncompliant) (See footnote 1 of this report.)			

Procedure	Findings		
	No Exception	Exception	N/A
<b>Vendors, service providers, and counterparties<sup>3</sup></b>			
d. Process for identifying and actual identification of vendors, service providers, and counterparties (hereinafter collectively referred to as <i>third parties</i> ) that the entity has determined to be significant (as defined by the entity) in the context of the entity's potential year 2000 problems			
e. Process for identifying and actual identification of significant third parties with respect to which the entity has determined either (1) the third party's lack of year 2000 readiness is expected to result in its inability to continue to provide goods and services or perform in the time and manner required, or (2) insufficient information is available to the entity to make an assessment as to the significant third party's year 2000 readiness			
<b>Electronic Interfaces</b>			
f. Process for identifying and actual identification of internal and external electronic interfaces (hereinafter collectively referred to as <i>interfaces</i> ) that the entity has determined to be significant (as defined by the entity) in the context of the entity's potential year 2000 problems			
g. Process for identifying and actual identification of significant interfaces that the entity has determined are noncompliant			
<b>Remediation strategy</b>			
<b>Mission-critical systems</b>			
h. Plans for repairing or replacing each noncompliant mission-critical system (including affected hardware and software)			

<sup>3</sup> For purposes of this report, vendors, service providers, and counterparties may include affiliated entities.



Procedure	Findings		
	No Exception	Exception	N/A
i. The date by which each non-compliant mission-critical system is expected to be year 2000 ready and either (1) a determination by the entity that such date is prior to the date that the entity expects the mission-critical system to fail, or (2) plans for resolving situations where mission-critical systems are not expected to be year 2000 ready before failure			
<b>Third Parties</b>			
j. Plans for resolving situations in which either (1) a significant third party's assessed lack of year 2000 readiness is expected to result in its inability to provide goods and services or perform in the time and manner required, or (2) insufficient information is available to the entity to make an assessment as to the significant third party's year 2000 readiness			
<b>Interfaces</b>			
k. Plans for repairing or replacing each significant noncompliant interface (including affected hardware and software)			
l. The date by which each significant noncompliant interface is expected to be year 2000 ready and either (1) a determination by the entity that such date is prior to the date that the entity expects the significant interfaces to fail or (2) plans for addressing situations in which significant interfaces are not expected to be year 2000 ready before failure			
<b>Staffing</b>			
m. Identification of staff resources needed, including the assignment of existing employees and/or hiring of new employees or contractors to implement the year 2000 project plans			

Procedure	Findings		
	No Exception	Exception	N/A
n. Process to evaluate staffing requirements on an ongoing basis throughout the term of the project			
<b>Testing</b>			
o. Plans for testing year 2000 project efforts relating to each mission-critical system and significant interface (including affected hardware and software) as follows:			
(1) Internal testing			
(2) Point-to-point testing:			
Depository Trust Company or other clearing organization			
Other			
p. Process for reporting results of testing (including exceptions) identified in item o above to members of management assigned oversight responsibility for the implementation of the year 2000 project plans (See item s below.)			
<b>Contingency plans</b>			
q. Plans for addressing unexpected failures or unsuccessful remediation efforts of mission-critical systems or significant interfaces and unexpected inability of significant third parties to continue to provide goods and services or perform in the time and manner required due to lack of year 2000 readiness			
<b>Timetable</b>			
r. Timetable with milestones for completion of the key elements (assessment, implementation of remediation strategy, staffing, testing, and contingency planning) of the entity's year 2000 project plans			
<b>Management Oversight</b>			
s. Specific identification of the member(s) of management who have been assigned oversight responsibility for the implementation of the year 2000 project plans			

Procedure	Findings		
	No Exception	Exception	N/A
<b>Monitoring</b>			
t. Procedures for reporting the progress of the year 2000 project efforts to members of management assigned oversight responsibility for the implementation of the year 2000 project plans (See item s above.)	_____	_____	_____
u. Procedures for reporting the progress of the year 2000 project efforts, including the results of testing, to the board of directors <sup>4</sup>	_____	_____	_____
v. Procedures for evaluating the progress of the year 2000 project efforts, including testing thereof, and making revisions to the year 2000 project plans as necessary	_____	_____	_____
3. We compared the information described in items 2a to 2v with the corresponding information in Form TA-Y2K and found it to be in agreement.	_____	_____	_____
4. We [read minutes of meetings of the board of directors, or made inquiries of individuals in attendance at meetings of the board of directors] and noted that the board of directors of the entity approved the year 2000 project plans. We compared this information with the corresponding information in Form TA-Y2K and found it to be in agreement.	_____	_____	_____
5. We [read minutes of meetings of the board of directors, or made inquiries of individuals in attendance at meetings of the board of directors] and noted that the board of directors has approved the commitment of financial resources determined by management to be sufficient to accomplish the objectives of the entity's year 2000 project plans. We compared this information with the corresponding information in Form TA-Y2K and found it to be in agreement. In performing this procedure, we did not evaluate the adequacy of the resources determined by management to be sufficient to accomplish the objectives of the year 2000 project plans.	_____	_____	_____

<sup>4</sup> As used in this report, *board of directors* refers to the board of directors, its designee committee for addressing year 2000 matters, or group equivalent to the board of directors or designee committee.

Procedure	Findings		
	No Exception	Exception	N/A
6. We obtained from management a list of business units <sup>5</sup> considered by the entity to be significant, and performed the following procedures.			
<b>Assessment</b>			
a. We inquired of management of five randomly selected (or 100 percent if less than five) significant business units (see list below), and obtained written representation therefrom, as to whether the identification of mission-critical systems included in the entity's year 2000 project plans included all systems that they considered critical to the continuation of operations in their respective business unit (see item 2b above). An exception would be reported if, as a result of this procedure, management of a significant business unit identified systems that they considered critical to the continuation of operations in their respective business unit that are not included in the entity's year 2000 project plans.			
<i>[List the five business units here.]</i>			
b. We inquired of management of five randomly selected (or 100 percent if less than five) significant business units (see list below), and obtained written representation therefrom, as to whether the identification of significant third parties included in the entity's year 2000 project plans included all third parties that they considered critical to the continuation of operations in their respective business unit (see item 2d above). An exception would be reported if, as a result			

<sup>5</sup> The entity's list of significant business units includes profit centers as well as support units such as treasury, accounting, payroll and human resources, order entry and trade execution, clearance and settlement, and regulatory reporting.

Procedure	Findings		
	No Exception	Exception	N/A
of this procedure, management of a significant business unit identified significant third parties that they considered critical to the continuation of operations in their respective business unit that are not included in the entity's year 2000 project plans.			
[List the five business units here.]			
c. We inquired of information technology management of five randomly selected (or 100 percent if less than five) significant business units (see list below), and obtained written representation therefrom, as to whether the identification of interfaces included in the entity's year 2000 project plans included all interfaces that they considered critical to the continuation of operations in their respective business unit (see item 2f above). An exception would be reported if, as a result of this procedure, information technology management of a significant business unit identified interfaces that they considered critical to the continuation of operations in their respective business unit that are not included in the entity's year 2000 project plans.			
[List the five business units here.]			

### Staffing

- d. We read [reports to or summaries of meetings attended by] the individual(s) of the management team with oversight responsibility for the execution of the year 2000 project plans indicating that implementation of staffing plans, as set forth in the year 2000 project plans, are being tracked and deviations from the year 2000 project plans are being identified.

Procedure	Findings		
	No Exception	Exception	N/A
e. We read contracts or other written evidence of engagements with five randomly selected (or 100 percent if less than five) individuals (not employees) or entities that were contracted to implement year 2000 project activities. We compared this information with the corresponding information in the year 2000 project plans and found them to be in agreement.			
<b>Testing</b>			
f. We read <i>[reports to or summaries of meetings attended by]</i> the individual(s) of the management team with oversight responsibility for the execution of the year 2000 project plans indicating that the status of testing of mission-critical systems and significant interfaces is being tracked and any delays in schedule are being identified.			
g. We obtained written representation from the individual(s) of the management team with oversight responsibility for the execution of the year 2000 project plans that the status of testing of mission-critical systems and significant interfaces is being tracked and any delays in schedule are being identified.			
<b>Monitoring</b>			
h. We <i>[read minutes of meetings of the board of directors, or made inquiries of individuals in attendance at meetings of the board of directors]</i> and noted that, as called for in the year 2000 project plans, the board of directors is receiving periodic updates of the status of the implementation progress of the year 2000 project plans.			
i. We read <i>[reports to or summaries of meetings attended by]</i> the individual(s) of the management team with oversight responsibil-			

Procedure	Findings		
	No Exception	Exception	N/A
ity for executing the year 2000 project plans indicating that modifications to the year 2000 project plans that they have determined are necessary, including those found to be necessary as a result of testing or delays in schedule, have been made.			
j. We obtained written representation from the individual(s) of the management team with oversight responsibility for executing the year 2000 project plans that modifications to the year 2000 project plans that they have determined are necessary, including those found to be necessary as a result of testing or delays in schedule, have been made.			
7. We compared the information described in items 6a to 6j with the corresponding information in Form TA-Y2K and found it to be in agreement.			

*[Include description of any exceptions.]*

We were not engaged to, and did not, perform an examination, the objective of which would be the expression of an opinion on the entity's assertions included in Form TA-Y2K referred to in the introductory paragraph of this report. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you. Our procedures also do not provide assurance that the entity is or will be year 2000 ready, that its year 2000 project plans will be successful in whole or in part, or that parties with which the entity does business will be year 2000 ready.

This report is intended solely for the information and use of the Board of Directors and Management of ABC Transfer Agent, and the Securities and Exchange Commission, and is not intended to be and should not be used by anyone other than these specified parties.

*[Signed]*

*[City]*

*[Date]*

Appendix C

Illustrative Agreed-Upon Procedures Report Pursuant to CFTC Advisories No. 17-98 and No. 42-98

Independent Accountant's Report  
on Applying Agreed-Upon Procedures

To the Board of Directors of ABC Futures Commission Merchant:

We have performed the procedures enumerated below as specified in the American Institute of Certified Public Accountants' (AICPA's) Statement of Position 98-8 [section 11,340] which were agreed to by ABC Futures Commission Merchant (hereinafter referred to as the *entity*) to assist the users in evaluating the entity's assertion as of [date] about the absence of a material inadequacy within the meaning of CFTC Regulation 1.16 relating to a year 2000 problem, included in its representation letter dated [insert date]. The Commodity Futures Trading Commission's (CFTC's) Advisory No. 42-98 states that these agreed-upon procedures will satisfy the Commission's regulatory requirements. This report is issued solely for these regulatory purposes.

This agreed-upon procedures engagement was performed in accordance with standards established by the AICPA. The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

Procedure	Findings		
	No Exception	Exception	N/A
1. We read the entity's written plans for preparing and testing the entity's computer systems for potential year 2000 problems <sup>1</sup> (year 2000 project plans) and—			
a. Determined, by comparison to organization charts (or similar corporate documents) that the year 2000 project plans include all divisions and branches of the registered entity and any subsidiary or affiliate as to which the registered entity (1) guarantees, endorses or assumes directly or indirectly the obligations or liabilities, or (2) receives flow-through capital treatment. <sup>2</sup>			

<sup>1</sup> Year 2000 problem is defined in CFTC Advisory No. 17-98.

<sup>2</sup> For further guidance, please refer to CFTC rule 1.17(f).



Procedure	Findings		
	No Exception	Exception	N/A
b. Obtained written representation from the entity's chief operating officer (or equivalent) that the organization charts (or similar corporate documents) used in performing this procedure were complete, accurate, and current.			
2. We read the entity's year 2000 project plans, and determined that the plans include each of the elements listed below. In performing this procedure, we did not evaluate the completeness or accuracy of the information contained within each element of the written document nor did we evaluate whether the year 2000 project plans will achieve the objectives set forth therein.			

**Assessment*****Mission-critical systems***

- |   |  |  |  |
|---|--|--|--|
| a. The entity's definition of mission-critical systems (In defining mission-critical, the entity included, as applicable, systems—whether developed and maintained inhouse or by an outside service organization—related to clearing and settlement, customer segregation, minimum financial requirements, financial reporting, and payroll, among other things.) |  |  |  |
| b. Process for identifying and actual identification of systems (including affected software and hardware) that the entity has determined are mission-critical systems  |  |  |  |
| c. Process for identifying and actual identification of mission-critical systems that the entity has determined present a potential year 2000 problem (hereinafter referred to as noncompliant) (See footnote 1 of this report.)  |  |  |  |

Procedure	Findings		
	No Exception	Exception	N/A
<b>Vendors, service providers, and counterparties<sup>3</sup></b>			
d. Process for identifying and actual identification of vendors, service providers, and counterparties (hereinafter collectively referred to as <i>third parties</i> ) that the entity has determined to be significant (as defined by the entity) in the context of the entity's potential year 2000 problems			
e. Process for identifying and actual identification of significant third parties with respect to which the entity has determined either (1) the third party's lack of year 2000 readiness is expected to result in its inability to continue to provide goods and services or perform in the time and manner required, or (2) insufficient information is available to the entity to make an assessment as to the significant third party's year 2000 readiness			
<b>Electronic Interfaces</b>			
f. Process for identifying and actual identification of internal and external electronic interfaces (hereinafter collectively referred to as <i>interfaces</i> ) that the entity has determined to be significant (as defined by the entity) in the context of the entity's potential year 2000 problems			
g. Process for identifying and actual identification of significant interfaces that the entity has determined are noncompliant			
<b>Remediation strategy</b>			
<b>Mission-critical systems</b>			
h. Plans for repairing or replacing each noncompliant mission-critical system (including affected hardware and software)			

<sup>3</sup> For purposes of this report, significant vendors, service providers, and counterparties may include affiliated entities.

Procedure	Findings		
	No Exception	Exception	N/A
i. The date by which each noncompliant mission-critical system is expected to be year 2000 ready and either (1) a determination by the entity that such date is prior to the date that the entity expects the mission-critical system to fail, or (2) plans for resolving situations where mission-critical systems are not expected to be year 2000 ready before failure			
<b>Third Parties</b>			
j. Plans for resolving situations in which either (1) a significant third party's assessed lack of year 2000 readiness is expected to result in its inability to provide goods and services or perform in the time and manner required, or (2) insufficient information is available to the entity to make an assessment as to the significant third party's year 2000 readiness			
<b>Interfaces</b>			
k. Plans for repairing or replacing each significant noncompliant interface (including affected hardware and software)			
l. The date by which each significant noncompliant interface is expected to be year 2000 ready and either (1) a determination by the entity that such date is prior to the date that the entity expects the significant interfaces to fail or (2) plans for addressing situations in which significant interfaces are not expected to be year 2000 ready before failure			
<b>Staffing</b>			
m. Identification of staff resources needed, including the assignment of existing employees and/or hiring of new employees or contractors to implement the year 2000 project plans			

Procedure	Findings		
	No Exception	Exception	N/A
n. Process to evaluate staffing requirements on an ongoing basis throughout the term of the project			
<b>Testing</b>			
o. Plans for testing year 2000 project efforts relating to each mission-critical system and significant interface (including affected hardware and software) as follows:			
(1) Internal testing			
(2) Point-to-point testing			
(3) Futures Industry Association's industry-wide testing			
p. Process for reporting results of testing (including exceptions) identified in item o above to members of management assigned oversight responsibility for the implementation of the year 2000 project plans (See item s below.)			
<b>Contingency plans</b>			
q. Plans for addressing unexpected failures or unsuccessful remediation efforts of mission-critical systems or significant interfaces and unexpected inability of significant third parties to continue to provide goods and services or perform in the time and manner required due to lack of year 2000 readiness			
<b>Timetable</b>			
r. Timetable with milestones for completion of the key elements (assessment, implementation of remediation strategy, staffing, testing, and contingency planning) of the entity's year 2000 project plans			
<b>Management Oversight</b>			
s. Specific identification of the member(s) of management who have been assigned oversight responsibility for the implementation of the year 2000 project plans			

Procedure	Findings		
	No Exception	Exception	N/A
<b>Monitoring</b>			
t. Procedures for reporting the progress of the year 2000 project efforts to members of management assigned oversight responsibility for the implementation of the year 2000 project plans (See item s above.)			
u. Procedures for reporting the progress of the year 2000 project efforts, including the results of testing, to the board of directors <sup>4</sup>			
v. Procedures for evaluating the progress of the year 2000 project efforts, including testing thereof, and making revisions to the year 2000 project plans as necessary			
3. We read [ <i>minutes of meetings of the board of directors, or made inquiries of individuals in attendance at meetings of the board of directors</i> ] and noted that the board of directors of the entity approved the year 2000 project plans.			
4. We read [ <i>minutes of meetings of the board of directors, or made inquiries of individuals in attendance at meetings of the board of directors</i> ] and noted that the board of directors has approved the commitment of financial resources determined by management to be sufficient to accomplish the objectives of the entity's year 2000 project plans. In performing this procedure, we did not evaluate the adequacy of the resources determined by management to be sufficient to accomplish the objectives of the year 2000 project plans.			
5. We obtained from management a list of business units <sup>5</sup> considered by the entity to be significant and performed the following procedures:			

<sup>4</sup> As used in this report, *board of directors* refers to the board of directors, its designee committee for addressing year 2000 matters, or group equivalent to the board of directors or designee committee.

<sup>5</sup> The entity's list of significant business units includes profit centers as well as support units such as treasury, accounting, payroll and human resources, order entry and trade execution, clearance and settlement, and regulatory reporting.

Procedure	Findings		
	No Exception	Exception	N/A
<b>Assessment</b>			
a. We inquired of management of five randomly selected (or 100 percent if less than five) significant business units (see list below), and obtained written representation therefrom, as to whether the identification of mission-critical systems included in the entity's year 2000 project plans included all systems that they considered critical to the continuation of operations in their respective business unit (see item 2b above). An exception would be reported if, as a result of this procedure, management of a significant business unit identified systems that they considered critical to the continuation of operations in their respective business unit that are not included in the entity's year 2000 project plans.			
[List the five business units here.]			
b. We inquired of management of five randomly selected (or 100 percent if less than five) significant business units (see list below), and obtained written representation therefrom, as to whether the identification of significant third parties included in the entity's year 2000 project plans included all third parties that they considered critical to the continuation of operations in their respective business unit (see item 2d above). An exception would be reported if, as a result of this procedure, management of a significant business unit identified significant third parties that they considered critical to the continuation of operations in their respective business unit that are not included in the entity's year 2000 project plans.			
[List the five business units here.]			

Procedure	Findings		
	No Exception	Exception	N/A
<p>c. We inquired of information technology management of five randomly selected (or 100 percent if less than five) significant business units (see list below), and obtained written representation therefrom, as to whether the identification of interfaces included in the entity's year 2000 project plans included all interfaces that they considered critical to the continuation of operations in their respective business unit (see item 2f above). An exception would be reported if, as a result of this procedure, information technology management of a significant business unit identified interfaces that they considered critical to the continuation of operations in their respective business unit that are not included in the entity's year 2000 project plans.</p> <p>[List the five business units here.]</p>			
<b>Staffing</b>			
<p>d. We read [reports to or summaries of meetings attended by] the individual(s) of the management team with oversight responsibility for the execution of the year 2000 project plans indicating that implementation of staffing plans; as set forth in the year 2000 project plans, are being tracked and deviations from the year 2000 project plans are being identified.</p>			
<p>e. We reviewed contracts or other written evidence of engagements with five randomly selected (or 100 percent if less than five) individuals (not employees) or entities that were contracted to implement year 2000 project activities. We compared this information with the corresponding information in the year 2000 project plans and found them to be in agreement.</p>			

Procedure	Findings		
	No Exception	Exception	N/A
<b>Testing</b>			
f. We read [reports to or summaries of meetings attended by] the individual(s) of the management team with oversight responsibility for the execution of the year 2000 project plans indicating that the status of testing of mission-critical systems and significant interfaces is being tracked and any delays in schedule are being identified.			
g. We obtained written representation from the individual(s) of the management team with oversight responsibility for the execution of the year 2000 project plans that the status of testing of mission-critical systems and significant interfaces is being tracked and any delays in schedule are being identified.			
<b>Monitoring</b>			
h. We [read minutes of meetings of the board of directors, or made inquiries of individuals in attendance at meetings of the board of directors] and noted that, as called for in the year 2000 project plans, the board of directors is receiving periodic updates of the status of the implementation progress of the year 2000 plans.			
i. We read [reports to or summaries of meetings attended by] the individual(s) of the management team with oversight responsibility for executing the year 2000 project plans indicating that modifications to the year 2000 project plans that they have determined are necessary, including those found to be necessary as a result of testing or delays in schedule, have been made.			
j. We obtained written representation from the individual(s) of the management team with oversight			



Procedure	Findings		
	No Exception	Exception	N/A
responsibility for executing the year 2000 project plans that modifications to the year 2000 project plans that they have determined are necessary, including those found to be necessary as a result of testing or delays in schedule, have been made.			

*[Include description of any exceptions.]*

We were not engaged to, and did not, perform an examination, the objective of which would be the expression of an opinion on the entity's assertion referred to in the introductory paragraph of this report. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you. Our procedures also do not provide assurance that the entity is or will be year 2000 ready, that its year 2000 project plans will be successful in whole or in part, or that parties with which the entity does business will be year 2000 ready.

This report is intended solely for the information and use of the Board of Directors and Management of ABC Futures Commission Merchant, the Commodity Futures Trading Commission, and ABC Futures Commission Merchant's designated self-regulatory organization and is not intended to be and should not be used by anyone other than these specified parties.

*[Signed]*

*[City]*

*[Date]*

## Appendix D

### Illustrative Combined Agreed-Upon Procedures Report Pursuant to CFTC Advisories No. 17-98 and No. 42-98 and SEC Rule 17a-5

#### Independent Accountant's Report on Applying Agreed-Upon Procedures

To the Board of Directors of ABC Futures Commission  
Merchant/Broker-Dealer:

We have performed the procedures enumerated below as specified in the American Institute of Certified Public Accountants' (AICPA's) Statement of Position 98-8 [section 11,340], which were agreed to by ABC Futures Commission Merchant/Broker-Dealer (hereinafter referred to as the *entity*) to assist the users in evaluating the entity's assertions made pursuant to the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission's (SEC's) regulatory requirements and in the following manner:

1. For the CFTC—the assertion as of *[date]* about the absence of a material inadequacy within the meaning of CFTC Regulation 1.16 relating to a year 2000 problem, included in its representation letter dated *[insert date]*.
2. For the SEC—the assertions in Parts I and II of Form BD-Y2K (Form BD-Y2K) as of March 15, 1999, prepared and filed pursuant to the requirements of SEC rule 17a-5.<sup>1</sup>

Pursuant to CFTC Advisory No. 42-98 and SEC Release No. 34-40608, these agreed-upon procedures will satisfy the CFTC and SEC's regulatory requirements. This report is issued solely for these regulatory purposes.

This agreed-upon procedures engagement was performed in accordance with standards established by the AICPA. The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

Procedure	Findings		
	No Exception	Exception	N/A
1. We read the entity's written plans for preparing and testing the entity's computer systems for potential year 2000 problems <sup>2</sup> (year 2000 project plans) and—			
a. Determined, by comparison to organization charts (or similar corporate documents) and the entity's			

<sup>1</sup> 17 C.F.R. 240.17a-5 (rule 17a-5).

<sup>2</sup> See CFTC Advisory No. 17-98 and SEC rule 17a-5(e)(5)(i) and for the CFTC's and SEC's definitions of year 2000 problem.

Procedure	Findings		
	No Exception	Exception	N/A
most recent net capital calculation, that the year 2000 project plans include all divisions and branches of the registered entity and any subsidiary or affiliate as to which the registered entity (1) guarantees, endorses, or assumes directly or indirectly the obligations or liabilities, or (2) receives flow-through capital treatment. <sup>3</sup>			
b. Obtained written representation from the entity's chief operating officer (or equivalent) that the organization charts (or similar corporate documents) used in performing this procedure were complete, accurate, and current.			
c. Obtained written representation from the entity's chief operating officer (or equivalent) that the net capital calculation includes any subsidiary or affiliate as to which the registered entity (1) guarantees, endorses, or assumes directly or indirectly the obligations or liabilities, or (2) receives flow-through capital treatment.			
d. Compared the organizational information in the year 2000 project plans (see item 1a) with the corresponding information in Form BD-Y2K and found them to be in agreement.			
2. We read the entity's year 2000 project plans, and determined that the plans include each of the elements listed below. In performing this procedure, we did not evaluate the completeness or accuracy of the information contained within each element of the written document nor did we evaluate whether the year 2000 project plans will achieve the objectives set forth therein.			

<sup>3</sup> For further guidance, please refer to CFTC rule 1.17(f) and appendix C [paragraph .41] to SEC rule 15c3-1.

Procedure	Findings		
	No Exception	Exception	N/A
<b>Assessment</b>			
<b>Mission-critical systems</b>			
a. The entity's definition of mission-critical systems (In defining <i>mission-critical</i> , the entity included, as applicable, systems—whether developed and maintained in-house or by an outside service organization—related to clearing and settlement, customer segregation, net capital, minimum financial requirements, financial reporting, and payroll, among other things.)			
b. Process for identifying and actual identification of systems (including affected software and hardware) that the entity has determined are mission-critical systems			
c. Process for identifying and actual identification of mission-critical systems that the entity has determined present a potential year 2000 problem (hereinafter referred to as noncompliant) (See footnote 1 of this report.)			
<b>Vendors, service providers, and counterparties<sup>4</sup></b>			
d. Process for identifying and actual identification of vendors, service providers, and counterparties (hereinafter collectively referred to as <i>third parties</i> ) that the entity has determined to be significant (as defined by the entity) in the context of the entity's potential year 2000 problems			
e. Process for identifying and actual identification of significant third parties with respect to which the entity has determined either (1) the third party's lack of year 2000 readiness is expected to result in its inability to continue to provide goods and ser-			

<sup>4</sup> For purposes of this report, vendors, service providers, and counterparties may include affiliated entities.

Procedure	Findings		
	No Exception	Exception	N/A
<p>vices or perform in the time and manner required, or (2) insufficient information is available to the entity to make an assessment as to the significant third party's year 2000 readiness</p>			
<b>Electronic Interfaces</b>			
<p>f. Process for identifying and actual identification of internal and external electronic interfaces (hereinafter collectively referred to as <i>interfaces</i>) that the entity has determined to be significant (as defined by the entity) in the context of the entity's potential year 2000 problems</p>			
<p>g. Process for identifying and actual identification of significant interfaces that the entity has determined are noncompliant</p>			
<b>Remediation strategy</b>			
<b>Mission-critical systems</b>			
<p>h. Plans for repairing or replacing each noncompliant mission-critical system (including affected hardware and software).</p>			
<p>i. The date by which each noncompliant mission-critical system is expected to be year 2000 ready and either (1) a determination by the entity that such date is prior to the date that the entity expects the mission-critical system to fail, or (2) plans for resolving situations where mission-critical systems are not expected to be year 2000 ready before failure</p>			
<b>Third Parties</b>			
<p>j. Plans for resolving situations in which either (1) a significant third party's assessed lack of year 2000 readiness is expected to result in its inability to provide goods and services or perform in the time and manner required, or (2) insufficient information is available to the entity to make an assessment as to the significant third party's year 2000 readiness</p>			

Procedure	Findings		
	No Exception	Exception	N/A
<b>Interfaces</b>			
k. Plans for repairing or replacing each significant noncompliant interface (including affected hardware and software)			
l. The date by which each significant noncompliant interface is expected to be year 2000 ready and either (1) a determination by the entity that such date is prior to the date that the entity expects the significant interfaces to fail or (2) plans for addressing situations in which significant interfaces are not expected to be year 2000 ready before failure			
<b>Staffing</b>			
m. Identification of staff resources needed, including the assignment of existing employees and/or hiring of new employees or contractors to implement the year 2000 project plans			
n. Process to evaluate staffing requirements on an ongoing basis throughout the term of the project			
<b>Testing</b>			
o. Plans for testing year 2000 project efforts relating to each mission-critical system and significant interface (including affected hardware and software) as follows:			
(1) Internal testing			
(2) Point-to-point testing			
(3) Industry-wide testing by Futures Industry Association			
(4) Industry-wide testing in Securities Industry Association Tier 1			
p. Process for reporting results of testing (including exceptions) identified in item o above to members of management assigned oversight responsibility for the implementation of the year 2000 project plans (See item s below.)			

Procedure	Findings		
	No Exception	Exception	N/A
<b>Contingency Plans</b>			
q. Plans for addressing unexpected failures or unsuccessful remediation efforts of mission-critical systems or significant interfaces and unexpected inability of significant third parties to continue to provide goods and services or perform in the time and manner required due to lack of year 2000 readiness			
<b>Timetable</b>			
r. Timetable with milestones for completion of the key elements (assessment, implementation of remediation strategy, staffing, testing, and contingency planing) of the entity's year 2000 project plans			
<b>Management Oversight</b>			
s. Specific identification of the member(s) of management who have been assigned oversight responsibility for the implementation of the year 2000 project plans			
<b>Monitoring</b>			
t. Procedures for reporting the progress of the year 2000 project efforts to members of management assigned oversight responsibility for the implementation of the year 2000 project plans (See item s above.)			
u. Procedures for reporting the progress of the year 2000 project efforts, including the results of testing, to the board of directors <sup>5</sup>			
v. Procedures for evaluating the progress of the year 2000 project efforts, including testing thereof, and making revisions to the year 2000 project plans as necessary			
3. We compared the information described in items 2a to 2v with the corresponding information in Form BD-Y2K and found it to be in agreement.			

<sup>5</sup> As used in this report, *board of directors* refers to the board of directors, its designee committee for addressing year 2000 matters, or group equivalent to the board of directors or designee committee.

Procedure	Findings		
	No Exception	Exception	N/A
4. We [read minutes of meetings of the board of directors, or made inquiries of individuals in attendance at meetings of the board of directors] and noted that the board of directors of the entity approved the year 2000 project plans. We compared this information with the corresponding information in Form BD-Y2K and found it to be in agreement.			
5. We [read minutes of meetings of the board of directors, or made inquiries of individuals in attendance at meetings of the board of directors] and noted that the board of directors has approved the commitment of financial resources determined by management to be sufficient to accomplish the objectives of the entity's year 2000 project plans. We compared this information with the corresponding information in Form BD-Y2K and found it to be in agreement. In performing this procedure, we did not evaluate the adequacy of the resources determined by management to be sufficient to accomplish the objectives of the year 2000 project plans.			
6. We obtained from management a list of business units <sup>6</sup> considered by the entity to be significant, and performed the following procedures:			
<b>Assessment</b>			
a. We inquired of management of five randomly selected (or 100 percent if less than five) significant business units (see list below), and obtained written representation therefrom, as to whether the identification of mission-critical systems included in the entity's year 2000 project plans included all systems that they considered critical to the			

6 The entity's list of significant business units includes profit centers as well as support units such as treasury, accounting, payroll and human resources, order entry and trade execution, clearance and settlement, and regulatory reporting.



Procedure	Findings		
	No Exception	Exception	N/A
<p>continuation of operations in their respective business unit (see item 2b above). An exception would be reported if, as a result of this procedure, management of a significant business unit identified systems that they considered critical to the continuation of operations in their respective business unit that are not included in the entity's year 2000 project plans.</p> <p><i>[List the five business units here.]</i></p>			
<p>b. We inquired of management of five randomly selected (or 100 percent if less than five) significant business units (see list below), and obtained written representation therefrom, as to whether the identification of significant third parties included in the entity's year 2000 project plans included all third parties that they considered critical to the continuation of operations in their respective business unit (see item 2d above). An exception would be reported if, as a result of this procedure, management of a significant business unit identified significant third parties that they considered critical to the continuation of operations in their respective business unit that are not included in the entity's year 2000 project plans.</p> <p><i>[List the five business units here.]</i></p>			
<p>c. We inquired of information technology management of five randomly selected (or 100 percent if less than five) significant business units (see list below), and obtained written representation therefrom, as to whether the identification of interfaces included in the entity's year 2000 project plans included all interfaces that they considered criti-</p>			

Procedure	Findings		
	No Exception	Exception	N/A
cal to the continuation of operations in their respective business unit (see item 2f above). An exception would be reported if, as a result of this procedure, information technology management of a significant business unit identified interfaces that they considered critical to the continuation of operations in their respective business unit that are not included in the entity's year 2000 project plans.			

[List the five business units here.]

### Staffing

- d. We read [reports to or summaries of meetings attended by] the individual(s) of the management team with oversight responsibility for the execution of the year 2000 project plans indicating that implementation of staffing plans, as set forth in the year 2000 project plans, are being tracked and deviations from the year 2000 project plans are being identified.

- e. We read contracts or other written evidence of engagements with five randomly selected (or 100 percent if less than five) individuals (not employees) or entities that were contracted to implement year 2000 project activities. We compared this information with the corresponding information in the year 2000 project plans and found them to be in agreement.

### Testing

- f. We read [reports to or summaries of meetings attended by] the individual(s) of the management team with oversight responsibility for the execution of the year

Procedure	Findings		
	No Exception	Exception	N/A
2000 project plans indicating that the status of testing of mission-critical systems and significant interfaces is being tracked and any delays in schedule are being identified.	_____	_____	_____
<i>g.</i> We obtained written representation from the individual(s) of the management team with oversight responsibility for the execution of the year 2000 project plans that the status of testing of mission-critical systems and significant interfaces is being tracked and any delays in schedule are being identified.	_____	_____	_____

**Monitoring**

- h.* We [read minutes of meetings of the board of directors, or made inquiries of individuals in attendance at meetings of the board of directors] and noted that, as called for in the year 2000 project plans, the board of directors is receiving periodic updates of the status of the implementation progress of the year 2000 project plans.
- i.* We read [reports to or summaries of meetings attended by] the individual(s) of the management team with oversight responsibility for executing the year 2000 project plans indicating that modifications to the year 2000 project plans that they have determined are necessary, including those found to be necessary as a result of testing or delays in schedule, have been made.
- j.* We obtained written representation from the individual(s) of the management team with oversight responsibility for executing the year 2000 project plans that modifications to the year 2000 pro-

_____	_____	_____
_____	_____	_____

Procedure	Findings		
	No Exception	Exception	N/A
ject plans that they have determined are necessary, including those found to be necessary as a result of testing or delays in schedule, have been made.			
7. We compared the information described in items 6a to 6j with the corresponding information in Form BD-Y2K and found it to be in agreement.			

[Include description of any exceptions.]

We were not engaged to, and did not, perform an examination, the objective of which would be the expression of an opinion on the entity's assertions referred to in the introductory paragraph of this report. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you. Our procedures also do not provide assurance that the entity is or will be year 2000 ready, that its year 2000 project plans will be successful in whole or in part, or that parties with which the entity does business will be year 2000 ready.

This report is intended solely for the information and use of the Board of Directors and Management of ABC Futures Commission Merchant/Broker-Dealer, the Commodity Futures Trading Commission, the Securities and Exchange Commission, and ABC Futures Commission Merchant/Broker-Dealer's designated self-regulatory organizations and is not intended to be and should not be used by anyone other than these specified parties.

[Signed]

[City]

[Date]

## Appendix E

### Report on Internal Control Required by CFTC Regulation 1.16, Modified to Limit the Scope of the Report for the Year 2000 Issue

The following is an illustration of the independent auditor's report on internal control required by Commodity Futures Trading Commission (CFTC) Regulation 1.16, modified to limit the scope of the report for the Year 2000 Issue.

Board of Directors  
ABC Commodities Corporation:

In planning and performing our audit of the consolidated financial statements of ABC Commodities Corporation (the Corporation) for the year ended December 31, 19X1, we considered its internal control, including control activities for safeguarding customer and firm assets, in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on internal control.

Also, as required by Regulation 1.16 of the Commodity Futures Trading Commission (CFTC), we have made a study of the practices and procedures followed by the Corporation including tests of such practices and procedures that we considered relevant to the objectives stated in Regulation 1.16 in making the following:

1. The periodic computations of minimum financial requirements pursuant to Regulation 1.17
2. The daily computations of the segregation requirements of section 4d(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based on such computations
3. The daily computations of the foreign futures and foreign options secured amount requirements pursuant to Regulation 30.7 of the CFTC

The management of the Corporation is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the CFTC's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Corporation has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in accordance with generally accepted accounting principles. Regu-

lation 1.16 lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control or the practices and procedures referred to above, errors or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

Our consideration of internal control would not necessarily disclose all matters in internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the specific internal control components does not reduce to a relatively low level the risk that error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving internal control, including controls for safeguarding customer and firm assets, that we consider to be material weaknesses as defined above.<sup>1</sup>

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the CFTC to be adequate for its purposes in accordance with the Commodity Exchange Act and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, except as discussed below, we believe that the Corporation's practices and procedures were adequate at December 31, 19X1, to meet the CFTC's objectives.<sup>2</sup>

CFTC Advisory No. 17-98, *Year 2000 Problem—Reporting and Disclosure Requirements*, as amended by CFTC Advisory No. 42-98, *Year 2000 Reporting Requirements For Certified Public Accountants*, states that a "year 2000 problem," as defined therein, is a material inadequacy within the meaning of Regulation 1.16. Our procedures with respect to year 2000 problems will be limited to those specified in the American Institute of Certified Public Accountants' Statement of Position 98-8 [section 11,340]. A separate report will be issued on those procedures. CFTC Advisory No. 42-98 states that those procedures will satisfy the CFTC's regulatory requirements. Accordingly, our study will not provide assurance that year 2000 problems deemed by the CFTC to constitute a material inadequacy would be detected,

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<sup>1</sup> If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fifth paragraph of the report should be modified as follows:

However, we noted the following matters involving the [control environment, accounting system, control activities, or control activities for safeguarding customer and firm assets] and its [their] operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the consolidated financial statements of the Corporation for the year ended December 31, 19X1, and this report does not affect our report thereon dated February 15, 19X2. [A description of the material weaknesses that have come to the auditor's attention and corrective action.]

<sup>2</sup> Whenever inadequacies are described, the report should modify the last sentence of the fifth paragraph as indicated in footnote above. The report should also describe material inadequacies the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the CFTC.

that the Corporation is or will be year 2000 ready, that the Corporation's year 2000 project plans will be successful in whole or in part, or that parties with which the Corporation does business will be year 2000 ready.<sup>3</sup>

This report is intended solely for the information and use of the Board of Directors, management, the CFTC, and other regulatory agencies that rely on Regulation 1.16 of the CFTC, and should not be used for any other purpose.

Accounting Firm

New York, New York

February 15, 19X2

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<sup>3</sup> As discussed in CFTC Advisory No. 42-98, CFTC registrants meeting specified criteria are exempt from the requirement to file the accountant's agreed-upon procedures report that is the subject of this SOP. It is important to note that the exemption for any registrant may be revoked at the discretion of either the CFTC or the registrant's designated self-regulatory organization. The criteria specified in CFTC Advisory No. 42-98 (all of which must be met) are as follows.

- a. The entity is not a clearing member of an exchange.
- b. The entity carries no funds, accounts or positions for customers.
- c. The entity has no mission-critical systems that interface with other registrants or major market participants
- d. The entity's designated self-regulatory organization has not provided notice to it that its exemption has been revoked. Also, the CFTC's Division of Trading and Markets has not notified the entity that it will be required to file the agreed-upon procedures report that is the subject of this SOP.

Therefore, in reports on internal control relating to these exempt registrants, this paragraph would be replaced with the following paragraph.

CFTC Advisory No. 17-98, *Year 2000 Problem—Reporting and Disclosure Requirements*, as amended by CFTC Advisory No. 42-98, *Year 2000 Reporting Requirements For Certified Public Accountants*, states that a "year 2000 problem," as defined therein, is a material inadequacy within the meaning of Regulation 1.16. Pursuant to the exemption described in CFTC Advisory No. 42-98, we performed no procedures with respect to year 2000 problems. Accordingly, our study will not provide assurance that year 2000 problems deemed by the CFTC to constitute a material inadequacy would be detected, that the Corporation is or will be year 2000 ready, that the Corporation's year 2000 project plans will be successful in whole or in part, or that parties with which the Corporation does business will be year 2000 ready.

**Securities Industry Year 2000  
Agreed-Upon Procedures Task Force**

***For the Auditing Standards Board***

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JAMES S. GERSON, *Vice Chair*  
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**Section 11,350*****Statement of Position 99-1  
Guidance to Practitioners in Conducting and  
Reporting on an Agreed-Upon Procedures  
Engagement to Assist Management in  
Evaluating the Effectiveness of Its Corporate  
Compliance Program*****May 21, 1999****NOTE**

This Statement of Position presents the recommendations of the AICPA Health Care Pilot Task Force regarding the application of Statements on Standards for Attestation Engagements to agreed-upon procedures attestation engagements performed to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a Corporate Integrity Agreement entered into with the Office of Inspector General of the U.S. Department of Health and Human Services. The Auditing Standards Board has found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

**Summary**

This Statement of Position (SOP) provides guidance to practitioners in conducting and reporting on an agreed-upon procedures engagement performed pursuant to the AICPA Statements on Standards for Attestation Engagements to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a Corporate Integrity Agreement (CIA) entered into with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services. CIAs are specific to the entity involved; consequently, users of this SOP should be familiar with the specific requirements of the entity's CIA.

**Introduction and Background**

.01 Within the past several years, the health care industry has experienced a significant increase in the number and magnitude of allegations of fraud and abuse involving federal health care programs (for example, Medicare and Medicaid) and private health care insurance. These allegations have triggered regulatory scrutiny, litigation, significant monetary settlements, and

negative publicity related to—among other things—coding and billing practices, patient referrals, cost reporting, quality of care, and clinical practices. Typically, as part of the global resolution of these allegations, the entity enters into a Corporate Integrity Agreement (CIA) with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services. Such agreements require that management annually report on its compliance with the terms of the CIA and that there be an assessment of the entity's compliance with the CIA. This assessment includes a billing analysis, which may be performed by an independent review organization (such as a practitioner or consultant) or the provider (if permitted by the OIG), and an agreed-upon procedures engagement.

.02 This SOP provides guidance to practitioners in conducting and reporting on an agreed-upon procedures engagement performed pursuant to the American Institute of Certified Public Accountants (AICPA) Statements on Standards for Attestation Engagements (SSAEs) to assist an entity in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a CIA.<sup>1</sup> The terms of a CIA are unique to the entity; consequently, users of this SOP need to be familiar with the actual CIA and its requirements.

.03 This SOP applies to agreed-upon procedures engagements to assist in evaluating an entity's compliance for a specified period. Such engagements should follow the AICPA attestation standards, including SSAE No. 1, *Attestation Standards* (AICPA, *Professional Standards*, vol. 1, AT sec. 100); SSAE No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500); and SSAE No. 4, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 600). The engagement should be conducted in accordance with standards established by the AICPA, including the criteria set forth in this SOP. However, this SOP is not intended to provide all the required criteria set forth in individual CIAs, nor all the applicable standards established by the AICPA. Additionally, the SOP contains some guidance that may be applied in evaluating an organization's corporate compliance program, even though the program was not imposed by a CIA.

## Overview of a Typical Corporate Integrity Agreement

.04 A CIA is an agreement between a health care provider and the OIG in conjunction with a global settlement of a fraud investigation. Such an agreement typically seeks to establish a compliance program within the health care provider (for example, hospital, clinical lab, physician group) that will promote compliance with the requirements of Medicare, Medicaid, and all other federal health care programs.

.05 CIAs are case-specific. Their terms are tailored to address the organizational and operating deficiencies related to providing and billing for health care services that have been identified by the OIG, the entity, or others. Detailed

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<sup>1</sup> The practitioner also might be engaged to assist in other areas beyond an agreed-upon procedures engagement such as providing consulting services in connection with evaluating the company's billing practices, policies, and procedures as required by the CIA or in implementing, assessing, and reporting on voluntarily adopted compliance programs. In addition, the practitioner may assist in preparing an entity's self-disclosure reports to federal health agencies related to billing errors and other compliance matters. Similarly, practitioners may be involved in an entity's preparation of government-required (but not CIA-imposed) compliance reporting (for example, contract requirements for Medicare part C) beyond an agreed-upon procedures engagement.

compliance requirements are imposed as a condition for continued participation in federal health care programs. A sample CIA, provided by the OIG and intended to identify potential requirements, is included in appendix A [paragraph .32], "Sample Corporate Integrity Agreement." Typical agreements cover five years and require the entity to address the following areas:

- Appointment of a compliance officer and establishment of a compliance committee
- Establishment of a code of conduct
- Establishment of policies and procedures regarding the compliance program
- Development of an information and education program as to CIA requirements, compliance program and code of conduct
- Annual assessment of billing policies, procedures, and practices
- Establishment of a confidential disclosure program
- Prohibition of employment of excluded or convicted persons
- Notification to OIG of investigation or legal proceedings
- Reporting of credible evidence of misconduct
- Notifications to OIG of new provider locations
- Provision of implementation and annual reports
- Proper notification and submission of required reports
- Granting of OIG access to documents and individuals to conduct assessments
- Documentation of record retention requirements
- Awareness of disclosure criteria
- Agreement to comply with certain default provisions, penalties, and remedies
- Review of rights as to dispute resolution
- Review of effective and binding agreement clauses

## Conditions for Engagement Performance

.06 A practitioner may perform an agreed-upon procedures engagement related to management's compliance with a CIA if all of the conditions specified in SSAE No. 4 (AT sec. 600.10) and SSAE No. 3 (AT sec. 500.09-.11) are met.

.07 As discussed more fully in the SSAEs noted in paragraph .06, management's assertions as to its compliance must be capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in or attached to the practitioner's report in a sufficiently clear and comprehensive manner. Generally, to avoid confusion, management's assertions, which are based on the specific terms of its CIA, should be attached to the practitioner's report. If the entity is not subject to a CIA, management may develop its assertions using the model CIA. A sample based on the model CIA, which is not meant to be all-inclusive, is included as appendix B [paragraph .33], "Sample Statement of Management's Assertions."

## Establishing an Understanding With the Client

.08 The practitioner should document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter. Appendix C [paragraph .34], "Sample Engagement Letter," contains a sample engagement letter that may be used for this kind of engagement.

## Users' Responsibilities

.09 Users typically would be the management of the health care provider and the OIG. Management is responsible for ensuring that the entity complies with the requirements of the CIA. That responsibility encompasses (a) identifying applicable compliance requirements, (b) establishing and maintaining internal control policies and procedures to provide reasonable assurance that the entity complies with those requirements, (c) evaluating and monitoring the entity's compliance, and (d) preparing reports that satisfy legal, regulatory, or contractual requirements. Management's evaluation may include documentation such as accounting or statistical data, policy manuals, accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, internal auditors' reports, and other special studies or analyses. The form and extent of documentation will vary depending on the nature of the compliance requirements and the size and complexity of the entity. Management may engage the practitioner to gather information to assist it in evaluating the entity's compliance. Regardless of the procedures performed by the practitioner, management must accept responsibility for its assertions and must not base such assertions solely on the practitioner's procedures.

.10 Specified users are responsible for the sufficiency (nature, timing, and extent) of the agreed-upon procedures because they best understand their own needs. The specified users assume the risk that such procedures might be insufficient for their purposes. In addition, the specified users assume the risk that they might misunderstand or otherwise inappropriately use findings properly reported by the practitioner.

## Practitioner's Responsibilities

.11 The objective of the practitioner's agreed-upon procedures is to present specific findings to assist users in evaluating an entity's compliance with the requirements specified in the CIA. (See appendix D [paragraph .35], "Sample Procedures.")

.12 The practitioner's procedures generally may be as limited or extensive as the specified users desire, as long as the specified users agree upon the procedures performed or to be performed and take responsibility for the sufficiency of the agreed-upon procedures for their purposes.

.13 To satisfy the requirements that the practitioner and the specified users agree upon the procedures performed or to be performed and that the specified users take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified users. For the purposes of these engagements, an effective way to obtain this agreement ordinarily is to distribute a draft of the report, detailing the procedures, that is expected to be issued to the OIG with a request for any comments it may have.

.14 To avoid possible misunderstandings, the practitioner should circulate the draft with a legend stating that these are the procedures expected to be performed, and unless informed otherwise, the practitioner assumes that there are no additional procedures that he or she is expected to perform. A legend such as the following might be used.

This draft is furnished solely for the purpose of indicating the form of report that we would expect to be able to furnish pursuant to the request by Management of [Provider] for our performance of limited procedures relating to [Provider's] compliance with the Corporate Integrity Agreement with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services. Based on our discussions with [Provider], it is our understanding that the procedures outlined in this draft report are those we are expected to follow. Unless informed otherwise within ninety (90) days of this transmittal, we shall assume that there are no additional procedures that we are expected to follow. The text of the definitive report will depend, of course, on the results of the procedures.

## Involvement of a Specialist<sup>2</sup>

.15 The practitioner's education and experience enable him or her to be knowledgeable about business matters in general, but he or she is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. In certain circumstances, it may be appropriate to involve a specialist to assist the practitioner in the performance of one or more procedures. The following are examples:

- An attorney might provide assistance concerning the application of laws, regulations, or rules to a client's situation.
- A medical specialist might provide assistance in understanding the characteristics of diagnosis codes documented in patient medical records.

.16 The practitioner and the specified users should agree to the involvement of a specialist in assisting a practitioner in the performance of an agreed-upon procedures engagement. This agreement may be reached when obtaining agreement on the procedures performed or to be performed and acknowledgment of responsibility for the sufficiency of the procedures, as discussed previously. The practitioner's report should describe the nature of the assistance provided by the specialist.

.17 A practitioner may agree to apply procedures to the report or work product of a specialist that does not constitute assistance by the specialist to the practitioner in an agreed-upon procedures engagement. For example, the practitioner may make reference to information contained in a report of a specialist in describing an agreed-upon procedure. However, it is inappropriate for the practitioner to agree to merely read the specialist's report solely to describe or repeat the findings, or to take responsibility for all or a portion of any procedures performed by a specialist or the specialist's work product.

## Internal Auditors and Other Personnel<sup>3</sup>

.18 The agreed-upon procedures to be enumerated or referred to in the practitioner's report are to be performed entirely by the practitioner except as

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<sup>2</sup> A *specialist* is a person (or firm) possessing special skill or knowledge in a particular field other than the attest function. As used herein, a specialist does not include a person employed by the practitioner's firm who participates in the attestation engagement.

<sup>3</sup> SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), does not apply to agreed-upon procedures engagements.

discussed in paragraphs .16–.18 of this SOP. However, internal auditors or other personnel may prepare schedules, accumulate data, perform an internal assessment of management's compliance, or provide other information for the practitioner's use in performing the agreed-upon procedures.

.19 A practitioner may agree to perform procedures on information documented in the working papers of internal auditors. For example, the practitioner may agree to—

- Repeat all or some of the procedures.
- Determine whether the internal auditors' working papers contain documentation of procedures performed and whether the findings documented in the working papers are presented in a report by the internal auditors.

.20 However, it is inappropriate for the practitioner to—

- Agree to merely read the internal auditor's report solely to describe or repeat its findings.
- Take responsibility for all or a portion of any procedures performed by internal auditors by reporting those findings as the practitioner's own.
- Report in any manner that implies shared responsibility for the procedures with the internal auditors.

## Planning the Engagement

.21 Planning an agreed-upon procedures engagement involves working with the users to develop an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners should have adequate technical training and proficiency in the attestation standards and have adequate knowledge in health care regulatory matters to enable them to sufficiently understand the events, transactions, and practices that, in their judgment, have a significant effect on the presentation of the assertions.

## Working Papers

.22 The practitioner should prepare and maintain working papers in connection with an engagement under the attestation standards; such working papers should be appropriate to the circumstances and the practitioner's needs on the engagement to which they apply.

.23 Concern over access to the practitioner's working papers might cause some clients to inquire about working paper requirements. In situations where the practitioner is requested to not maintain copies of certain client documentation, or to not prepare and maintain documentation similar to client documents, the practitioner may refer to the Auditing Interpretation, "The Auditor's Consideration of the Completeness Assertion" (AICPA, *Professional Standards*, vol. 1, AU sec. 9326.06–.17), for guidance. See the Attest Interpretation, "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards*, vol. 1, AT sec. 9100.58), for guidance related to providing access to or photocopies of working papers to a regulator in connection with work performed on an attestation engagement.

## Management's Representations

.24 The practitioner should obtain written representation from management on various matters including the following:

- a. Acknowledging management's responsibility for complying with the CIA
- b. Acknowledging management's responsibility for establishing and maintaining effective internal control over compliance
- c. Stating that management has performed an evaluation of the entity's compliance with CIA-specified requirements
- d. Stating management's assertions about the entity's compliance with all aspects of the CIA, including the specific issues that gave rise to the CIA<sup>4</sup>
- e. Stating that management has disclosed to the practitioner all known noncompliance with the CIA
- f. Stating that management has made available all documentation relating to compliance with the CIA
- g. Stating management's interpretation of any compliance requirements that have varying interpretations
- h. Stating that management has disclosed any communication from regulatory agencies, internal auditors, legal counsel, and other parties concerning matters regarding the design, implementation, and monitoring of the policies and procedures in place, including communication received between the end of the reporting period and the date of the practitioner's report (the date of signature)
- i. Stating that management has disclosed any known noncompliance occurring subsequent to the end of the reporting period
- j. Describing any related material fraud or abuse, other fraud, abuse or illegal acts that, whether or not material, involve management or other employees who have a significant role in the entity's design, implementation, and monitoring of the policies and procedures in place upon which compliance is based
- k. Stating that management has disclosed to the practitioners, orally or in writing, information about past noncompliance issues covered in the settlement agreement that gave rise to the CIA and the related corrective measures taken to support compliance in those areas

Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the engagement sufficient to require withdrawal from the engagement.

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<sup>4</sup> Depending on the circumstances, representations in the following areas might be appropriate.

- Violations or possible violations of laws or regulations, such as those related to the Medicare and Medicaid antifraud and abuse statutes
- Compliance of third-party billings with applicable coding guidelines (for example, ICD-9-CM, CPT) and laws and regulations (including medical necessity, proper approvals, and proper rendering of care)
- Proper filing of all required Medicare, Medicaid, and similar reports under the applicable reimbursement rules and regulations (including nature of costs—allowable, patient-related, properly allocated, in accordance with applicable rules and regulations, properly adjusted to reflect prior audit adjustments) and adequacy of disclosures (including disputed costs)

## Reporting Considerations

**.25** A practitioner should present the results of applying agreed-upon procedures to the specific subject matter in the form of findings. The practitioner should not provide negative assurance about whether the assertion is fairly stated in accordance with established or stated criteria. For example, the practitioner should not include a statement that “nothing came to my attention that caused me to believe that the assertion is not fairly stated in accordance with (established or stated) criteria.”

**.26** The practitioner should report all findings from the application of the agreed-upon procedures. The concept of materiality does not apply to findings to be reported in an agreed-upon procedures engagement unless the definition of materiality is agreed to by the specified users. Any agreed-upon materiality limits should be described in the practitioner's report.

**.27** The practitioner has no obligation to perform procedures beyond the agreed-upon procedures. However, if noncompliance related to management's assertion comes to the practitioner's attention by other means, such information ordinarily should be included in his or her report.

**.28** The practitioner may become aware of noncompliance related to management's assertion that occurs subsequent to the reporting period but before the date of the practitioner's report. The practitioner should consider including information regarding such noncompliance in his or her report. However, the practitioner has no responsibility to perform procedures to detect such noncompliance other than obtaining management's representation about noncompliance in the subsequent period.

**.29** The practitioner should follow the reporting guidance in SSAE No. 4 (AT sec. 600.33–.38). A sample report is included in appendix E [paragraph 36], “Sample Report.”

**.30** Evaluating compliance with certain requirements may require interpretation of the laws, regulations, rules, contracts, or other agreements that establish those requirements. In such situations, the practitioner should consider whether he or she is provided with the reasonable criteria required to evaluate an assertion under the third general attestation standard. If these interpretations are significant, the practitioner may include a paragraph stating the description and the source of interpretations made by the entity's management. An example of such a paragraph, which should precede the procedures and findings paragraph(s), follows:

*We have been informed that, under [name of entity's] interpretation of [identify the compliance requirement], [explain the nature and source of the relevant interpretation].*

**.31** The date of completion of the agreed-upon procedures should be used as the date of the practitioner's report.



## Appendix A

### Sample Corporate Integrity Agreement Between the Office of Inspector General of the Department of Health and Human Services and [Provider]

#### I. Preamble

[Provider] (“[Provider]”) hereby enters into this Corporate Integrity Agreement (“CIA”) with the Office of Inspector General (“OIG”) of the United States Department of Health and Human Services (“HHS”) to ensure compliance by its employees with the requirements of Medicare, Medicaid and all other Federal health care programs (as defined in 42 U.S.C. 1320a-7b(f)) (hereinafter collectively referred to as the “Federal health care programs”). [Provider’s] compliance with the terms and conditions in this CIA shall constitute an element of [Provider’s] present responsibility with regard to participation in the Federal health care programs. Contemporaneously with this CIA, [Provider] is entering into a Settlement Agreement with the United States, and this CIA is incorporated by reference into the Settlement Agreement.

#### II. Term of the CIA

The period of the compliance obligations assumed by [Provider] under this CIA shall be 5 years from the effective date of this CIA (unless otherwise specified). The effective date of this CIA will be the date on which the final signatory of this CIA executes this CIA (the “effective date”).\*

#### III. Corporate Integrity Obligations

[Provider] shall establish a compliance program that includes the following elements:

##### A. Compliance Officer

Within ninety (90) days after the effective date of this CIA, [Provider] shall appoint an individual to serve as Compliance Officer, who shall be responsible for developing and implementing policies, procedures, and practices designed to ensure compliance with the requirements set forth in this CIA and with the requirements of the Federal health care programs. The Compliance Officer shall be a member of senior management of [Provider], shall make regular (at least quarterly) reports regarding compliance matters directly to the CEO and/or to the Board of Directors of [Provider] and shall be authorized to report to the Board of Directors at any time. The Compliance Officer shall be responsible for monitoring the day-to-day activities engaged in by [Provider] to further its compliance objectives as well as any reporting obligations created under this CIA. In the event a new Compliance Officer is appointed during the term of this CIA, [Provider] shall notify the OIG, in writing, within fifteen (15) days of such a change.

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\* Source: Office of the Inspector General of the United States Department of Health and Human Services.

[Provider] shall also appoint a Compliance Committee within ninety (90) days after the effective date of this CIA. The Compliance Committee shall, at a minimum, include the Compliance Officer and any other appropriate officers as necessary to meet the requirements of this CIA within the provider's corporate structure (e.g., senior executives of each major department, such as billing, clinical, human resources, audit, and operations). The Compliance Officer shall chair the Compliance Committee and the Committee shall support the Compliance Officer in fulfilling his/her responsibilities.

**B. Written Standards**

1. *Code of Conduct.* Within ninety (90) days of the effective date of this CIA, [Provider] shall establish a Code of Conduct. The Code of Conduct shall be distributed to all employees within ninety (90) days of the effective date of this CIA. [Provider] shall make the promotion of, and adherence to, the Code of Conduct an element in evaluating the performance of managers, supervisors, and all other employees. The Code of Conduct shall, at a minimum, set forth:
  - a. [Provider's] commitment to full compliance with all statutes, regulations, and guidelines applicable to Federal health care programs, including its commitment to prepare and submit accurate billings consistent with Federal health care program regulations and procedures or instructions otherwise communicated by the Health Care Financing Administration ("HCFA") (or other appropriate regulatory agencies) and/or its agents;
  - b. [Provider's] requirement that all of its employees shall be expected to comply with all statutes, regulations, and guidelines applicable to Federal health care programs and with [Provider's] own policies and procedures (including the requirements of this CIA);
  - c. the requirement that all of [Provider's] employees shall be expected to report suspected violations of any statute, regulation, or guideline applicable to Federal health care programs or with [Provider's] own policies and procedures;
  - d. the possible consequences to both [Provider] and to any employee of failure to comply with all statutes, regulations, and guidelines applicable to Federal health care programs and with [Provider's] own policies and procedures or of failure to report such non-compliance; and
  - e. the right of all employees to use the confidential disclosure program, as well as [Provider's] commitment to confidentiality and non-retaliation with respect to disclosures.

Within ninety (90) days of the effective date of the CIA, each employee shall certify, in writing, that he or she has received, read, understands, and will abide by [Provider's] Code of Conduct. New employees shall receive the Code of Conduct and shall complete the required certification within two (2) weeks after the commencement of their employment or within ninety (90) days of the effective date of the CIA, whichever is later.

[Provider] will annually review the Code of Conduct and will make any necessary revisions. These revisions shall be distributed within

thirty (30) days of initiating such a change. Employees shall certify on an annual basis that they have received, read, understand and will abide by the Code of Conduct.

2. *Policies and Procedures.* Within ninety (90) days of the effective date of this CIA, [Provider] shall develop and initiate implementation of written Policies and Procedures regarding the operation of [Provider's] compliance program and its compliance with all federal and state health care statutes, regulations, and guidelines, including the requirements of the Federal health care programs. At a minimum, the Policies and Procedures shall specifically address *[insert language relevant to allegations in the case]*. In addition, the Policies and Procedures shall include disciplinary guidelines and methods for employees to make disclosures or otherwise report on compliance issues to [Provider] management through the Confidential Disclosure Program required by section III.E. [Provider] shall assess and update as necessary the Policies and Procedures at least annually and more frequently, as appropriate. A summary of the Policies and Procedures will be provided to OIG in the Implementation Report. The Policies and Procedures will be available to OIG upon request.

Within ninety (90) days of the effective date of the CIA, the relevant portions of the Policies and Procedures shall be distributed to all appropriate employees. Compliance staff or supervisors should be available to explain any and all policies and procedures.

### **C. Training and Education**

1. *General Training.* Within ninety (90) days of the effective date of this CIA, [Provider] shall provide at least two (2) hours of training to each employee. This general training shall explain [Provider's]:
  - a. Corporate Integrity Agreement requirements;
  - b. Compliance Program (including the Policies and Procedures as they pertain to general compliance issues); and
  - c. Code of Conduct.

These training materials shall be made available to the OIG, upon request.

New employees shall receive the general training described above within thirty (30) days of the beginning of their employment or within ninety (90) days after the effective date of this CIA, whichever is later. Each year, every employee shall receive such general training on an annual basis.

2. *Specific Training.* Within ninety (90) days of the effective date of this CIA, each employee who is involved directly or indirectly in the delivery of patient care and/or in the preparation or submission of claims for reimbursement for such care (including, but not limited to, coding and billing) for any Federal health care programs shall receive at least *[insert number of training hours]* hours of training in addition to the general training required above. This training shall include a discussion of:
  - a. the submission of accurate bills for services rendered to Medicare and/or Medicaid patients;

- b. policies, procedures and other requirements applicable to the documentation of medical records;
- c. the personal obligation of each individual involved in the billing process to ensure that such billings are accurate;
- d. applicable reimbursement rules and statutes;
- e. the legal sanctions for improper billings; and
- f. examples of proper and improper billing practices.

These training materials shall be made available to OIG, upon request. Persons providing the training must be knowledgeable about the subject area.

Affected new employees shall receive this training within thirty (30) days of the beginning of their employment or within ninety (90) days of the effective date of this CIA, whichever is later. If a new employee has any responsibility for the delivery of patient care, the preparation or submission of claims and/or the assignment of procedure codes prior to completing this specific training, a [Provider] employee who has completed the substantive training shall review all of the untrained person's work regarding the assignment of billing codes.

Each year, every employee shall receive such specific training on an annual basis.

3. *Certification.* Each employee shall certify, in writing, that he or she has attended the required training. The certification shall specify the type of training received and the date received. The Compliance Officer shall retain the certifications, along with specific course materials. These shall be made available to OIG upon request.

#### **D. Review Procedures**

[Provider] shall retain an entity, such as an accounting, auditing or consulting firm (hereinafter "Independent Review Organization"), to perform review procedures to assist [Provider] in assessing the adequacy of its billing and compliance practices pursuant to this CIA. This shall be an annual requirement and shall cover a twelve (12) month period. The Independent Review Organization must have expertise in the billing, coding, reporting and other requirements of the Federal health care programs from which [Provider] seeks reimbursement. The Independent Review Organization must be retained to conduct the assessment of the first year within ninety (90) days of the effective date of this CIA. For purposes of complying with this review procedures requirement, the OIG at its discretion, may permit the [Provider] to utilize internal auditors to perform the review(s). In such case, the [Provider] will engage the Independent Review Organization to verify the propriety of the internal auditors' methods and accuracy of their results. The [Provider] will request the Independent Review Organization to produce a report on its findings which report shall be included in the Annual Report to the OIG.

The Independent Review Organization (or the [Provider], if permitted by the OIG, as set forth above) will conduct two separate engagements. One will be an analysis of [Provider's] billing to the Federal health care programs to assist the [Provider] and OIG in determining compliance

with all applicable statutes, regulations, and directives/guidance ("billing engagement"). The second engagement will assist the [Provider] and OIG in determining whether [Provider] is in compliance with this CIA ("compliance engagement").

1. *Billing Engagement.* The billing engagement shall consist of a review of a statistically valid sample of claims for the relevant period. The sample size shall be determined through the use of a probe sample.<sup>1</sup> At a minimum, the full sample must be within a ninety (90) percent confidence level and a precision of twenty-five (25) percent. The probe sample must contain at least thirty (30) sample units and cannot be used as part of the full sample. Both the probe sample and the sample must be selected through random numbers. [Provider] shall use OIG's Office of Audit Services Statistical Sampling Software, also known as "RAT-STATS", which is available through the Internet at [www.hhs.gov/progorg/ratstat.html](http://www.hhs.gov/progorg/ratstat.html).

Each annual billing engagement analysis shall include the following components in its methodology:

- a. *Billing Engagement Objective:* Provide a statement stating clearly the objective intended to be achieved by the billing engagement and the procedure or combination of procedures that will be applied to achieve the objective.
- b. *Billing Engagement Population:* Identify the population, which is the group about which information is needed. Explain the methodology used to develop the population and provide the basis for this determination.
- c. *Sources of Data:* Provide a full description of the source of the information upon which the billing engagement conclusions will be based, including the legal or other standards applied, documents relied upon, payment data, and/or any contractual obligations.
- d. *Sampling Unit:* Define the sampling unit, which is any of the designated elements that comprise the population of interest.
- e. *Sampling Frame:* Identify the sampling frame, which is the totality of the sampling units from which the sample will be selected.

As part of the billing engagement:

- a. *Inquire of management as to the procedures and controls affecting the billing process subject to the annual assessment as specified in the CIA.* Document that aspect of the billing process (e.g., flow of documents, processing activities), and those controls that will be tested in the sample. The documentation may consist of flow charts, excerpts from policies and procedures manuals, control questionnaires, etc.
- b. *Report the sample results, including the overall error rate and the nature of the errors found (e.g., no documentation, inadequate documentation, assignment of incorrect code).*

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<sup>1</sup> Probe sample is defined as a small, random preliminary sample.

- c. Document findings related to [Provider's] procedures to correct inaccurate billings and codings to the Federal health care programs and findings regarding the steps [Provider] is taking to bring its operations into compliance or to correct problems identified by the audit.
2. *Agreed-upon Procedures or Compliance Engagement.* An Independent Review Organization (or the [Provider], if permitted by the OIG) shall also conduct an agreed-upon procedures or compliance engagement, which shall assist the users in determining whether [Provider's] program, policies, procedures, and operations comply with the terms of this CIA. This engagement shall include a section by section analysis of the requirements of this CIA.

A complete copy of the Independent Review Organization's billing and agreed-upon procedures or compliance engagement shall be included in each of [Provider's] Annual Reports to OIG.

3. *Disclosure of Overpayments and Material Deficiencies.* If, as a result of these engagements, [Provider] or the Independent Review Organization identifies any billing, coding or other policies, procedures and/or practices that result in an overpayment, [Provider] shall notify the payor (e.g., Medicare fiscal intermediary or carrier) within 30 days of discovering the deficiency or overpayment and take remedial steps within 60 days of discovery (or such additional time as may be agreed to by the payor) to correct the problem, including preventing the deficiency from recurring. The notice to the payor shall include:
  - a. a statement that the refund is being made pursuant to this CIA;
  - b. a description of the complete circumstances surrounding the overpayment;
  - c. the methodology by which the overpayment was determined;
  - d. the amount of the overpayment;
  - e. any claim-specific information used to determine the overpayment (e.g., beneficiary health insurance number, claim number, service date, and payment date);
  - f. the cost reporting period; and
  - g. the provider identification number under which the repayment is being made.

If [Provider] determines an overpayment represents a material deficiency, contemporaneous with [Provider's] notification to the payor as provided above, [Provider] shall also notify OIG of:

- a. a complete description of the material deficiency;
  - b. amount of overpayment due to the material deficiency;
  - c. [Provider's] action(s) to correct and prevent such material deficiency from recurring;
  - d. the payor's name, address, and contact person where the overpayment was sent;

- e. the date of the check and identification number (or electronic transaction number) on which the overpayment was repaid.

For purposes of this CIA, an “overpayment” shall mean the amount of money the provider has received in excess of the amount due and payable under the Federal health care programs’ statutes, regulations or program directives, including carrier and intermediary instructions.

For purposes of this CIA, a “material deficiency” shall mean anything that involves: (i) a substantial overpayment or improper payment relating to the Medicare and/or Medicaid programs; (ii) conduct or policies that clearly violate the Medicare and/or Medicaid statute, regulations or directives issued by HCFA and/or its agents; or (iii) serious quality of care implications for federal health care beneficiaries or recipients. A material deficiency may be the result of an isolated event or a series of occurrences.

4. *Verification/Validation.* In the event that the OIG determines that it is necessary to conduct an independent review to determine whether or the extent to which [Provider] is complying with its obligations under this CIA, [Provider] agrees to pay for the reasonable cost of any such review or engagement by the OIG or any of its designated agents.

#### **E. Confidential Disclosure Program**

Within ninety (90) days after the effective date of this CIA, [Provider] shall establish a Confidential Disclosure Program, which must include measures (e.g., a toll-free compliance telephone line) to enable employees, contractors, agents or other individuals to disclose, to the Compliance Officer or some other person who is not in the reporting individual’s chain of command, any identified issues or questions associated with [Provider’s] policies, practices or procedures with respect to the Federal health care program, believed by the individual to be inappropriate. [Provider] shall publicize the existence of the hotline (e.g., e-mail to employees or post hotline number in prominent common areas).

The Confidential Disclosure Program shall emphasize a non-retribution, non-retaliation policy, and shall include a reporting mechanism for anonymous, confidential communication. Upon receipt of a complaint, the Compliance Officer (or designee) shall gather the information in such a way as to elicit all relevant information from the individual reporting the alleged misconduct. The Compliance Officer (or designee) shall make a preliminary good faith inquiry into the allegations set forth in every disclosure to ensure that he or she has obtained all of the information necessary to determine whether a further review should be conducted. For any disclosure that is sufficiently specific so that it reasonably: (1) permits a determination of the appropriateness of the alleged improper practice, and (2) provides an opportunity for taking corrective action, [Provider] shall conduct an internal review of the allegations set forth in such a disclosure and ensure that proper follow-up is conducted.

The Compliance Officer shall maintain a confidential disclosure log, which shall include a record and summary of each allegation received, the status of the respective investigations, and any corrective action taken in response to the investigation.

**F. Ineligible Persons**

[Provider] shall not hire or engage as contractors any "Ineligible Person." For purposes of this CIA, an "Ineligible Person" shall be any individual or entity who: (i) is currently excluded, suspended, debarred or otherwise ineligible to participate in the Federal health care programs; or (ii) has been convicted of a criminal offense related to the provision of health care items or services and has not been reinstated in the Federal health care programs after a period of exclusion, suspension, debarment, or ineligibility.

Within ninety (90) days of the effective date of this CIA, [Provider] will review its list of current employees and contractors against the General Services Administration's List of Parties Excluded from Federal Programs (available through the Internet at <http://www.arnet.gov/epls>) and the HHS/OIG Cumulative Sanction Report (available through the Internet at <http://www.dhhs.gov/progorg/oig>) to ensure that it is not currently employing or contracting with any Ineligible Person. Thereafter, [Provider] will review the list once semi-annually to ensure that no current employees or contractors are or have become Ineligible Persons.

To prevent hiring or contracting with any Ineligible Person, [Provider] shall screen all prospective employees and prospective contractors prior to engaging their services by (i) requiring applicants to disclose whether they are Ineligible Persons, and (ii) reviewing the General Services Administration's List of Parties Excluded from Federal Programs (available through the Internet at <http://www.arnet.gov/epls>) and the HHS/OIG Cumulative Sanction Report (available through the Internet at <http://www.dhhs.gov/progorg/oig>).

If [Provider] has notice that an employee or agent is charged with a criminal offense related to any Federal health care program, or is suspended or proposed for exclusion during his or her employment or contract with [Provider], within 10 days of receiving such notice [Provider] will remove such employee from responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs until the resolution of such criminal action, suspension, or proposed exclusion. If [Provider] has notice that an employee or agent has become an Ineligible Person, [Provider] will remove such person from responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs and shall remove such person from any position for which the person's salary or the items or services rendered, ordered, or prescribed by the person are paid in whole or in part, directly or indirectly, by Federal health care programs or otherwise with Federal funds at least until such time as the person is reinstated into participation in the Federal health care programs.

**G. Notification of Proceedings**

Within thirty (30) days of discovery, [Provider] shall notify OIG, in writing, of any ongoing investigation or legal proceeding conducted or brought by a governmental entity or its agents involving an allegation that [Provider] has committed a crime or has engaged in fraudulent activities or any other knowing misconduct. This notification shall include a description of the allegation, the identity of the investigating or prosecuting agency, and the status of such investigation or legal proceeding. [Provider] shall also provide written notice to OIG within



thirty (30) days of the resolution of the matter, and shall provide OIG with a description of the findings and/or results of the proceedings, if any.

#### **H. Reporting**

1. *Credible evidence of misconduct.* If [Provider] discovers credible evidence of misconduct from any source and, after reasonable inquiry, has reason to believe that the misconduct may violate criminal, civil, or administrative law concerning [Provider's] practices relating to the Federal health care programs, then [Provider] shall promptly report the probable violation of law to OIG. Defendants shall make this disclosure as soon as practicable, but, not later than thirty (30) days after becoming aware of the existence of the probable violation. The [Provider's] report to OIG shall include:

- a. the findings concerning the probable violation, including the nature and extent of the probable violation;
- b. [Provider's] actions to correct such probable violation; and
- c. any further steps it plans to take to address such probable violation and prevent it from recurring.

To the extent the misconduct involves an overpayment, the report shall include the information listed in section III.D.3 regarding material deficiencies.

2. *Inappropriate Billing.* If [Provider] discovers inappropriate or incorrect billing through means other than the Independent Review Organization's engagement, the provider shall follow procedures in section III.D.3 regarding overpayments and material deficiencies.

#### **IV. New Locations**

In the event that [Provider] purchases or establishes new business units after the effective date of this CIA, [Provider] shall notify OIG of this fact within thirty (30) days of the date of purchase or establishment. This notification shall include the location of the new operation(s), phone number, fax number, Federal health care program provider number(s) (if any), and the corresponding payor(s) (contractor specific) that has issued each provider number. All employees at such locations shall be subject to the requirements in this CIA that apply to new employees (e.g., completing certifications and undergoing training).

#### **V. Implementation and Annual Reports**

##### **A. Implementation Report**

Within one hundred and twenty (120) days after the effective date of this CIA, [Provider] shall submit a written report to OIG summarizing the status of its implementation of the requirements of this CIA. This Implementation Report shall include:

1. the name, address, phone number and position description of the Compliance Officer required by section III.A;
2. the names and positions of the members of the Compliance Committee required by section III.A;
3. a copy of [Provider's] Code of Conduct required by section III.B.1;

4. the summary of the Policies and Procedures required by section III.B.2;
5. a description of the training programs required by section III.C including a description of the targeted audiences and a schedule of when the training sessions were held;
6. a certification by the Compliance Officer that:
  - a. the Policies and Procedures required by section III.B have been developed, are being implemented, and have been distributed to all pertinent employees;
  - b. all employees have completed the Code of Conduct certification required by section III.B.1; and;
  - c. all employees have completed the training and executed the certification required by section III.C;
7. a description of the confidential disclosure program required by section III.E;
8. the identity of the Independent Review Organization(s) and the proposed start and completion date of the first audit; and
9. a summary of personnel actions taken pursuant to section III.F.

**B. Annual Reports**

[Provider] shall submit to OIG an Annual Report with respect to the status and findings of [Provider's] compliance activities. The Annual Reports shall include:

1. any change in the identity or position description of the Compliance Officer and/or members of the Compliance Committee described in section III.A;
2. a certification by the Compliance Officer that:
  - a. all employees have completed the annual Code of Conduct certification required by section III.B.1; and
  - b. all employees have completed the training and executed the certification required by section III.C;
3. notification of any changes or amendments to the Policies and Procedures required by section III.B and the reasons for such changes (e.g., change in contractor policy);
4. a complete copy of the report prepared pursuant to the Independent Review Organization's billing and compliance engagement, including a copy of the methodology used;
5. [Provider's] response/corrective action plan to any issues raised by the Independent Review Organization;
6. a summary of material deficiencies reported throughout the course of the previous twelve (12) months pursuant to III.D.3 and III.H;
7. a report of the aggregate overpayments that have been returned to the Federal health care programs that were discovered as a direct or indirect result of implementing this CIA. Overpayment amounts should be broken down into the following categories: Medicare, Medicaid (report each applicable state separately) and other Federal health care programs;

8. a copy of the confidential disclosure log required by section III.E;
9. a description of any personnel action (other than hiring) taken by [Provider] as a result of the obligations in section III.F;
10. a summary describing any ongoing investigation or legal proceeding conducted or brought by a government entity involving an allegation that [Provider] has committed a crime or has engaged in fraudulent activities, which have been reported pursuant to section III.G. The statement shall include a description of the allegation, the identity of the investigating or prosecuting agency, and the status of such investigation, legal proceeding or requests for information;
11. a corrective action plan to address the probable violations of law identified in section III.H; and
12. a listing of all of the [Provider's] locations (including locations and mailing addresses), the corresponding name under which each location is doing business, the corresponding phone numbers and fax numbers, each location's Federal health care program provider identification number(s) and the payor (specific contractor) that issued each provider identification number.

The first Annual Report shall be received by the OIG no later than one year and thirty (30) days after the effective date of this CIA. Subsequent Annual Reports shall be submitted no later than the anniversary date of the due date of the first Annual Report.

### **C. Certifications**

The Implementation Report and Annual Reports shall include a certification by the Compliance Officer under penalty of perjury, that: (1) [Provider] is in compliance with all of the requirements of this CIA, to the best of his or her knowledge; and (2) the Compliance Officer has reviewed the Report and has made reasonable inquiry regarding its content and believes that, upon such inquiry, the information is accurate and truthful.

## **VI. Notifications and Submission of Reports**

Unless otherwise stated in writing subsequent to the effective date of this CIA, all notifications and reports required under this CIA shall be submitted to the entities listed below:

OIG:

Civil Recoveries Branch—Compliance Unit  
Office of Counsel to the Inspector General  
Office of Inspector General  
U.S. Department of Health and Human Services  
Cohen Building, Room 5527  
330 Independence Avenue, SW  
Washington, DC 20201  
Phone 202-619-2078; Fax 202-205-0604

[Provider]:

[Address and Telephone number of Provider's Compliance Contact]

## **VII. OIG Inspection, Audit and Review Rights**

In addition to any other rights OIG may have by statute, regulation, or contract, OIG or its duly authorized representative(s), may examine [Provider's] books, records, and other documents and supporting materials for

the purpose of verifying and evaluating: (a) [Provider's] compliance with the terms of this CIA; and (b) [Provider's] compliance with the requirements of the Federal health care programs in which it participates. The documentation described above shall be made available by [Provider] to OIG or its duly authorized representative(s) at all reasonable times for inspection, audit or reproduction. Furthermore, for purposes of this provision, OIG or its duly authorized representative(s) may interview any of [Provider's] employees who consent to be interviewed at the employee's place of business during normal business hours or at such other place and time as may be mutually agreed upon between the employee and OIG. [Provider] agrees to assist OIG in contacting and arranging interviews with such employees upon OIG's request. [Provider's] employees may elect to be interviewed with or without a representative of [Provider] present.

### **VIII. Document and Record Retention**

[Provider] shall maintain for inspection all documents and records relating to reimbursement from the Federal health care programs or to compliance with this CIA one year longer than the term of this CIA (or longer if otherwise required by law).

### **IX. Disclosures**

Subject to HHS's Freedom of Information Act ("FOIA") procedures, set forth in 45 C.F.R. Part 5, the OIG shall make a reasonable effort to notify [Provider] prior to any release by OIG of information submitted by [Provider] pursuant to its obligations under this CIA and identified upon submission by [Provider] as trade secrets, commercial or financial information and privileged and confidential under the FOIA rules. [Provider] shall refrain from identifying any information as trade secrets, commercial or financial information and privileged and confidential that does not meet the criteria for exemption from disclosure under FOIA.

### **X. Breach and Default Provisions**

[Provider] is expected to fully and timely comply with all of the obligations herein throughout the term of this CIA or other time frames herein agreed to.

#### ***A. Stipulated Penalties for Failure to Comply with Certain Obligations***

As a contractual remedy, [Provider] and OIG hereby agree that failure to comply with certain obligations set forth in this CIA may lead to the imposition of the following monetary penalties (hereinafter referred to as "Stipulated Penalties") in accordance with the following provisions.

1. A Stipulated Penalty of \$2,500 (which shall begin to accrue on the day after the date the obligation became due) for each day, beginning 120 days after the effective date of this CIA and concluding at the end of the term of this CIA, [Provider] fails to have in place any of the following:
  - a. a Compliance Officer;
  - b. a Compliance Committee;
  - c. a written Code of Conduct;
  - d. written Policies and Procedures;
  - e. a training program; and
  - f. a Confidential Disclosure Program;

2. A Stipulated Penalty of \$2,500 (which shall begin to accrue on the day after the date the obligation became due) for each day [Provider] fails to meet any of the deadlines to submit the Implementation Report or the Annual Reports to the OIG.
3. A Stipulated Penalty of \$2,000 (which shall begin to accrue on the date the failure to comply began) for each day [Provider]:
  - a. hires or contracts with an Ineligible Person after that person has been listed by a federal agency as excluded, debarred, suspended or otherwise ineligible for participation in the Medicare, Medicaid or any other Federal health care program (as defined in 42 U.S.C. 1320a7b(f)). This Stipulated Penalty shall not be demanded for any time period if [Provider] can demonstrate that it did not discover the person's exclusion or other ineligibility after making a reasonable inquiry (as described in section III.F) as to the status of the person;
  - b. employs or contracts with an Ineligible Person and that person: (i) has responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs or (ii) is in a position for which the person's salary or the items or services rendered, ordered, or prescribed by the person are paid in whole or in part, directly or indirectly, by the Federal health care programs or otherwise with Federal funds (this Stipulated Penalty shall not be demanded for any time period during which [Provider] can demonstrate that it did not discover the person's exclusion or other ineligibility after making a reasonable inquiry (as described in III.F) as to the status of the person);
  - c. employs or contracts with a person who: (i) has been charged with a criminal offense related to any Federal health care program, or (ii) is suspended or proposed for exclusion, and that person has responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs (this Stipulated Penalty shall not be demanded for any time period before 10 days after [Provider] received notice of the relevant matter or after the resolution of the matter).
4. A Stipulated Penalty of \$1,500 (which shall begin to accrue on the date the [Provider] fails to grant access) for each day [Provider] fails to grant access to the information or documentation as required in section V of this CIA.
5. A Stipulated Penalty of \$1,000 (which shall begin to accrue ten (10) days after the date that OIG provides notice to [Provider] of the failure to comply) for each day [Provider] fails to comply fully and adequately with any obligation of this CIA. In its notice to [Provider], the OIG shall state the specific grounds for its determination that the [Provider] has failed to comply fully and adequately with the CIA obligation(s) at issue.

#### **B. Payment of Stipulated Penalties**

1. *Demand Letter.* Upon a finding that [Provider] has failed to comply with any of the obligations described in section X.A and

determining that Stipulated Penalties are appropriate, OIG shall notify [Provider] by personal service or certified mail of (a) [Provider's] failure to comply; and (b) the OIG's exercise of its contractual right to demand payment of the Stipulated Penalties (this notification is hereinafter referred to as the "Demand Letter").

Within fifteen (15) days of the date of the Demand Letter, [Provider] shall either (a) cure the breach to the OIG's satisfaction and pay the applicable stipulated penalties, or (b) request a hearing before an HHS administrative law judge ("ALJ") to dispute the OIG's determination of noncompliance, pursuant to the agreed-upon provisions set forth below in section X.D. In the event [Provider] elects to request an ALJ hearing, the Stipulated Penalties shall continue to accrue until [Provider] cures, to the OIG's satisfaction, the alleged breach in dispute. Failure to respond to the Demand Letter in one of these two manners within the allowed time period shall be considered a material breach of this CIA and shall be grounds for exclusion under section X.C.

2. *Timely Written Requests for Extensions.* [Provider] may submit a timely written request for an extension of time to perform any act or file any notification or report required by this CIA. Notwithstanding any other provision in this section, if OIG grants the timely written request with respect to an act, notification, or report, Stipulated Penalties for failure to perform the act or file the notification or report shall not begin to accrue until one day after [Provider] fails to meet the revised deadline as agreed to by the OIG-approved extension. Notwithstanding any other provision in this section, if OIG denies such a timely written request, Stipulated Penalties for failure to perform the act or file the notification or report shall not begin to accrue until two (2) business days after [Provider] receives OIG's written denial of such request. A "timely written request" is defined as a request in writing received by OIG at least five (5) business days prior to the date by which any act is due to be performed or any notification or report is due to be filed.
3. *Form of Payment.* Payment of the Stipulated Penalties shall be made by certified or cashier's check, payable to "Secretary of the Department of Health and Human Services," and submitted to OIG at the address set forth in section VI.
4. *Independence from Material Breach Determination.* Except as otherwise noted, these provisions for payment of Stipulated Penalties shall not affect or otherwise set a standard for the OIG's determination that [Provider] has materially breached this CIA, which decision shall be made at the OIG's discretion and governed by the provisions in section X.C, below.

**C. Exclusion for Material Breach of this CIA**

1. *Notice of Material Breach and Intent to Exclude.* The parties agree that a material breach of this CIA by [Provider] constitutes an independent basis for [Provider's] exclusion from participation in the Federal health care programs (as defined in 42 U.S.C. 1320a7b(f)). Upon a determination by OIG that [Provider] has materially breached this CIA and that exclusion should be imposed, the OIG shall notify [Provider] by certified mail of (a) [Provider's] material breach; and (b) OIG's intent to exercise its

contractual right to impose exclusion (this notification is herein-after referred to as the "Notice of Material Breach and Intent to Exclude").

2. *Opportunity to Cure.* [Provider] shall have thirty-five (35) days from the date of the Notice of Material Breach and Intent to Exclude Letter to demonstrate to the OIG's satisfaction that:
  - a. [Provider] is in *full* compliance with this CIA;
  - b. the alleged material breach has been cured; or
  - c. the alleged material breach cannot be cured within the 35-day period, but that: (i) [Provider] has begun to take action to cure the material breach, (ii) [Provider] is pursuing such action with due diligence, and (iii) [Provider] has provided to OIG a reasonable timetable for curing the material breach.
3. *Exclusion Letter.* If at the conclusion of the thirty-five (35) day period, [Provider] fails to satisfy the requirements of section X.C.2, OIG may exclude [Provider] from participation in the Federal health care programs. OIG will notify [Provider] in writing of its determination to exclude [Provider] (this letter shall be referred to hereinafter as the "Exclusion Letter"). Subject to the Dispute Resolution provisions in section X.D, below, the exclusion shall go into effect thirty (30) days after the date of the Exclusion Letter. The exclusion shall have national effect and will also apply to all other federal procurement and non-procurement programs. If [Provider] is excluded under the provisions of this CIA, [Provider] may seek reinstatement pursuant to the provisions at 42 C.F.R. §§1001.3001–.3004.
4. *Material Breach.* A material breach of this CIA means:
  - a. a failure by [Provider] to report a material deficiency, take corrective action and pay the appropriate refunds, as provided in section III.D;
  - b. repeated or flagrant violations of the obligations under this CIA, including, but not limited to, the obligations addressed in section X.A of this CIA;
  - c. a failure to respond to a Demand Letter concerning the payment of Stipulated Penalties in accordance with section X.B above; or
  - d. a failure to retain and use an Independent Review Organization for review purposes in accordance with section III.D.

#### **D. Dispute Resolution**

1. *Review Rights.* Upon the OIG's delivery to [Provider] of its Demand Letter or of its Exclusion Letter, and as an agreed-upon contractual remedy for the resolution of disputes arising under the obligation of this CIA, [Provider] shall be afforded certain review rights comparable to the ones that are provided in 42 U.S.C. §§1320a7(f) and 42 C.F.R. §1005 as if they applied to the Stipulated Penalties or exclusion sought pursuant to this CIA. Specifically, the OIG's determination to demand payment of Stipulated Penalties or to seek exclusion shall be subject to review

by an ALJ and, in the event of an appeal, the Departmental Appeals Board ("DAB"), in a manner consistent with the provisions in 42 C.F.R. §§1005.2–21. Notwithstanding the language in 42 C.F.R. §1005.2(c), the request for a hearing involving stipulated penalties shall be made within fifteen (15) days of the date of the Demand Letter and the request for a hearing involving exclusion shall be made within thirty (30) days of the date of the Exclusion Letter.

2. *Stipulated Penalties Review.* Notwithstanding any provision of Title 42 of the United States Code or Chapter 42 of the Code of Federal Regulations, the only issues in a proceeding for stipulated penalties under this CIA shall be (a) whether [Provider] was in full and timely compliance with the obligations of this CIA for which the OIG demands payment; and (b) the period of noncompliance. [Provider] shall have the burden of proving its full and timely compliance and the steps taken to cure the noncompliance, if any. If the ALJ finds for the OIG with regard to a finding of a breach of this CIA and orders [Provider] to pay Stipulated Penalties, such Stipulated Penalties shall become due and payable twenty (20) days after the ALJ issues such a decision notwithstanding that [Provider] may request review of the ALJ decision by the DAB.
3. *Exclusion Review.* Notwithstanding any provision of Title 42 of the United States Code or Chapter 42 of the Code of Federal Regulations, the only issues in a proceeding for exclusion based on a material breach of this CIA shall be (a) whether [Provider] was in material breach of this CIA; (b) whether such breach was continuing on the date of the Exclusion Letter; and (c) the alleged material breach cannot be cured within the 35-day period, but that (i) [Provider] has begun to take action to cure the material breach, (ii) [Provider] is pursuing such action with due diligence, and (iii) [Provider] has provided to OIG a reasonable timetable for curing the material breach.

For purposes of the exclusion herein, exclusion shall take effect only after an ALJ decision that is favorable to the OIG. [Provider's] election of its contractual right to appeal to the DAB shall not abrogate the OIG's authority to exclude [Provider] upon the issuance of the ALJ's decision. If the ALJ sustains the determination of the OIG and determines that exclusion is authorized, such exclusion shall take effect twenty (20) days after the ALJ issues such a decision, notwithstanding that [Provider] may request review of the ALJ decision by the DAB.

4. *Finality of Decision.* The review by an ALJ or DAB provided for above shall not be considered to be an appeal right arising under any statutes or regulations. Consequently, the parties to this CIA agree that the DAB's decision (or the ALJ's decision if not appealed) shall be considered final for all purposes under this CIA and [Provider] agrees to waive any right it may have to appeal the decision administratively, judicially or otherwise seek review by any court or other adjudicative forum.

## **XI. Effective and Binding Agreement**

Consistent with the provisions in the Settlement Agreement pursuant to which this CIA is entered, and into which this CIA is incorporated, [Provider] and OIG agree as follows:



- a. This CIA shall be binding on the successors, assigns and transferees of [Provider];
- b. This CIA shall become final and binding on the date the final signature is obtained on the CIA;
- c. Any modifications to this CIA shall be made with the prior written consent of the parties to this CIA; and
- d. The undersigned [Provider] signatories represent and warrant that they are authorized to execute this CIA. The undersigned OIG signatory represents that he is signing this CIA in his official capacity and that he is authorized to execute this CIA.

**On Behalf of [Provider]**

	[Date]
	[Date]
	[Date]

[Please identify all signatories]

**ON BEHALF OF THE OFFICE OF INSPECTOR GENERAL  
OF THE DEPARTMENT OF HEALTH AND HUMAN SERVICES**

Lewis Moris	[Date]
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**Assistant Inspector General for Legal Affairs  
Office of Inspector General  
U.S. Department of Health and Human Services**

## Appendix B

### Sample Statement of Management's Assertions

[Date]

In connection with the Corporate Integrity Agreement (CIA) entered into with the Office of the Inspector General of the United States Department of Health and Human Services dated [date], we make the following assertions, which are true to the best of our knowledge and belief.

#### Governance

Within 90 days of the date of the CIA, we—

1. Established a Compliance Committee, which meets at least monthly and requires a quorum to meet.
2. Appointed to our Compliance Committee members who include at a minimum those individuals specified in the CIA.
3. Delegated to the Compliance Committee the authority to implement and monitor the CIA, as evidenced by the organization chart or the Compliance Committee's charter.
4. Appointed a compliance officer, who reports directly to the individual specified in the CIA.

We appointed a compliance officer who—

1. Has sufficient staff and resources to carry out his or her responsibilities.
2. Actively participates in compliance training.
3. Has authority to conduct full and complete internal investigations without restriction.
4. Periodically revises the compliance program to meet changing circumstances and risks.

#### Billing Practices, Policies, and Procedures

Although no system of internal controls can provide absolute assurance that all bills comply in all respects with Medicare, Medicaid, and other federal health care program guidelines, we are not aware of any material weaknesses in our billing practices, policies, and procedures. Billings to third-party payors comply in all material respects with applicable coding principles and laws and regulations (including those dealing with Medicare and Medicaid antifraud and abuse) and only reflect charges for goods and services that were medically necessary, properly approved by regulatory bodies (e.g., the Food and Drug Administration), if required and properly rendered. *[Insert other assertions as necessary to address matters covered in the CIA.]* Any Medicare, Medicaid, and other federal health care program billing deficiencies that we identified have been properly reported to the applicable payor within 60 days of discovery of the deficiency.

#### Corporate Integrity Policy

1. Our policy was developed and implemented within [number] days of execution of the CIA.

2. The policy addresses the Company's commitment to preparation and submission of accurate billings consistent with the standards set forth in federal health care program statutes, regulations, procedures and guidelines or as otherwise communicated by Health Care Financing Administration (HCFA), its agents or any other agency engaged in the administration of the applicable federal health care program.
3. The policy addressed the specific issues that gave rise to the settlement, as well as other risk areas identified by the OIG in published Fraud Alerts issued through [date].
4. Further details on the development and implementation of our policy were provided to the OIG in our letter dated [date].
5. Our policy was distributed to all employees, physicians and independent contractors involved in submitting or preparing requests for reimbursement.
6. We have prominently displayed a copy of our policy on the Company's premises.

## Information and Education Program

As discussed more fully in our letter to the OIG dated [date], we conducted an Information and Education Program within [number] days of the CIA. The Information and Education Program requires that each officer, employee, agent and contractor charged with administering federal health care programs (including, but not limited to billers, coders, nurses, physicians, medical records, hospital administration and other individuals directly involved in billing federal health care programs) receive at least [number] hours of training.

The training provided to employees involved in billing, coding, and/or charge capture consisted of instructions on submitting accurate bills, the personal obligations of each individual to ensure billings are accurate, the nature of company-imposed disciplinary actions on individuals who violate company policies and/or laws and regulations, applicable federal health care program rules, legal sanctions against the company for submission of false or fraudulent information, and how to report potential abuses or fraud. The training material addresses those issues underlying our settlement with the OIG.

The experience of the trainers is consistent with the topics presented.

## Confidential Disclosure Program

Our Confidential Disclosure Program—

1. Was established within [number] days of the CIA.
2. Enables any employee to disclose any practices or billing procedures relating to federal health care programs.
3. Provides a toll-free telephone line maintained by the Company, which Company representatives have indicated is maintained twenty-four hours a day, seven days a week, for the purpose of making any disclosures regarding compliance with the Company's Compliance Program, the obligations in the CIA, and Company's overall compliance with federal and state standards.

4. Includes policies requiring the review of any disclosures to permit a determination of the appropriateness of the billing practice alleged to be involved and any corrective action to be taken to ensure that proper follow-up is conducted.
5. A detailed summary of the communications (including the number of disclosures by employees and the dates of such disclosures) concerning billing practices reported as, and found to be, inappropriate under the Confidential Disclosure Program, and the results of any internal review and the follow-up on such disclosures are summarized in Attachment [title] to our Annual Report.

## Excluded Individuals or Entities

Company policy—

1. Prohibits the employment of or contracting with an individual or entity that is listed by a federal agency as convicted of abuse or excluded, suspended or otherwise ineligible for participation in federal health care programs.
2. Includes a process to make an inquiry into the status of any potential employee or independent contractor.
3. Provides for an annual review of the status of all existing employees and contractors to verify whether any individual had been suspended or excluded or charged with a criminal offense relating to the provision of federal health care services.

We are not aware of any individuals employed in contravention of the prohibitions in the CIA.

## Record Retention

Our record retention policy is consistent with the requirements of the CIA.

Signed by:

\_\_\_\_\_  
[Chief Executive Officer]

\_\_\_\_\_  
[Chief Financial Officer]

\_\_\_\_\_  
[Corporate Compliance Officer]

## Appendix C

### Sample Engagement Letter

The following is an illustration of a sample engagement letter that may be used for this kind of engagement.

*[CPA Firm Letterhead]*

*[Client's Name and Address]*

Dear \_\_\_\_\_:

This will confirm our understanding of the arrangements for our performance of certain agreed-upon procedures in connection with management's compliance with the terms of the Corporate Integrity Agreement (CIA) with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services (HHS) dated *[date of CIA]* for the period ending *[date]*.

We will perform those procedures enumerated in the attachment to this letter. Our responsibility is to carry out these procedures and report our findings. We will conduct our engagement in accordance with standards established by the American Institute of Certified Public Accountants. Our planned procedures were agreed to by management and will be communicated to the OIG for its review and are based on the terms specified in the CIA. The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, it is understood that we make no representation regarding the sufficiency of the procedures described in the attachment for the purpose for which this report has been requested or for any other purpose.

Management is responsible for the Company's compliance with all applicable laws, regulations, and contracts and agreements, including the CIA. Management also is responsible for the design, implementation, and monitoring of the policies and procedures upon which compliance is based.

Our engagement to perform agreed-upon procedures is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's compliance with the CIA. Accordingly, we will not express such an opinion or any other form of assurance thereon.<sup>1</sup>

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<sup>1</sup> The independent accountant may wish to include an understanding with the client about any limitation or other arrangements regarding liability of the practitioner or the client in the engagement letter. For example, the following might be included in the letter:

Our maximum liability relating to services rendered under this letter (regardless of form of action, whether in contract, negligence or otherwise) shall be limited to the charges paid to us for the portion of the services or work products giving rise to liability. We will not be liable for consequential or punitive damages (including lost profits or savings) even if aware of their possible existence.

You will indemnify us against any damage or expense that may result from any third-party claim relating to our services or any use by you of any work product, and you will reimburse us for all expenses (including counsel fees) as incurred by us in connection with any such claim, except to the extent such claim (i) is finally determined to have resulted from our gross negligence or willful misconduct or (ii) is covered by any of the preceding indemnities.

Working papers that are prepared in connection with this engagement are the property of the independent accountant. The working papers are prepared for the purpose of providing the principal support for the independent accountant's report. At the completion of our work, we expect to issue an agreed-upon procedures report in the attached form.

If, however, we are not able to complete all of the specified procedures, we will so advise you. At that time, we will discuss with you the form of communication, if any, that you desire for our findings. We will ask you to confirm your request in writing at that time. If you request that we delay issuance of our report until corrective action is taken that will result in compliance with all aspects of the CIA, we will do so only at your written request. Our working papers will be retained in accordance with our firm's working paper retention policy.

The distribution of the independent accountant's report will be restricted to the governing board and management of the Company and the OIG.

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees.

We agree that to the extent required by law, we will allow the Comptroller General of the United States, HHS, and their duly authorized representatives to have access to this engagement letter and our documents and records to the extent necessary to verify the nature and amount of costs of the services provided to the Company, until the expiration of four years after we have concluded providing services to the Company that are performed pursuant to this Engagement Letter. In the event the Comptroller General, HHS, or their duly authorized representatives request such records, we agree to notify the Company of such request as soon as practicable.

In the event we are requested or authorized by the Company or are required by government regulation, subpoena, or other legal process to produce our documents or our personnel as witnesses with respect to our engagements for the Company, the Company will, so long as we are not a party to the proceeding in which the information is sought, reimburse us for our professional time and expenses, as well as the fees and expenses of our counsel, incurred in responding to such requests.

If this letter correctly expresses your understanding of this engagement, please sign the enclosed copy where indicated and return it to us. We appreciate the opportunity to serve you.

Sincerely, \_\_\_\_\_  
[Partner's Signature]  
[Firm Name or Firm Representative]

Accepted and agreed to: \_\_\_\_\_  
[Client Representative's Signature]

[Title] \_\_\_\_\_

[Date] \_\_\_\_\_

## Appendix D

### Sample Procedures

#### *Procedure*

#### *Findings*

#### **Governance**

1. We read the Company's corporate minutes and organization chart and ascertained that, within [number] days of the date of the Corporate Integrity Agreement (CIA), the Company—
  - a. Established a Compliance Committee, which is to meet meets at least monthly and requires a quorum to meet.
  - b. Appointed to its Compliance Committee members who include, at a minimum, those individuals specified in the CIA.
  - c. Delegated to the Compliance Committee the authority to implement and monitor the CIA, as evidenced by the organization chart or the Compliance Committee's charter.
  - d. Appointed a compliance officer who reports directly to the individual specified in the CIA.
2. We interviewed the compliance officer and were informed that, in his or her opinion, the Compliance Officer—
  - a. Has sufficient staff and resources to carry out his or her responsibilities.
  - b. Actively participates in compliance training.
  - c. Has the authority to conduct full and complete internal investigations without restriction.
  - d. Periodically revises the compliance program to meet changing circumstances and risks.
3. We read the OIG notification letter as specified in the CIA and noted that the appropriate official signed the letter, that it was addressed to the OIG, that it covered items (a) through (d) in Step 1, and that it was dated within [number of] days of the execution of the CIA.

#### **Billing Practices, Policies, and Procedures**

*The practitioner might be engaged to provide consulting services in connection with the evaluation of the Company's billing practices, policies, and procedures. If so, generally no agreed-upon procedures would be performed relating to this area.*

*Alternatively, if the procedures relating to the Company's billing practices, policies, and procedures are performed by others such as the Company's internal audit staff, the practitioner performs Steps 4 through 9.*

**Procedure****Findings**

4. We read the compliance work plan and noted the following:
  - a. The work plan's stated objectives include the determination that billings are accurate and complete, for services rendered that have been deemed by medical specialists as being necessary, and are submitted in accordance with federal program guidelines.
  - b. The work plan sampling methodology sets confidence levels consistent with those defined in the CIA.
  - c. The work plan identifies risk areas, as defined in the CIA (if applicable), and specifies testing procedures by risk area.
  - d. The work plan specifies that samples are taken in risk areas (if applicable) identified by the CIA.
  - e. The work plan includes testing procedures, which the practitioner should modify as required by the CIA, for the following risks areas (if applicable) identified in the CIA:
    - (1) Clinical documentation, as follows:
      - (i) No documentation of service
      - (ii) Insufficient documentation of service
      - (iii) Improper diagnosis or treatment plan giving rise to the provision of a medically unnecessary service or treatment
      - (iv) Service or treatment does not conform medically with the documented diagnosis or treatment plan
      - (v) Services incorrectly coded
    - (2) Billing and coding, as follows:
      - (i) Noncovered or unallowable service
      - (ii) Duplicate payment
      - (iii) DRG window error
      - (iv) Unbundling
      - (v) Utilization
      - (vi) Medicare credit balances
- [*Note to Practitioner:* Modify the preceding list as required by the CIA.]
5. We selected [*quantity*] probe samples performed by the independent review organization for the following risk areas [*list risk areas tested*]. For the probe samples selected, we noted that the—
  - a. Sample patient billing files were randomly selected.
  - b. Sample size reflected confidence levels specified in the CIA.
  - c. Sample plan describes how missing items (if any) would be treated.



**Procedure****Findings**

- d. Patient billing files tested were pulled per the listing of random numbers and all patient billing files were accounted for in the working papers.
  - e. Work plans for the specific sample described the risk areas (if applicable) being tested and the testing approach/procedures.
  - f. Working papers noted the completion of each work plan step.
  - g. Working papers contained a summary of findings for the sample.
6. We reperformed the work plan steps [*list of specific steps performed*] for the sample patient billing files. The reperformance of work plan steps related to the medical review of the sample patient billing files was performed by the following individuals [*note the professional qualifications of individuals without listing names*]. Any exceptions between our findings and the Company's are summarized in the Attachment to this report.
7. We read the summary findings of all internal compliance reviews that the Company's Internal Audit department indicated it had performed for the Company and noted that all material billing deficiencies [*specify material threshold as defined by the Company*] noted therein were discussed in written communications addressed to the appropriate payor (for example, Medicare Part B carrier) and were dated within 60 days from the time the deficiency occurred.<sup>1</sup>
8. We inquired of [*individual*] as to whether the Company took remedial steps within [*number of*] days (or such additional time as agreed to by the payor) to correct all material billing deficiencies noted in Step 7. We were informed that such remedial steps had been taken.
9. By reading applicable correspondence, we noted that any material billing deficiencies noted in Step 7 were communicated to the OIG, including specific findings relative to the deficiency, the Company's actions taken to correct the deficiency, and any further steps the Company plans to take to prevent any similar deficiencies from recurring.

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<sup>1</sup> The CIA provides its own legal definition of a "material deficiency." Determination of whether a billing or other act meets this definition is normally beyond the auditor's professional competence and may have to await final determination by a court of law. Accordingly, to avoid confusion, a working definition different from that provided in the CIA (e.g., a specified dollar threshold) may be necessary.

**Procedure****Findings****Corporate Integrity Policy**

10. We read the Company's Corporate Integrity Policy and noted the following.
  - a. The policy was developed and implemented within [number of] days of execution of the CIA.
  - b. The policy addressed the Company's commitment to preparation and submission of accurate billings consistent with the standards set forth in federal health care program statutes, regulations, procedures, and guidelines or as otherwise communicated by HCFA, its agents, or any other agency engaged in the administration of the applicable federal health care program.
  - c. The policy addressed the specific issues that gave rise to the settlement, as well as other risk areas identified by the OIG in published Fraud Alerts issued through [agency].
  - d. Correspondence addressed to the OIG covered the development and implementation of the policy.
  - e. Documentation indicating that the policy was distributed to all employees, physicians, and independent contractors involved in submitting or preparing requests for reimbursement.
  - f. The prominent display of a copy of the policy on the Company's premises.
11. We selected a sample of ten employees (involved in submitting and preparing requests for reimbursement) and examined written confirmation in the employee's personnel file indicating receipt of a copy of the Corporate Integrity Policy.

**Information and Education Program**

12. We read the Company's Information and Education Program and noted the following.
  - a. The Information and Education Program agenda was dated within [number of] days of execution of the CIA.
  - b. Correspondence covering the development and implementation of the Information and Education Program was addressed to the OIG.
  - c. The Information and Education Program requires that each officer, employee, agent, and contractor charged with administering federal health care programs (including, but not limited to billers, coders, nurses, physicians, medical records, hospital administration and other individuals directly involved in billing federal health care programs) receive at least [number of] hours of training.

**Procedure****Findings**

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13. We selected a sample of ten employees involved in billing, coding and/or charge capture and examined sign-in logs of the training classes and noted that each had signed indicating that they had received at least *[number of]* hours of training as specified in the Information and Education Program. We also reviewed tests and surveys completed by each of the ten trained employees noting evidence that they were completed.
14. We inquired as to the training of individuals not present during the regularly scheduled training programs and were informed that each such individual is trained either individually or in a separate make-up session. We inquired as to the names of individuals not initially present and selected one such individual and examined that individual's post-training test and survey for completion.
15. We read the course agenda and noted that the training provided to employees involved in billing, coding, and/or charge capture consisted of instructions on submitting accurate bills, the personal obligations of each individual to ensure billings are accurate, the nature of company-imposed disciplinary actions on individuals who violate company policies and/or laws and regulations applicable to federal health care program rules, legal sanctions against the company for submission of false or fraudulent information, and how to report potential abuses or fraud. We also noted that the training material addressed the following issues which gave rise to the settlement *[practitioner list]*.
16. We inquired of the Corporate Compliance Officer as to the qualifications and experience of the trainers and were informed that, in the Corporate Compliance Officer's opinion, they were consistent with the topics presented.
17. We noted that the Company's draft Annual Report to the OIG dated *[date]* addresses certification of training.

**Confidential Disclosure Program**

18. We read documentation of the Company's Confidential Disclosure Program and noted that it—
  - a. Includes the printed effective date that was within *[number of]* days of execution of the CIA.
  - b. Consists of a confidential disclosure program enabling any employee to disclose any practices or billing procedures relating to federal health care programs.

**Procedure****Findings**

- c. Provides a toll-free telephone line maintained by the Company, which Company representatives have indicated is maintained twenty-four hours a day, seven days a week, for the purpose of making any disclosures regarding compliance with the Company's Compliance Program, the obligations in the CIA, and Company's overall compliance with federal and state standards.
  - d. Includes policies requiring the review of any disclosures to permit a determination of the appropriateness of the billing practice alleged to be involved and any corrective action to be taken to ensure that proper follow-up is conducted.
19. We made five test calls to the toll-free telephone line (hotline) and noted the following.
- a. Each call was captured in the hotline logs and reported with all other incoming calls.
  - b. Anonymity is not discouraged.
20. We noted that the Company included in its draft Annual Report addressed to OIG dated [date] a detailed summary of the communications (including the number of disclosures by employees and the dates of such disclosures) concerning billing practices reported as, and found to be, inappropriate under the Confidential Disclosure Program, and the results of any internal review and the follow-up on such disclosures.
21. We observed the display of the Company's Confidential Disclosure Program, including notice of the availability of its hotline, on the Company's premises.

**Excluded Individuals or Entities**

22. We read the Company's written policy relating to dealing with excluded or convicted persons or entities and noted that the policy—
- a. Prohibits the hiring of or contracting with an individual or entity that is listed by a federal agency as convicted of abuse or excluded, suspended, or otherwise ineligible for participation in federal health care programs.
  - b. Includes a process to make an inquiry into the status of any potential employee or independent contractor.
  - c. Provides for a semi-annual review of the status of all existing employees and contractors to verify whether any individual had been suspended or excluded or charged with a criminal offense relating to the provision of federal health care services.

**Procedure****Findings**

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23. We selected a sample of ten employees hired over the course of the test period as defined in the CIA and examined support in the employee's personnel file documenting inquiries made into the status of the employee, including documentation of comparison to the *[source specified in the CIA]*.
24. We performed the following procedures related to the Company's semi-annual review of employee status.
- a. Read documentation of the semi-annual review as evidence that a review was performed.
  - b. Selected and reviewed the lesser of ten or all exceptions and determined that such employees were removed from responsibility for or involvement with Provider business operations related to the Federal health care programs.
  - c. Examined a notification letter addressed to the OIG and dated within 30 days of the employee's removal from employment.
  - d. Inquired of *[officer]* as to whether he or she was aware of any individuals employed in contravention of the prohibitions in the CIA. If so, we further noted that *[indicate specific procedures]* to confirm that such situation was cured within 30 days by *[indicate how situation was cured]*.

**Annual Report**

25. We read the Company's draft Annual Report dated *[date]* and determined that it included the following items, to be modified as appropriate, by the practitioner:
- a. Compliance Program Charter and organization chart
  - b. Amendments to policies
  - c. Detailed descriptions of reviews and audits
  - d. Summary of hotline communications
  - e. Summary of annual review of employees
  - f. Cross-referencing to items noted in the CIA

**Record Retention**

26. We read the Company's record retention policy and noted that it was consistent with the requirements as outlined in the CIA.

## Appendix E

### Sample Report

#### Independent Accountant's Report

[Date]

[Sample Health Care Provider]

Office of Inspector General of the U.S. Department of Health and Human Services

We have performed the procedures enumerated in the Attachment, which were agreed to by Sample Health Care Provider (Company) and the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services, solely to assist the users in evaluating management's assertion about [name of entity's] compliance with the Corporate Integrity Agreement (CIA) with the OIG dated [date of CIA] for the [period] ending [date], which is included as Attachment A to this report. This agreed-upon procedures engagement was performed in accordance with standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described in Attachment B either for the purpose for which this report has been requested or for any other purpose.

We were not engaged to and did not perform an examination, the objective of which would be the expression of an opinion on management's compliance with the CIA. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the Compliance Committee and management of the Company and the OIG, and is not intended to be and should not be used by anyone other than those specified parties.

[Include as Attachments the CIA and the summary that enumerates procedures and findings.]

[Signature]

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# PB Section 12,000

## PRACTICE BULLETINS

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## Section 12,010

# **Practice Bulletin 1** **Purpose and Scope of AcSEC Practice** **Bulletins and Procedures for Their Issuance**

November, 1987

### **NOTICE TO READERS**

Practice bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under Rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

.01 The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants has decided to publish AcSEC Practice Bulletins to provide practitioners and preparers with guidance on narrow financial accounting and reporting issues. This bulletin presents background information on AcSEC Practice Bulletins and describes their purpose and scope and the procedures for issuing them.

## **Background**

.02 In 1984, AcSEC established a task force to study its role. The task force recommended, among other things, that AcSEC adopt a procedure for issuing practice bulletins as a means to make its views on narrow financial and reporting issues more easily retrievable. AcSEC has previously stated its views on such issues in notices to practitioners published in the *CPA Letter* or in the *Journal of Accountancy*.

## **Purpose and Scope**

.03 Practice bulletins are used to disseminate AcSEC's views for the purpose of providing guidance to AICPA members on narrow financial accounting and reporting issues. The guidance provided will be similar to that previously published as notices to practitioners.<sup>1</sup> The issues will be limited to those

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<sup>1</sup> Previously issued notices to practitioners that continue to be relevant and applicable are listed and reprinted without change in the appendix [paragraph .09] to this practice bulletin. Other notices to practitioners are no longer relevant or applicable, as indicated in the appendix [paragraph .09].

that have not been and are not being considered by the Financial Accounting Standards Board (FASB) or the Governmental Accounting Standards Board (GASB). The purpose of practice bulletins is to enhance the quality and comparability of financial statements.

## Procedures for Publication

**.04** Drafts of practice bulletins are discussed in open meetings of AcSEC and are available to the public as part of the agenda papers for such meetings. Practice bulletins need not be exposed for comment and are not the subject of public hearings.

**.05** A practice bulletin may be published only if—

- a.* Two-thirds of AcSEC approve publication.
- b.* The FASB and GASB have had the opportunity to review it, and each of those bodies has informed AcSEC that it has no current plans to consider the issue.

**.06** The procedures for issuing amendments of practice bulletins are the same as the procedures for issuing original practice bulletins.

**.07** Once a practice bulletin has been approved for issuance, it is distributed to all practice units and other interested parties. The bulletin includes a notice to readers that indicates that—

- a.* AcSEC is the issuing body.
- b.* The document is not covered by rule 203 of the AICPA Code of Conduct.

**.08** Practice bulletins will be numbered to facilitate reference and retrievability.

.09

## Appendix

The following notices to practitioners, first published in the *CPA Letter*, are still relevant and are reprinted in this appendix (exhibits A through I).

<u>Title</u>	<u>Date Published</u>	<u>Exhibit</u>
<i>ACRS Lives and GAAP</i>	11/23/81	A
<i>Accounting by Colleges and Universities for Compensated Absences</i>	9/13/82	B
<i>ADC Arrangements</i>	2/10/86	I

The following notices to practitioners published in the *CPA Letter* or in the *Journal of Accountancy* are no longer relevant or applicable.

<u>Title</u>	<u>Date Published</u>	<u>Comments</u>
<i>Fee Regulations</i>	3/10/80*	FASB Statement No. 91, <i>Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans</i> , now provides authoritative guidance.
<i>Accounting for Combinations of Mutual Savings and Loan Associations or Mutual Savings Banks</i>	1/11/82*	FASB Statement No. 72, <i>Accounting for Certain Acquisitions of Banking or Thrift Institutions</i> , now provides authoritative guidance.
<i>Mortgage Banking Activities</i>	6/27/83*	Superseded by the AICPA Audit and Accounting Guide <i>Banks and Savings Institutions</i> , 1996.
<i>Interest as a Holding Cost</i>	10/10/83*	Superseded by the AICPA Audit and Accounting Guide <i>Banks and Savings Institutions</i> , 1996.
<i>Certain Real Estate Lending Activities of Financial Institutions</i>	11/83†	Superseded by the 2/10/86 notice on accounting for real estate acquisition, development, and construction (ADC) arrangements.
<i>Allowance for Loan Losses, Insider Loans, and Loan Participations</i>	12/12/83*	The October 1986 Auditing Procedure Study, <i>Auditing the Allowance for Credit Losses of Banks</i> , now provides guidance.

\* Published in the *CPA Letter*.

† Published in the *Journal of Accountancy*.

<u>Title</u>	<u>Date Published</u>	<u>Comments</u>
<i>Bank Loan Disclosures</i>	12/26/83*	Superseded by the AICPA Audit and Accounting Guide <i>Banks and Savings Institutions</i> , 1996.
<i>Accounting and Disclosures for Reinsurance Transactions</i>	1/23/84*	Effectively superseded by FASB Statement No. 113, <i>Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts</i> .
<i>Accounting and Disclosure for Income Taxes of Stock Life Insurance Companies in 1983 Financial Statements</i>	1/23/84*	Applied only to financial statements in 1983.
<i>Loan Origination Fees</i>	9/24/84*	FASB Statement No. 91, <i>Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans</i> , now provides authoritative guidance.
<i>Deposit Float</i>	9/24/84*	Superseded by and incorporated into the AICPA Audit and Accounting Guide <i>Banks and Savings Institutions</i> , 1996.
<i>ADC Loans</i>	11/26/84*	Superseded by the 2/10/86 notice on ADC arrangements.
<i>Accounting for Foreign Loan Swaps</i>	5/27/85*	Superseded by and incorporated into the AICPA Audit and Accounting Guide <i>Banks and Savings Institutions</i> , 1996.

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\* Published in the CPA Letter.



## Exhibit A

**ACRS Lives and GAAP\***

The Economic Recovery Tax Act of 1981 established the Accelerated Cost Recovery System (ACRS), which replaces the depreciation system for income tax purposes. ACRS eliminates for income taxes the need to select a depreciation method and to determine each asset's useful life and salvage value. Instead of depreciation deductions permitted by prior tax laws, enterprises must now use recovery deductions in determining taxable income. The recovery deductions are determined by applying percentages specified by the law to the tax basis of the asset for a specified number of years.

The Institute's accounting standards executive committee has been asked whether the recovery deductions used for income tax purposes also may be used as depreciation expense for financial reporting.

Generally accepted accounting principles require that the cost of depreciable assets be allocated to expense over the expected useful life of the asset in a systematic and rational manner. In contrast, the recovery deductions required under ACRS were designed to encourage investment in productive assets by allowing accelerated deduction of the tax basis of an asset.

If the number of years specified by ACRS for recovery deductions for an asset does not fall within a reasonable range of the asset's useful life, the recovery deductions should not be used as depreciation expense for financial reporting. Depreciation expense in financial statements for such an asset should be determined based on the asset's useful life.

If the recovery deductions for income tax purposes differ from depreciation expense for financial reporting, deferred income taxes should be provided in financial statements for the temporary differences that result, as required by FASB Statement No. 109, *Accounting for Income Taxes*. [Revised, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

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\* Reprinted from the *CPA Letter*, November 23, 1981.

## Exhibit B

## Accounting by Colleges and Universities for Compensated Absences

FASB Statement of Financial Accounting Standards No. 43, *Accounting for Compensated Absences*, requires an employer to accrue a liability for employees' rights to receive compensation for future absences if certain conditions are met. The National Association of College and University Business Officers (NACUBO) asked the FASB to defer the applicability for Statement No. 43 to colleges and universities, which use fund accounting, until fund accounting questions have been resolved.

The board decided not to defer the applicability of Statement No. 43 to colleges and universities and indicated that the statement applies to institutions covered by the AICPA industry audit guide, *Audits of Colleges and Universities*. The audit guide states that it covers "nonprofit institutions of higher education including colleges, universities, community or junior colleges." Such an institution therefore should accrue a liability for compensated absences in accordance with Statement No. 43 following the guidance in this announcement.

AICPA members have recently asked several questions on how to apply Statement No. 43 to institutions covered by the audit guide, especially how to account for the charge when the liability is first recorded. Confusion has resulted from the publication of articles indicating that institutions were recording the liability directly in their plant funds. Research does not reveal any case in which that treatment has been followed.

Although the audit guide was published before Statement No. 43 was issued and therefore does not refer specifically to the application of the statement to those institutions, the audit guide can provide guidance on the questions.

The accounting standards executive committee recently discussed the problem and makes these observations to clarify the application of Statement No. 43 within the guidance provided by the audit guide:

- The liability and charge for compensated absences related to current and previous years should be recorded in the unrestricted current fund.
- Neither the liability nor the charge should be recorded in the plant funds.
- There has been some question as to whether a receivable and related revenue could be recorded for the portion of the liability expected to be paid from present or future state appropriations or grants and contracts for sponsored research and training programs. A receivable and related revenue should be recognized only if the receivable meets the definition of an asset in FASB Statement of Financial Accounting Concepts No. 3, *Elements of Financial Statements of Business Enterprises*. In applying the definition, the college or university should consider factors such as measurability, collectibility and legal rights and should look, for example, to entitlements under state constitutions or contracts with the federal government.

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\* Reprinted from the *CPA Letter*, September 13, 1982.

- The effect of the charge on the unrestricted current fund balance caused by recognition of such a liability may be offset in whole or in part by interfund transfers resulting in a receivable in the unrestricted current fund only if (1) unrestricted assets are available for permanent transfer and (2) payment (or settlement by other means) to the unrestricted current fund is expected within a reasonable period of time.

Exhibit C

**Mortgage Banking Activities<sup>[\*]</sup>**

[Superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

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<sup>[\*]</sup> [Footnote deleted.]

Exhibit D

**Interest as a Holding Cost<sup>[\*]</sup>**

[Superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

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[\*] [Footnote deleted.]

Exhibit E

**Bank Loan Disclosures<sup>[\*]</sup>**

[Superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

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<sup>[\*]</sup> [Footnote deleted.]

Exhibit F

**Accounting and Disclosures for Reinsurance Transactions<sup>[\*]</sup>**

[Effectively superseded by FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*.]

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<sup>[\*]</sup> [Footnote deleted.]

**Exhibit G**

**Deposit Float<sup>[\*]</sup>**

[Superseded by and incorporated into the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

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<sup>[\*]</sup> [Footnote deleted.]



Exhibit H

**Accounting for Foreign Loan Swaps<sup>[\*]</sup>**

[Superseded by and incorporated into the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

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<sup>[\*]</sup> [Footnote deleted.]

## Exhibit I

**ADC Arrangement<sup>\*</sup>**

The AICPA accounting standards executive committee (AcSEC) has prepared the following guidance on accounting for real estate acquisition, development, or construction (ADC) arrangements of financial institutions. This guidance is intended to clarify and expand upon the two Notices to Practitioners issued in November 1983 and November 1984 on this subject; accordingly, it supersedes those notices. Because practice and guidance on this matter have been the subject of debate and evolution over time, the guidance contained in this notice should be applied to ADC arrangements entered into after its issuance.

1. Financial institutions may enter into ADC arrangements in which they have virtually the same risks and potential rewards as those of owners or joint venturers. AcSEC believes that, in some instances, accounting for such arrangements as loans would not be appropriate and thus is providing this guidance in determining the proper accounting.

**Scope**

2. This notice applies only to those ADC arrangements in which the lender participates in *expected residual profit*, as further described below.

**Expected Residual Profit**

3. Expected residual profit is the amount of profit, whether called interest or another name, such as equity kicker, above a reasonable amount of interest and fees expected to be earned by the lender.

4. The extent of such profit participation and its forms may vary. An example of a simple form might be one in which the contractual interest and fees, if any, on a condominium project are considered to be at fair market rates; the expected sales prices are sufficient to cover at least principal, interest, and fees; and the lender shares in an agreed proportion, for example, 20 percent, 50 percent, or 90 percent, of any profit on sale of the units.

5. A slightly different form of arrangement may produce approximately the same result. For example, the interest rate and/or fees may be set at a level higher than in the preceding example, and the lender may receive a smaller percentage of any profit on sale of the units. Thus, a greater portion of the expected sales price is required to cover the contractual interest and/or fees, leaving a smaller amount to be allocated between the lender and the borrower. The lender's share of expected residual profit in such an arrangement may be approximately the same as in the preceding example. A different arrangement may cause the same result if the interest rate and/or fees are set at a sufficiently high level and the lender does not share in any proportion of profit on sale of the units. Another variation is one in which the lender shares in gross rents or net cash flow from a commercial project, for example, an office building or an apartment complex.

6. The profit participation agreement may or may not be part of the mortgage loan agreement. Consequently, the auditor should be aware of the

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<sup>\*</sup> Reprinted from the *CPA Letter, Special Supplement*, February 10, 1986.

possibility that such agreements may exist and should design audit procedures accordingly. Those procedures could include inquiries to, and requests for written representation from, both the lender and the borrower.

7. The accounting guidance in paragraphs 16 and 17 is based on a consideration of the following characteristics of ADC arrangements. A particular ADC arrangement may have one or more of these characteristics.

### **Characteristics of ADC Arrangements Implying Investments in Real Estate or Joint Ventures**

8. As stated in the "Scope" section, this notice applies to an ADC arrangement in which the lender participates in expected residual profit. In addition to the lender's participation in expected residual profit, the following characteristics suggest that the risks and rewards of an ADC arrangement are similar to those associated with an investment in real estate or joint venture:

- a. The financial institution agrees to provide all or substantially all necessary funds to acquire, develop, or construct the property. The borrower has title to but little or no equity in the underlying property.
- b. The financial institution funds the commitment or origination fees or both by including them in the amount of the loan.
- c. The financial institution funds all or substantially all interest and fees during the term of the loan by adding them to the loan balance.
- d. The financial institution's only security is the ADC project. The financial institution has no recourse to other assets of the borrower, and the borrower does not guarantee the debt.
- e. In order for the financial institution to recover the investment in the project, the property must be sold to independent third parties, the borrower must obtain refinancing from another source, or the property must be placed in service and generate sufficient net cash flow to service debt principal and interest.
- f. The arrangement is structured so that foreclosure during the project's development as a result of delinquency is unlikely because the borrower is not required to make any payments until the project is complete, and, therefore, the loan normally cannot become delinquent.

### **Characteristics of ADC Arrangements Implying Loans**

9. Even though the lender participates in expected residual profit, the following characteristics suggest that the risks and rewards of an ADC arrangement are similar to those associated with a loan:

- a. The lender participates in less than a majority of the expected residual profit.
- b. The borrower has an equity investment, substantial to the project, not funded by the lender. The investment may be in the form of cash payments by the borrower or contribution by the borrower of land (without considering value expected to be added by future development or construction) or other assets. The value attributed to the land or other assets should be net of encumbrances. There may be little value to assets with substantial prior liens that make foreclosure to collect less likely. Recently acquired property generally should be valued at no higher than cost.

- c. The lender has 1) recourse to substantial tangible, saleable assets of the borrower, with a determinable sales value, other than the ADC project that are not pledged as collateral under other loans; or 2) the borrower has provided an irrevocable letter of credit from a creditworthy, independent third party to the lender for a substantial amount of the loan over the entire term of the loan.
- d. A take-out commitment for the full amount of the financial institution's loans has been obtained from a creditworthy, independent third party. Take-out commitments often are conditional. If so, the conditions should be reasonable and their attainment probable.
- e. Noncancelable sales contracts or lease commitments from creditworthy, independent third parties are currently in effect that will provide sufficient net cash flow on completion of the project to service normal loan amortization, that is, principal and interest. Any associated conditions should be probable of attainment.

## Personal Guarantees

10. Some ADC arrangements include personal guarantees of the borrower and/or a third party. AcSEC believes that the existence of a personal guarantee alone rarely provides a sufficient basis for concluding that an ADC arrangement should be accounted for as a loan. In instances where the substance of the guarantee and the ability of the guarantor to perform can be reliably measured, and the guarantee covers a substantial amount of the loan, concluding that an ADC arrangement supported by a personal guarantee should be accounted for as a loan may be justified.

11. The substance of a personal guarantee depends on a) the ability of the guarantor to perform under the guarantee, b) the practicality of enforcing the guarantee in the applicable jurisdiction, and c) a demonstrated intent to enforce the guarantee.

12. Examples of personal guarantees that have the ability to perform would include those supported by liquid assets placed in escrow, pledged marketable securities, or irrevocable letters of credit from a creditworthy, independent third party[ies] in amounts sufficient to provide necessary equity support for an ADC arrangement to be considered a loan. In the absence of such support for the guarantee, the financial statements and other information of the guarantor may be considered to determine the guarantor's ability to perform. Due to the high-risk nature of many ADC arrangements, AcSEC believes financial statements that are current, complete, and include appropriate disclosures and that are reviewed or audited by independent CPAs are the most helpful in this determination.

13. Particular emphasis should be placed on the following factors when considering the financial statements of the guarantor:

- a. *Liquidity as well as net worth of the guarantor*—There should be evidence of sufficient liquidity to perform under the guarantee. There may be little substance to a personal guarantee if the guarantor's net worth consists primarily of assets pledged to secure other debt.
- b. *Guarantees provided by the guarantor to other projects*—If the financial statements do not disclose and quantify such information, inquir-

ies should be made as to other guarantees. Also, it may be appropriate to obtain written representation from the guarantor regarding other contingent liabilities.

14. The enforceability of the guarantee in the applicable jurisdiction should also be determined. Even if the guarantee is legally enforceable, business reasons that might preclude the financial institution from pursuing the guarantee should be assessed. Those business reasons could include the length of time required to enforce a personal guarantee, whether it is normal business practice in that jurisdiction to enforce guarantees on similar transactions, and whether the lender must choose between pursuing the guarantee or the project's assets, but cannot pursue both. The auditor should consider obtaining written representation from management regarding its intent to enforce personal guarantees.

## Sweat Equity

15. Some ADC arrangements recognize value, not funded by the lender, for the builder's efforts after inception of the arrangement, sometimes referred to as *sweat equity*. AcSEC believes that sweat equity is not at risk by the borrower at the inception of an ADC project. Consequently, AcSEC believes sweat equity should not be considered a substantial equity investment on the part of the borrower in determining whether the ADC arrangement should be treated as a loan.

## Accounting Guidance

16. In the interest of more uniformity in accounting for ADC arrangements, AcSEC believes the following guidance is appropriate:

- a. If the lender is expected to receive over 50 percent of the expected residual profit, as previously defined, from the project, the lender should account for income or loss from the arrangement as a real estate investment as specified by Statement of Financial Accounting Standards (SFAS) No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*,<sup>1</sup> and SFAS No. 66, *Accounting for Sales of Real Estate*.<sup>2</sup>
- b. If the lender is expected to receive 50 percent or less of the expected residual profit, the entire arrangement should be accounted for either as a loan or as a real estate joint venture, depending on the circumstances. At least one of the characteristics identified in paragraph 9, b through e, or a qualifying personal guarantee should be present for the arrangement to be accounted for as a loan. Otherwise, real estate joint venture accounting would be appropriate.
  1. In the case of a loan, interest and fees may be appropriately recognized as income subject to recoverability. Statement of Position (SOP) No. 75-2, *Accounting Practices of Real Estate Investment Trusts*,<sup>3</sup> and the AICPA Audit and Accounting Guide en-

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<sup>1</sup> Statement of Financial Accounting Standards (SFAS) No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects* (Stamford: FASB, 1982).

<sup>2</sup> SFAS No. 66, *Accounting for Sales of Real Estate* (Stamford: FASB, 1982).

<sup>3</sup> Statement of Position (SOP) No. 75-2, *Accounting Practices of Real Estate Investment Trusts* (New York: AICPA, 1975).

titled, *Banks and Savings Institutions*,<sup>[4]</sup> provide guidance that may be relevant in those industries in assessing the recoverability of such loan amounts and accrued interest.

2. In the case of a real estate joint venture, the provisions of SOP No. 78-9, *Accounting for Investments in Real Estate Ventures*,<sup>5</sup> and SFAS No. 34, *Capitalization of Interest Cost*,<sup>6</sup> as amended by SFAS No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*,<sup>7</sup> provide guidance for such accounting. In particular, paragraph 34 of SOP No. 78-9 provides guidance on the circumstances under which interest income should not be recognized.

17. ADC arrangements accounted for as investments in real estate or joint ventures should be combined and reported in the balance sheet separately from those ADC arrangements accounted for as loans.

## Other Considerations

18. Transactions have occurred in which the lender's share of the expected residual profit in a project is sold to the borrower or a third party for cash or other consideration. If the expected residual profit in an ADC arrangement accounted for as a loan is sold, AcSEC believes the proceeds from the sale should be recognized prospectively as additional interest over the remaining term of the loan. The expected residual profit is considered additional compensation to the lender, and the sale results in a quantification of the profit. When an ADC arrangement is accounted for as an investment in real estate or joint venture and the expected residual profit is sold, gain recognition, if any, is appropriate only if the criteria of SFAS No. 66 are met after giving consideration to the entire ADC arrangement including the continuing relationship between the financial institution and the project.

19. If the financial institution was the seller of the property at the initiation of the project, gain recognition, if any, should be determined by reference to SFAS No. 66.

20. The factors that were evaluated in determining the accounting treatment at inception subsequently change for some ADC arrangements, for example, as a result of a renegotiation of the terms. Consequently, the accounting treatment for an ADC arrangement should be periodically reassessed. An ADC arrangement originally classified as an investment or joint venture could subsequently be treated as a loan if the risk to the lender diminishes significantly, and the lender will not be receiving over 50 percent of the expected residual profit in the project. The lender must demonstrate a change in the facts relied upon when initially making the accounting decision, not just the absence of, or reduced participation in, the expected residual profit. For instance, risk may be reduced if a valid take-out commitment from another lender who has the capability to perform under the commitment is obtained and all conditions affecting the take-out have been met, thus assuring the primary lender recovery

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<sup>[4]</sup> [Footnote deleted.]

<sup>5</sup> SOP No. 78-9, *Accounting for Investments in Real Estate Ventures* (New York: AICPA, 1978).

<sup>6</sup> SFAS No. 34, *Capitalization of Interest Cost* (Stamford: FASB, 1979).

<sup>7</sup> SFAS No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method* (Stamford: FASB, 1982).

of its funds. If the lender on the other hand assumes further risks and/or rewards in an ADC arrangement by, for example, releasing collateral supporting a guarantee and/or increasing its percentage of profit participation to over 50 percent, the lender's position may change to that of an investor in real estate. Neither an improvement in the economic prospects for the project or successful, on-going development of the project nor a deterioration in the economic prospects for the project justifies a change in classification of an ADC arrangement. A change in classification is expected to occur infrequently and should be supported by appropriate documentation. The change in factors in an ADC arrangement should be evaluated based on the guidance in this notice and accounted for prospectively.

**21.** If an ADC arrangement accounted for as a real estate joint venture continues into a permanent phase with the project generating a positive cash flow and paying debt service currently, income should be recognized in accordance with SOP No. 78-9.

**22.** Regardless of the accounting treatment for an ADC arrangement, management has a continuing responsibility to review the collectibility of uncollected principal, accrued interest, and fees and provide for appropriate allowances. The auditor should determine whether the allowances provided by management are adequate. In connection with this determination, the auditor should review relevant evidential matter including feasibility studies, appraisals, forecasts, non-cancelable sales contracts or lease commitments and information concerning the track record of the developer. In addition, ADC arrangements may involve related parties and the auditor should be aware of such a possibility and design procedures accordingly. Progress information may be less than desirable for the auditor's purpose and may require supplemental procedures. Additional procedures might include on-site inspection of projects or the independent use of experts such as property appraisers or construction consultants to assist in the assessment of the collateral value.

**23.** Many participations in loans or whole loans are bought and sold by other financial institutions. The accounting treatment for a purchase that involves ADC arrangements should be based on a review of the transaction at the time of purchase in accordance with the guidance in this notice. In applying this guidance, a participant would look to its individual percentage of expected residual profit; for example, a participant who will not share in any of the expected residual profit is not subject to this notice. However, the responsibility to review collectibility and provide allowances applies equally to purchased ADC arrangements. Any reciprocal transactions between institutions, including multi-party transactions, should be viewed in their entirety and accounted for in accordance with their combined effects.

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**Section 12,020****Practice Bulletin 2**  
**Elimination of Profits Resulting From**  
**Intercompany Transfers of LIFO Inventories****November, 1987****NOTICE TO READERS**

Practice bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

**.01** The Accounting Standards Executive Committee (AcSEC) believes it is desirable to issue a reminder concerning inventory transfers between or from LIFO (last in, first out) pools, either within a company or between subsidiaries or divisions of a reporting entity, particularly if a LIFO inventory liquidation has occurred in any transferring LIFO pool during the year.<sup>1</sup>

**.02** A LIFO liquidation (also called a decrement) occurs when the number of units (or total base year cost if dollar value LIFO is used) in a LIFO pool at year end is less than that at the beginning of the year, causing prior years' costs, rather than current year's costs, to be charged to current year's income. For example, in periods of rising prices, prior years' costs are less than current year's costs and, in such periods, charging prior years' costs to current year's income results in reporting current year's net income higher than it would be reported without a liquidation.

**.03** Accounting for a LIFO liquidation is more complex with intercompany transfers of inventories. Accounting Research Bulletin (ARB) 51, *Consolidated Financial Statements*, states that "the purpose of consolidated financial statements is to present . . . the results of operations and the financial position of the parent company and its subsidiaries essentially as if the group were a single company with one or more branches." Under ARB 51, intercompany pro-

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<sup>1</sup> This subject was identified in paragraph 3-2 of AcSEC's November 30, 1984, issues paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories*.

fit on assets remaining within the group should be eliminated.<sup>2</sup> Results of operations and financial position, therefore, should not be affected solely because of inventory transfers within a reporting entity. Inventory transferred between or from LIFO pools may cause LIFO inventory liquidations which could affect the amount of intercompany profit to be eliminated.

.04 Many different approaches are used by entities in eliminating such profit. AcSEC believes that each reporting entity should adopt an approach that, if consistently applied, defers reporting intercompany profits from transfers within a reporting entity until such profits are realized by the reporting entity through dispositions outside the consolidated group. The approach should be suited to the entity's individual circumstances.

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<sup>2</sup> APB Opinion 18, *The Equity Method of Accounting for Investments in Common Stock*, also requires elimination of a portion of intercompany profit.

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## Section 12,040

**Practice Bulletin 4**  
**Accounting for Foreign Debt/Equity Swaps**

May, 1988

**NOTICE TO READERS**

Practice Bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under Rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

.01 The Accounting Standards Executive Committee and the Banking Committee of the American Institute of Certified Public Accountants (AICPA) have considered the accounting treatment by financial institutions for exchanges of their public or private sector loans to debtors in financially troubled countries for equity investments in companies in the same countries. These transactions are generally referred to as *debt/equity swaps*. As a result of these deliberations, the committees have prepared the following guidance, based on existing authoritative accounting literature, for financial institutions and independent auditors.

.02 Debt/equity swap programs are in place in several financially troubled countries. Although the programs differ somewhat among the countries, the principal elements of each program generally are as follows. Holders of U.S. dollar-denominated debt of these countries can choose to convert that debt into approved local equity investments. The holders are credited with local currency, at the official exchange rate, approximately equal to the U.S. dollar debt. A discount from the official exchange rate is usually imposed as a transaction fee. The local currency credited to the holder must be used for an approved equity investment. The local currency is not available to the holders for any other purpose. Dividends on the equity investment can generally be paid annually, although there may be restrictions on the amounts of the dividends or on payment of dividends in the early years of the investment. Capital usually cannot be repatriated for several years, and although some countries permit the investment to be sold, the proceeds from any such sale are generally subject to similar repatriation restrictions.

.03 A debt/equity swap is an exchange transaction of a monetary for a nonmonetary asset, which should be measured at fair value at the date the transaction is agreed to by both parties. (See paragraph .11 for a discussion of loss recoveries or gains.)

.04 There is a significant amount of precedent in the accounting for exchange transactions to consider both the fair value of the consideration given up as well as the fair value of the assets received in arriving at the most informed valuation—especially if the value of the consideration given up is not readily determinable or may not be a good indicator of the value received. For example, in acquisitions involving consideration in the form of stock, an examination of the value of the net assets received is often considered necessary if the stock is thinly traded or restricted.

.05 APB Opinion 16, *Business Combinations*, deals with the acquisition of assets (paragraph 67) and with determining the cost of an acquired company (paragraphs 72-75). In summary, paragraph 67 states that assets acquired should be recorded based on the fair value of assets exchanged, liabilities incurred, or stock issued, unless the fair value of the assets received is more clearly determinable ("cost may be determined either by fair value of consideration given up or by fair value of property acquired, whichever is the more clearly evident"). Paragraph 72 states that the same accounting principles apply to determining the cost of assets acquired individually, those acquired in a group, and those acquired in business combinations. APB Opinion 29, *Accounting for Nonmonetary Transactions*, paragraph 18, provides similar guidance.

.06 FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, deals with the receipt of assets in satisfaction of a loan and, in paragraph 28, states that a creditor shall account for assets received (including an equity interest) at their fair value at the time of the restructuring, unless the fair value of the receivable satisfied is more clearly evident.

.07 Debt/equity swaps have characteristics similar to both the acquisition of assets contemplated by APB Opinions 16 and 29 and the receipt of assets in satisfaction of a loan contemplated by FASB Statement No. 15. Since the secondary market for debt of financially troubled countries is presently considered to be thin, it may not be the best indicator of the value of the equity investment or of net assets received. In light of this thin secondary market and of the unique nature of the transaction, it is also necessary to examine the value of the equity investment or net assets received. The committees therefore believe that in arriving at the fair value of a debt/equity swap, both the secondary market price of the loan given up and the fair value of the equity investment or net assets received should be considered. It is the responsibility of management to make the valuation considering all of the circumstances. It is the responsibility of independent auditors to become satisfied that the valuation is based on reasonable methods and assumptions, including, as needed, information from independent appraisals. Factors to consider in determining current fair values include the following:

- Similar transactions for cash
- Estimated cash flows from the equity investment or net assets received
- Market value, if any, of similar equity investments
- Currency restrictions, if any, affecting dividends, the sale of the investment, or the repatriation of capital

**.08** In accordance with generally accepted accounting principles, a financial institution's loan portfolio should be carried at amortized historical cost less both loan write-offs and the allowance for loan losses, as long as the financial institution has the ability and intent to hold the loans until their maturity. Management may decide to dispose (by sale of swap) of loans prior to maturity for a number of reasons, including liquidity needs, tax considerations, portfolio diversification objectives, and management practices of generating loans specifically for disposition, in which case the loans should be carried at the lower of cost (amortized historical cost less loan write-offs) or fair value.

**.09** If the fair value of the equity investment or net assets received in a debt/equity swap is less than the recorded investment in the loan, the committees believe that a loss should be recognized and recorded at the date the transaction is agreed to by both parties. Although some portion of the swap loss may result from factors such as a change in the interest rate environment for similar loans, the committees believe that the loss results principally from a concern as to the ultimate collectibility of the loan. Therefore, the swap loss generally should be charged to the allowance for loan losses and should include any discounts from the official exchange rate that are imposed as a transaction fee.

**.10** All other fees and transaction costs involved in a debt/equity swap should not be capitalized but should be charged to expense as incurred.

**.11** Loss recoveries or even gains might be indicated in a swap transaction as a result of the valuation process. However, due to the subjective nature of the valuation process, the committees believe that such loss recoveries or gains ordinarily should not be recorded until the equity investment or net assets received in the swap transaction are realized in unrestricted cash or cash equivalents.

**.12** In addition to recording specific transactions during an accounting period, a financial institution, in the course of preparing its financial statements, should review its loan portfolio in order to assess the adequacy of the allowance for loan losses. Allowances are established and write-offs taken based on management's judgment regarding ultimate collectibility of the loans in the normal course of business. Recognition of a debt/equity swap loss should be among the factors to be considered by management in its periodic assessment of the adequacy of the allowance for loan losses with respect to its remaining portfolio of loans to debtors in financially troubled countries.

**.13** The committees recommend that the guidance in this practice bulletin be adopted upon issuance.

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**Section 12,050****Practice Bulletin 5**  
**Income Recognition on Loans to Financially Troubled Countries**

July, 1988

**NOTICE TO READERS**

Practice Bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under Rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

**.01** Loans to financially troubled countries (LDC loans) of many banks currently meet the conditions in paragraph 8 of FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, for accrual of loss contingencies. As a result, those banks should have established loan loss allowances for their LDC loans by charges to income.

**.02** A financially troubled country may suspend the payment of interest on its loans. Banks with outstanding loans from such a country have also suspended accrual of interest income (placed them on nonaccrual status).

**.03** A country that has suspended payment of interest may later resume payment. Guidance on accounting by a creditor for the receipt of interest payments from a debtor that had previously suspended payment, on pages 51 and 52 in the industry audit guide *Audits of Banks* (2nd ed. [1983]) published by the Institute, is as follows:

Many banks suspend accrual of interest income on loans when the payment of interest has become delinquent or collection of the principal has become doubtful. Such action is prudent and appropriate. Regulatory reporting guidelines for nonaccrual loans have been established by federal supervisory agencies.

Although placing a loan in a nonaccrual status, including loans accruing at a reduced rate, does not necessarily indicate that the principal of the loan is uncollectible in whole or in part, it generally warrants reevaluation of collectibility of principal and previously accrued interest. If amounts are received on a loan on which the accrual of interest has been suspended, a determination should be made about whether the payment received should be recorded as a reduction of the principal balance or as interest income.

If the ultimate collectibility of principal, wholly or partially, is in doubt, any payment received on a loan on which the accrual of interest has been suspended should be applied to reduce principal to the extent necessary to eliminate such doubt.

.04 At issue is whether this guidance means that the creditor should credit receipt of renewed interest payments to the principal balance of the loan or to income.

## Interpretation

.05 The Accounting Standards Executive Committee and the Committee on Banking agree on the interpretation of that section of the guide as set forth in paragraph .07 of this practice bulletin.

[.06] [Effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*.]

.07 When a country becomes current as to principal and interest payments and has normalized relations with the international financial community including, as appropriate, having in place an understanding with the International Monetary Fund regarding its economic stabilization program, and assuming that the allowance for loan losses is adequate, the creditor may recognize receipt of interest payments as income.

.08 Although a country has met the conditions described in paragraph .07, that should not automatically lead to the conclusion that the loans should be returned to accrual status. Some period of payment performance generally is necessary in order to make an assessment of collectibility that would permit returning the loans to accrual status.

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**Section 12,060****Practice Bulletin 6**  
**Amortization of Discounts on Certain**  
**Acquired Loans****August, 1989****NOTICE TO READERS**

Practice Bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under Rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

.01 The Accounting Standards Executive Committee (AcSEC) has prepared the following guidance, based on existing authoritative literature, regarding amortization of discounts on certain acquired loans for which there is uncertainty as to the amounts or timing of future cash flows.

**Scope**

.02 This practice bulletin addresses the accounting and reporting by purchasers of loans (1) that are acquired in a purchase business combination, bought at a discount from face value in a transaction other than a business combination, or transferred to a newly created subsidiary after having been written down to fair value with the intent of transferring the stock of the subsidiary as a dividend to the shareholders of the parent company and (2) for which it is not probable that the undiscounted future cash collections will be sufficient to recover the face amount of the loan and contractual interest.

.03 This practice bulletin applies to loans and other debt securities, such as corporate or governmental bonds, notes, and loan-backed securities, such as pass-through certificates, collateralized mortgage obligations, and other so-called securitized loans. For convenience, those other debt securities are hereinafter referred to as *loans*. It does not apply to loans that are carried at market values or at the lower of cost or market, nor does it apply to loans held by liquidating banks.<sup>1</sup> Enterprises that acquire loans primarily for the rewards of ownership of the underlying nonmonetary collateral should record the collateral rather than the loan. Accordingly, this practice bulletin does not apply

<sup>1</sup> Financial reporting by liquidating banks is dealt with in the minutes of the FASB's Emerging Issues Task Force for Issue 88-25, "Ongoing Accounting and Reporting for a Newly Created Liquidating Bank."

to such transactions. SEC Financial Reporting Release No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities*, and the February 10, 1986, notice to practitioners on ADC arrangements, reprinted in AcSEC Practice Bulletin 1 [section 12,010], may be helpful in determining whether a loan was acquired for that purpose.

## Background

.04 Loans may be acquired at discounts from their face amounts. The discounts normally are amortized with corresponding increases in income over the estimated or contractual lives of the loans. APB Opinion 21, *Interest on Receivables and Payables*, describes the accounting for originated loans:

*Note received or issued for cash.* The total amount of interest during the entire period of a cash loan is generally measured by the difference between the actual amount of cash received by the borrower and the total amount agreed to be repaid to the lender. Frequently, the stated or coupon interest rate differs from the prevailing rate applicable to similar notes, and the proceeds of the note differ from its face amount. As the Appendix to this Opinion demonstrates, such differences are related to differences between the present value upon issuance and the face amount of the note. The difference between the face amount and the proceeds upon issuance is shown as either discount or premium, which is amortized over the life of the note. (paragraph 6)

.05 APB Opinion 16, *Business Combinations*, gives general guidance for assigning amounts to loans acquired in a purchase business combination:

Receivables [should be recorded] at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary. (paragraph 88[b])

.06 FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, describes the accounting for loans purchased at discounts:

The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. (paragraph 15)

Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest. (paragraph 17)

Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in paragraph 20. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization. (paragraph 18)

.07 The FASB's Emerging Issues Task Force's minutes for Issue 87-17 addressed accounting for spin-offs and other distributions of loans receivable to shareholders and relied in part on APB Opinion 29, *Accounting for Non-monetary Transactions*:

Other nonreciprocal transfers of nonmonetary assets to owners should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution. (paragraph 23)

The Emerging Issues Task Force minutes state:

An enterprise distributes loans receivable to its owners by forming a subsidiary and transferring those loans receivable to the subsidiary and then distributing the stock of that subsidiary to shareholders of the parent. If the book value of the loans receivable, which may be either the "recorded investment in the receivable" or the "carrying amount of the receivable," is in excess of their fair value, the accounting issue is whether the enterprise should report the distribution at book value as a spin-off or at fair value as a dividend-in-kind and how the recipient should record the transaction.

The Task Force reached a consensus that the assets should be reported at fair value by the enterprise and the recipient. Task Force members noted that the transaction is not a spin-off because the subsidiary is not an operating company. Rather, the transaction may be considered a dividend-in-kind. Under paragraph 23 of APB Opinion 29, *Accounting for Nonmonetary Transactions*, dividends-in-kind are nonreciprocal transfers of nonmonetary assets to owners that should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would clearly be realizable to the distributing entity in an outright sale at or near the time of distribution.

.08 SEC Staff Accounting Bulletin (SAB) No. 61, *Adjustments of Allowances for Business Combination Loan Losses—Purchase Method Accounting*, states that the allowance for credit losses related to loans acquired by a bank in a purchase business combination should be the same as the allowance provided for those loans by the acquired bank unless the acquiring bank's plans for the ultimate recovery of those loans differ from the plans that served as the basis for the acquired bank's estimation of losses on those loans.

.09 SAB No. 61 states that if the acquired bank's financial statements as of the acquisition date are not fairly stated because of an unreasonable allowance for credit losses, the acquired bank's preacquisition financial statements should be restated to reflect a reasonable allowance, with the resulting adjustment applied to the restated preacquisition income statement of the acquired bank; the allowance for credit losses may not be changed through a purchase accounting adjustment.

.10 *Audits of Banks* (2nd ed. [1983], pp. 51 and 52), an AICPA industry audit guide, includes guidance on the suspension of the accrual of interest income on loans and the subsequent treatment of amounts received on those loans:

Many banks suspend accrual of interest income on loans when the payment of interest has become delinquent or collection of the principal has become doubtful. Such action is prudent and appropriate. Regulatory reporting guidelines for nonaccrual loans have been established by federal supervisory agencies.

Although placing a loan in nonaccrual status, including loans accruing at a reduced rate, does not necessarily indicate that the principal of the loan is uncollectible in whole or in part, it generally warrants reevaluation of collectibility of principal and previously accrued interest. If amounts are received on a loan on which the accrual of interest has been suspended, a determination should be made about whether the payment received should be recorded as a reduction of the principal balance or as interest income.

If the ultimate collectibility of principal, wholly or partially, is in doubt, any payment received on a loan on which the accrual of interest has been suspended should be applied to reduce principal to the extent necessary to eliminate such doubt.

.11 *Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)*, an AICPA industry audit and accounting guide, also includes guidance on the suspension of the accrual of interest income on loans:

A finance company's revenues from loans should be accrued over time in accordance with the terms of the contracts using the interest (actuarial) method. Even if collections are not timely, the amounts at which assets are recorded in the form of receivables generally should continue to increase. If collection is not probable, however, continuing to accrue income would not reflect economic substance. Accruals or amortization of discount and, in accordance with FASB Statement No. 91, paragraph 17, amortization of deferred net fees or costs should therefore be suspended if collectibility of interest or principal is not probable. The following are examples of events that could cause such uncertainty on consumer loans:

- a. The borrower is in default under the terms of the loan agreement, and interest or principal payments are past due (often a stipulated number of days past due as established in company policies).
- b. The ability of the borrower to repay is in doubt because of events such as a loss of employment or bankruptcy.
- c. The loan terms have been renegotiated.

Identifying commercial loans on which interest should be suspended is, at least mechanically, more difficult because, unlike consumer loans, commercial loans usually lack homogeneous characteristics. In addition to the factors described above, considerations may include whether—

- a. Significant unsecured balances are due from debtors suffering continued operating losses.
- b. The financial condition of the debtor is weak.
- c. The outlook for the debtor's industry is unfavorable.
- d. The ratio of collateral values to loans has decreased because of changes in market conditions.
- e. A portion of the unpaid principal or accrued interest has been written off.

When recognition of interest has been suspended, interest income that has accrued on such loans should not be reversed even though receipt of those amounts may not be forthcoming. The potential uncollectibility of such amounts should be taken into consideration in the computation of the allowance for losses.

Accrual of interest generally should not be resumed until future collectibility of the loan and accrued interest becomes probable. Determining future collectibility is a matter of judgment that depends on considerations such as—

- Whether the customer has resumed making regular payments for a certain number of installments.
- Whether the reason for the customer's delinquency has been eliminated (such as reemployment of a consumer borrower or an improved economic outlook for a commercial borrower) or was an isolated circumstance unlikely to recur.



- Whether there are any other substantive indications of the customer's regaining an ability to repay the loan. (2d ed., rev., pp. 14-15)

.12 Some entities have amortized the discounts, or portions of the discounts, on certain acquired loans, with corresponding increases in income, over the estimated or contractual lives of the loans. The effect of such amortization has been to produce higher reported rates of return on loans that, before acquisition, yielded lower reported rates of return or no reported returns, despite the fact that the acquisition had no effect on the quality of the loans. AcSEC has concluded that it should examine the accounting in such circumstances.

## Accounting Guidance

### Date of Acquisition

.13 At the time of acquisition, the sum of the acquisition amount of the loan and the discount to be amortized should not exceed the undiscounted future cash collections that are both reasonably estimable and probable.<sup>2</sup> The discount on an acquired loan should be amortized over the period in which the payments are probable of collection only if the amounts and timing of collections, whether characterized as interest or principal, are reasonably estimable and the ultimate collectibility of the acquisition amount of the loan and the discount is probable. If these criteria are not satisfied, the loan should be accounted for using the cost-recovery method (see paragraphs .16 and .17).

.14 If at the date of acquisition it is known that interest income on a particular loan is not being recognized by the seller because of concerns about the collectibility of the loan principal or interest, it should be presumed that the loan does not meet the criteria in paragraph .13. That presumption may be overcome if the acquirer's assessment of factors affecting collectibility, such as those discussed in paragraph .18, strongly indicate that collection of the acquisition amount and the discount is probable and the amounts and timing of collections are reasonably estimable. In accordance with FASB Statement No. 91, discounts should be amortized using the interest method.

### Subsequent to the Date of Acquisition

.15 Collectibility should continue to be evaluated throughout the life of the acquired loan. If, upon evaluation—

- The estimate of the total probable collections is increased or decreased but is still greater than the sum of the acquisition amount less collections plus the discount amortized to date and it is probable that collection will occur, the amount of the discount to be amortized should be adjusted accordingly. The adjustment should be accounted for as a change in estimate in accordance with APB Opinion 20, *Accounting Changes*, and the amount of periodic amortization adjusted over the remaining life of the loan.

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<sup>2</sup> FASB Statement No. 91 states that the difference between the acquisition amount of the loan and the principal amount should be recognized as an adjustment of yield over the life of the loan. Statement No. 91 provides accounting guidance for loans acquired at a discount because of net origination fees and costs and differences between prevailing interest rates on the date of origination and the date of acquisition. This practice bulletin addresses amortization of discounts on acquired loans that reflect impairment of the borrowers' credit.

- The estimate of amounts probable of collection is reduced and *it is less than the acquisition amount less collections plus the discount amortized to date*, amortization should cease, and either the loan should be written down or an allowance for uncollectibility relating to that loan should be recognized.
- It is not possible to estimate the amount and timing of collection, amortization should cease, and the cost-recovery method should be used as described in paragraph .17 below.
- It is determined that collection is less than probable, amortization should cease, either the loan should be written down or an allowance for uncollectibility related to that loan should be recognized, and the cost-recovery method should be used as described in paragraph .17 below.
- It is determined that the loan is held primarily for the rewards of ownership of the underlying nonmonetary collateral, the collateral should be accounted for in accordance with the guidance on ADC arrangements in AcSEC Practice Bulletin 1 [section 12,010].

### Cost-Recovery Method

.16 Application of the cost-recovery method requires that any amounts received be applied first against the recorded amount of the loan; when that amount has been reduced to zero, any additional amounts received are recognized as income.

.17 The cost-recovery method should be used until it is determined that the amount and timing of collections are reasonably estimable and collection is probable. If the remaining amount that is probable of collection is less than the sum of the acquisition amount less collections and the discount amortized to date, then either the loan should be written down or an allowance for uncollectibility related to that loan should be recognized. If the remaining amount that is probable of collection is greater than that sum, then the difference between that sum and the revised amount that is probable of collection should be amortized on a prospective basis over the remaining life of the loan.

### Collectibility

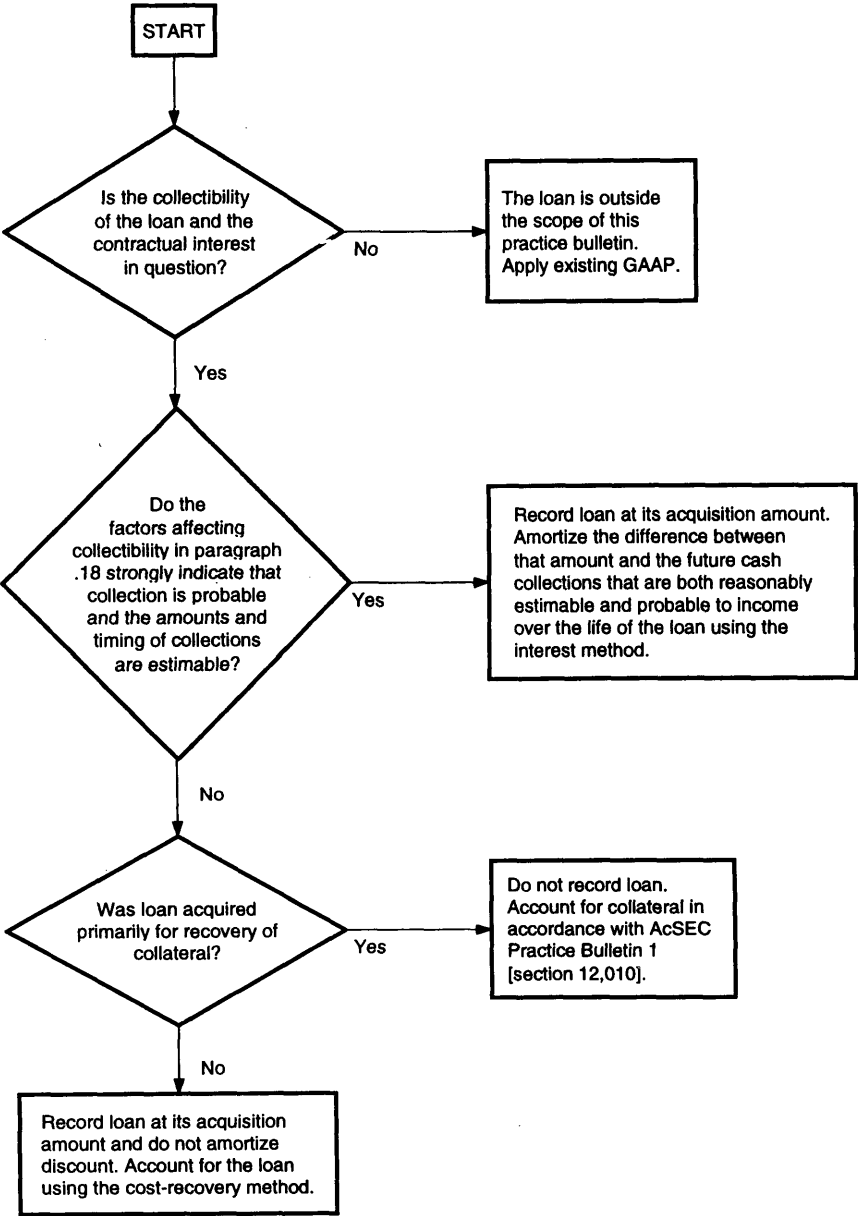
.18 Whether the acquisition amount of an acquired loan less collections and the discount amortized to date are collectible is a matter of judgment. Some of the factors that should be considered in assessing collectibility include—

- a. The financial condition of the borrower.
- b. A substantial equity of the borrower in the collateral underlying the loan that is *not* funded by the lender. This may reflect, to some extent, the borrower's commitment to pay the loan.
- c. Historical cash flows from the acquired loan.
- d. The prospect of near-term cash flows from the acquired loan.
- e. Irrevocable letters of credit, enforceable personal guarantees, or takeout commitments from creditworthy parties. (The guidance on ADC arrangements in AcSEC Practice Bulletin 1 [section 12,010], may be useful in evaluating these items.)

- f.* The nature of any asset underlying the loan and the probability that it will generate sufficient future cash flows to cover future principal and interest payments when due (for example, the forecasted earnings of a commercial property that are expected to cover future principal and interest payments on a loan).

Appendix A

Accounting at the Date of Acquisition



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## Appendix B

### Illustrations of the Application of the Practice Bulletin

These illustrations are provided to assist in the interpretation of the principles set forth in this practice bulletin. They are not intended to provide guidance on whether the transactions should be accounted for as in-substance foreclosures.

#### **Illustration 1**

Z acquires a loan that is thirty days past due. Shortly after acquisition, the loan becomes current; collection of principal and interest is probable and the amounts and timing are reasonably estimable.

#### **Task Force's Conclusion:**

The discount should be amortized.

#### **Illustration 2**

Z acquires a loan that is thirty days past due. The loan is restructured with no loss recognized on the restructuring.

#### **Additional Assumptions—A**

The loan was restructured to pay no interest. Principal is to be paid in periodic installments, and it is probable that all of the principal will be collected.

#### **Task Force's Conclusion:**

The discount should be amortized, because the amount and timing of the cash flows that are probable of collection suggest that the presumption in paragraph .14 that the loan does not meet the criteria for amortization of discounts has been overcome.

#### **Additional Assumptions—B**

The loan was restructured to pay 4-percent interest, an amount less than the market rate and the original contractual rate. The original contractual principal payments continue to be made. The loan is not fully amortizing; that is, a substantial balloon payment will be required at maturity.

#### **Task Force's Conclusion:**

Due to the significance of the balloon payment, sole reliance on the payment as a basis for overcoming the presumption in paragraph .14 that the loan does not meet the criteria for amortization of discounts is not appropriate. Other evidence that supports the probability of collection would have to be assessed.

#### **Additional Assumptions—C**

Same assumptions as in B, except that the original contractual principal payments have been reduced and, consequently, a larger balloon payment will be required at maturity. (The new periodic payment is based on an amortization schedule longer than the term of the loan.)

#### **Task Force's Conclusion:**

The discount should not be amortized.

**Additional Assumptions—D**

The loan was restructured to pay no interest; principal is to be paid in a single amount at maturity.

**Task Force's Conclusion:**

The discount should not be amortized.

**Illustration 3**

Z acquires a loan that is thirty days past due at acquisition and begins to accrue interest income receivable and amortize the discount. The loan becomes ninety days past due, and Z stops accruing interest.

**Task Force's Conclusion:**

Amortization of the discount should stop.

**Illustration 4**

Z acquires a loan that is thirty days past due at acquisition. The amount and timing of the future payments are reasonably estimable, and the amount is probable of collection. Z begins to accrue interest income receivable and amortize the discount. The borrower makes all subsequent required payments but does not bring the loan current—that is, the borrower does not make the missed payment.

**Task Force's Conclusion:**

The discount should continue to be amortized.

**Illustration 5**

Z acquires a loan on which the borrower is making the contractual interest payments when due. The entire principal is due in a lump sum at maturity. Z believes repayment of some of the principal is probable, but repayment of the remainder is less than probable.

**Task Force's Conclusion:**

The discount, that is, the difference between the acquisition amount and the sum of the part of the principal and interest payments that are reasonably estimable and probable of collection, should be amortized to income over the life of the loan using the interest method. If the estimate of the amount that is probable of collection is revised, the periodic amortization should be adjusted accordingly.

**Illustration 6**

Y, an acquired bank, had a loan that originally paid 12-percent interest and that was secured by cash flows from a producing oil well. The well had proven reserves and the collateral coverage was 125 percent of the loan based on net cash flows [oil produced X market price of oil— cost to produce].

The price of oil subsequently decreased. Y agreed to accept reduced interest payments in a troubled debt restructuring, because estimates of cash flows at that time indicated that the loan principal plus 4-percent interest would be repaid. The borrower will continue to operate the well, and it is reasonably possible that cash flows of the borrower from additional sources would become available to the bank.

Z acquired Y in a purchase business combination and, in accordance with APB Opinion 16, recorded the loan "at present values of amounts to be received determined at appropriate current interest rates." Z believes that the amount and timing of the cash flows are reasonably estimable and the amount is probable of collection.

### **Task Force's Conclusion:**

Z should amortize the discount because the cash flows are probable. However, amortization of the discount should stop if the price of oil drops further such that the probability of collection becomes uncertain.

### **Illustration 7**

Acquiree bank has a \$1,000,000 construction loan at 10-percent interest that was due on September 30, 1988. A takeout commitment on the loan was not honored, and the borrower continues to seek refinancing. The current market rate considering the creditworthiness of the borrower is 12 percent for a mortgage loan. Acquirer bank is acquiring Acquiree bank on December 31, 1988, at which time the loan is ninety days past due and interest is not being accrued. Acquirer bank is willing to renegotiate the loan so that it pays out. The borrower will operate the property, and it is reasonably possible that cash flows of the borrower from additional sources would become available to Acquirer bank.

### **Additional Assumptions—A**

The property is leased under long-term leases. It is probable that the borrower will pay \$10,000 a month from cash flow from the property. Over eighteen years and nine months that amount would repay all principal and contractual interest on the loan (approximately \$2,250,000).

### **Task Force's Conclusion:**

Acquirer bank should discount \$2,250,000 at 12 percent and amortize the resulting discount to income, because the future cash collections are both reasonably estimable and probable.

### **Additional Assumptions—B**

The property is 25 percent leased under long-term leases. It is probable that the borrower will pay \$5,000 a month from cash flow from the property. Over twenty-five years (the estimated useful life of the property) that amount (\$1,500,000) would not repay all principal and interest on the loan.

### **Task Force's Conclusion:**

Acquirer bank should discount \$1,500,000 at 12 percent and amortize the resulting discount to income, because the future cash collections totaling that amount are both reasonably estimable and probable.

### **Additional Assumptions—C**

The property is not leased, and the borrower is unable to determine when payments can be made.

**Task Force's Conclusion:**

Acquirer bank would record the loan at the fair value of the note and account for it using the cost-recovery method. (If the Acquirer bank expects to obtain repayment of the loan through foreclosure of the underlying collateral, the collateral should be accounted for in accordance with AcSEC Practice Bulletin 1 [section 12,010].)



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## Section 12,080

### **Practice Bulletin 8** **Application of FASB Statement No. 97,** **Accounting and Reporting by Insurance** **Enterprises for Certain Long-Duration** **Contracts and for Realized Gains and** **Losses From the Sale of Investments, to** **Insurance Enterprises**

November, 1990

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.01 This practice bulletin provides guidance, in the form of questions and answers, for insurance enterprises regarding the application of Financial Accounting Standards Board (FASB) Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*.

### **Acquisition Costs**

.02 *Question 1:* Is the definition of capitalized acquisition costs for investment contracts and universal life-type contracts under FASB Statement No. 97 the same as the definition under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*?

.03 FASB Statement No. 60, paragraph 28, defines acquisition costs as "those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts."

.04 *Answer 1:* Yes. However, FASB Statement No. 97, paragraph 24, specifies that certain acquisition costs should not be capitalized, but instead should be considered as maintenance and other period costs that are expensed as incurred, as follows:

Acquisition costs that vary in a constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount from period to period, shall be charged to expense in the period incurred.

.05 Certain acquisition costs have been excluded because, under FASB Statement No. 97, capitalized acquisition costs for universal life-type contracts and investment contracts ordinarily are amortized in relation to estimated gross profits, whereas under FASB Statement No. 60, capitalized acquisition costs are amortized in proportion to premium revenue recognized. Costs such as recurring premium taxes and ultimate level commissions, which vary with premium revenue, are effectively charged to expense in the periods incurred.

.06 *Question 2:* What method should be used for amortizing deferred policy acquisition costs (DPAC) incurred on investment contracts?

.07 *Answer 2:* The amortization method described in FASB Statement No. 97 for universal life-type contracts should be used for investment contracts that include significant surrender charges or that yield significant revenues from sources other than the investment of contract holders' funds. This method matches the amortization of DPAC with the recognition of gross profits. Otherwise, DPAC on investment contracts should be amortized using an accounting method that recognizes acquisition and interest costs as expenses at a constant rate applied to net policy liabilities and that is consistent with the interest method under FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases* (interest method).

.08 Under both the FASB Statement No. 97 amortization method and the interest method, assumptions used should be updated to be consistent with the concepts underlying the method used:

- Under the FASB Statement No. 97 amortization method, assumptions should be updated in compliance with paragraph 25 of FASB Statement No. 97, which states that "estimates of expected gross profit used as a basis for amortization shall be evaluated regularly, and the total amortization recorded to date shall be adjusted by a charge or credit to the statement of earnings if actual experience or other evidence suggests that earlier estimates should be revised."
- Under the interest method, the incidence of surrenders (if they are probable and can be reasonably estimated) can be anticipated for purposes of determining the amortization period. The rate of DPAC amortization should be adjusted for changes in the incidence of surrenders to be consistent with the handling of principal prepayments under FASB Statement No. 91.
- DPAC related to investment contracts should be reported as an asset to be consistent with the reporting of DPAC on insurance products covered by FASB Statement No. 97. Under some reserving methods, the insurance reserve may be calculated net of DPAC. In that event, the amounts of DPAC and reserves have to be determined separately.

## Limited-Payment Contracts

.09 *Question 3:* Should the deferred profit liability (excess of gross premiums over net premiums), if any, on limited-payment contracts be amortized

in relation to the discounted amount of insurance in force (or expected future benefit), and should interest accrue to the unamortized deferred profit liability balance?

**.10 Answer 3:** Yes. The deferred profit liability should be amortized in relation to the discounted amount of the insurance in force or expected future benefit payments, and interest should accrue to the unamortized balance. The use of interest in the amortization is consistent with the determination of the deferred profit using discounting.

**.11 Question 4:** Should costs related to the acquisition of new and renewal business that are not capitalized (because, for example, the costs do not vary with the acquisition of the business) be included in the calculation of net premium used in determining the profit to be deferred on limited-payment contracts?

**.12 Answer 4:** No. Those costs are period costs, which should be recognized when incurred. The inclusion of such costs in the calculation of net premium would result in their deferral.

**.13** Costs that would be included in the determination of net premium under FASB Statement No. 97 and for purposes of determining the deferred profit for limited-payment contracts are policy-related costs that are not primarily related to the acquisition of business (such as policy administration, maintenance, and settlement costs) and acquisition costs that are capitalized under FASB Statement No. 97.

**.14 Question 5:** Does the method of amortizing DPAC on limited-payment contracts under FASB Statement No. 97 differ from the method required under FASB Statement No. 60?

**.15 Answer 5:** No. DPAC should continue to be amortized in proportion to premium revenue recognized, as required under FASB Statement No. 60, paragraph 29. Premium revenue used in the calculation should be the gross premium recorded, that is, the amount before adjustment for excess of gross over net premiums (the deferred profit liability).

**.16 Question 6:** Does paragraph 16 of FASB Statement No. 97, which addresses limited-payment contracts, apply to limited-payment participating and limited-payment nonguaranteed-premium contracts that are not, in substance, universal life-type contracts?

**.17 Answer 6:** Yes. These contracts are limited-payment contracts under paragraph 9 of FASB Statement No. 97 and are not excluded under paragraph 11 because they are not conventional forms of participating or nonguaranteed-premium contracts.

## Internal Replacements

**.18 Question 7:** Does the accounting specified by FASB Statement No. 97, paragraph 26, for internal replacement transactions apply only to the replacement of traditional insurance contracts by universal life-type contracts?

**.19 Answer 7:** Yes. FASB Statement No. 97 addresses only replacements of traditional insurance contracts by universal life-type contracts. The accounting for other internal replacements should be based on the circumstances of the transaction. Paragraphs 70 to 72 of FASB Statement No. 97 discuss the Board's rationale for requiring recognition of loss on the termination of the replaced contract.

**.20 Question 8:** How should insurance enterprises report changes in accounting practices for internal replacements other than replacements by universal life-type contracts?

**.21 Answer 8:** If the accounting practice for internal replacements other than replacement by a universal life-type contract is changed, and if the effect is material, insurance enterprises should disclose the change in their reports to shareholders as a change in accounting principle, as described in paragraphs 18 to 26 of APB Opinion No. 20, *Accounting Changes*.

## Scope of FASB Statement No. 97

**.22 Question 9:** According to paragraph 14 of FASB Statement No. 97, the statement does not apply to certain long-duration insurance contracts, such as those that provide benefits related only to illness, physical injury, or disability. Should FASB Statement No. 97 be applied to contracts that provide those kinds of benefits but that also have characteristics and benefits falling under FASB Statement No. 97, such as significant cash surrender benefits and limited-payment or universal-type provisions?

**.23 Answer 9:** Yes. If insurance contracts have characteristics significant to the contracts that are covered by FASB Statement No. 97—for example, limited-payment or universal life-type contracts—the accounting for the contracts should be guided by the concepts of FASB Statement No. 97. For example, universal disability contracts that have many of the same characteristics as universal life-type contracts, with the exception of providing disability benefits instead of life insurance benefits, should be accounted for in a manner consistent with universal life-type contracts.

## Estimated Gross Profits—Universal Life-Type Contracts

**.24 Question 10:** FASB Statement No. 97, paragraph 23b, states that estimated gross profits (EGP) used to determine DPAC amortization for universal life-type contracts should include estimates of costs expected to be incurred for contract administration, including acquisition costs not included in capitalized acquisition costs. What kinds of costs should be included in contract administration costs, and should non-policy-related costs and costs that are not capitalized under FASB Statement No. 60, paragraph 28, because they do not vary with the acquisition of new and renewal insurance contracts be included?

**.25 Answer 10:** Contract administration costs included in the calculation of EGP should consist of the following:

- Policy-related costs that are not primarily related to the acquisition of business, such as policy administration, settlement, and maintenance costs
- Policy-related acquisition costs that are not capitalized under FASB Statement No. 97, paragraph 24, such as ultimate renewal commission and recurring premium taxes

**.26** Non-policy-related expenses, such as certain overhead costs, and costs that are related to the acquisition of business that are not capitalized under FASB Statement No. 60, such as certain advertising costs, should not be included in EGP.

**.27 Question 11:** Should gains and losses from sales of investments be included in amounts expected to be earned from the investment of policyholder balances used to determine EGP?

**.28 Answer 11:** Yes. Expected gains and losses from sales of investments related to universal life contracts should be included in the determination of EGP, because earned investment income should be based on the expected total yield of the investments. If the timing and amount of realized gains and losses from the sales of investments change from those expected and materially affect the expected total yield and the estimated gross profits, DPAC amortization should be reevaluated.

## **Transition**

**.29 Question 12:** Accounting changes resulting from the adoption of FASB Statement No. 97 are required to be applied retroactively through restatement of all previously issued financial statements that are being presented. FASB Statement No. 97 requires that if restatement of all years presented is not practicable, the cumulative effect of the accounting changes be reported in net income in the year the statement is adopted. If a company is adopting FASB Statement No. 97 through a cumulative-effect adjustment because restatement is not practicable, should the company nevertheless restate prior years' income statements for the change in reporting realized investment gains and losses under FASB Statement No. 97?

**.30 Answer 12:** Yes. A company should adopt FASB Statement No. 97's change in reporting realized investment gains and losses through restatement of prior years' income statements even if other provisions of the standard are adopted through a cumulative-effect adjustment. A company should adopt all provisions of FASB Statement No. 97 in the same period.

**.31 Question 13:** When adopting FASB Statement No. 97 retroactively through restatement of prior years' financial statements, should companies use the original accounting assumptions, such as assumptions regarding estimated gross profits, that they would have used in those prior periods, or may hindsight be used so that experience subsequent to those periods may be substituted for original assumptions?

**.32 Answer 13:** Assumptions used in restating prior years' financial statements should not include significant subsequent fluctuations in experience that could not reasonably have been foreseen—for example, a significant unexpected change in lapse experience resulting from specific circumstances occurring in a subsequent period, restructuring of policy charges, or a major change in investment strategy. The effects of such changes should be included in the restated results of the period in which the changes occurred, which may require the adjustment of total DPAC amortization recorded to date as specified in paragraph 25 of FASB Statement No. 97.

## **Recoverability and Loss Recognition— Investment Contracts**

**.33 Question 14:** Should DPAC related to investment contracts defined under FASB Statement No. 97 be written off if it is determined that the amount at which the asset is stated is probably not recoverable?

**.34 Answer 14:** Yes. As stated in paragraph 87 in FASB Statement of Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, “[a]n expense or loss is recognized if it becomes evident that previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits.” The DPAC asset should be reduced to the level that can be recovered. Further guidance is provided in paragraphs .35 and .36 of this practice bulletin.

**.35 Question 15:** Should the provisions of FASB Statement No. 60 concerning loss recognition (premium deficiency), by which an additional liability is established for anticipated losses on contracts, apply to investment contracts defined in FASB Statement No. 97?

**.36 Answer 15:** No. Such loss recognition, as described in paragraph .34 above, is not permitted for investment contracts under FASB Statement No. 97.



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## Section 12,110

# **Practice Bulletin 11** **Accounting for Preconfirmation** **Contingencies in Fresh-Start Reporting**

March, 1994

### **NOTICE TO READERS**

Practice bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under Rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

## **Introduction**

.01 This practice bulletin interprets certain provisions of AICPA Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code* [section 10,460]. SOP 90-7 [section 10,460] provides guidance for financial reporting by entities that file petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11 of title 11 of the United States Code. The SOP was issued on November 19, 1990, and is effective for financial statements of enterprises that filed petitions under the Bankruptcy Code after December 31, 1990.

.02 SOP 90-7 [section 10,460] states that an entity should adopt fresh-start reporting upon emergence from Chapter 11 reorganization if the reorganization value of assets immediately before the date of confirmation is less than the total of all postpetition liabilities and allowed claims, and if holders of existing voting shares immediately before confirmation receive less than 50 percent of the voting shares of the emerging entity. Reorganization value generally approximates fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after restructuring. The reorganization value of an entity is the amount of resources available and to become available for the satisfaction of postpetition liabilities and allowed claims and interest, as negotiated or litigated between the debtor-in-possession or trustee, the creditors, and the holders of equity interests.

.03 SOP 90-7 [section 10,460] identifies the principles to be applied in adopting fresh-start reporting, which include the following:

- Reorganization value of the entity should be allocated to the entity's assets in conformity with the procedures specified by Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*, for transactions recorded on the basis of the purchase method. Any reorganization value in excess of amounts allocable to identifiable assets should be amortized in conformity with APB Opinion 17, *Intangible Assets*.
- Each liability existing at the plan confirmation date, other than deferred taxes, should be stated at the present values of amounts to be paid.

.04 SOP 90-7 [section 10,460] does not provide specific guidance on accounting for contingencies existing at the date fresh-start reporting is adopted.<sup>1</sup> Some believe that the effects of adjusting or resolving all such contingencies should be included in postconfirmation earnings. Others believe that accounting similar to that in FASB Statement of Financial Accounting Standards No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*, should be applied. Such accounting could result in adjustments to reorganization value in excess of amounts allocable to identifiable assets. The Accounting Standards Executive Committee (AcSEC) has been asked to clarify the issue.

## Interpretation

.05 Certain uncertainties that were not resolved during the Chapter 11 proceedings may continue to exist at the confirmation date. For purposes of applying SOP 90-7 [section 10,460], such uncertainties are referred to as *preconfirmation contingencies*, defined as contingencies<sup>2</sup> of an entity that emerges from Chapter 11 reorganization and applies fresh-start reporting, and that exist at the date of confirmation of the plan. A preconfirmation contingency can be a contingent asset, a contingent liability, or a contingent impairment of an asset.

.06 Preconfirmation contingencies include uncertainties concerning

- Amounts ultimately to be realized upon the disposition of assets designated for sale by the confirmed plan; proceeds upon disposition may vary from values estimated at confirmation.
- Nondischargeable claims (for example, environmental issues).
- Claims that are disputed, unliquidated, or contingent and that are unresolved at confirmation; these claims may be estimated for purposes of voting on the plan. The confirmed plan may provide for issuance of shares (or release of shares from escrow) in resolution of certain claims.

.07 Preconfirmation contingencies do not include—

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<sup>1</sup> See paragraphs .35 and .55 of SOP 90-7 [section 10,460.35 and .55].

<sup>2</sup> FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty concerning possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.

- Allocation of reorganization value to the entity's assets. The initial allocation of the value of the reconstituted entity to individual assets in conformity with the procedures specified by APB Opinion 16 may require the use of estimates. Those estimates may change when information the entity has arranged to obtain has been received—for example, once appraisals of certain assets of the reconstituted business have been received.
- Deductible temporary differences or net operating loss and tax-credit carryforwards that exist at confirmation. FASB Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, and paragraph .38 of SOP 90-7 [section 10,460.38], specify the accounting for those items.

.08 After the adoption of fresh-start reporting, adjustments that result from a preconfirmation contingency shall be included in the determination of net income in the period in which the adjustment is determined. Such adjustments can result from resolution of a contingency or changes in estimates of amounts initially recorded at emergence from Chapter 11 (see paragraph .05 herein).

.09 Adjustment of preconfirmation contingencies should be included in income or loss from continuing operations of the emerged entity and should be separately disclosed.

.10 This practice bulletin is effective for adjustments of preconfirmation contingencies made after March 31, 1994. Earlier application is encouraged.

## Basis for Conclusions

.11 Paragraph .58 of SOP 90-7 [section 10,460.58] states, in part, “. . . in the reorganization process, extensive information available to the parties in interest, the adversarial negotiation process, the involvement of the Bankruptcy Court, the use of specialists by one or more of the parties in interest, and the fact that all elements of the determination are focused solely on the economic viability of the emerging entity result in an objective and reliable determination of reorganization value.” Thus, all contingencies that are significant to the reorganization proceedings are identified and generally estimated by the confirmation date.

.12 FASB Statement No. 38 describes an allocation period as the time required by a purchaser of a business to identify and quantify the assets acquired and the liabilities assumed. The allocation period ends when the acquiring entity is no longer waiting for information that it has arranged to obtain and that is known to be available or obtainable. Any adjustment after the end of the allocation period that results from a preacquisition contingency is included in earnings. AcSEC believes that in reorganization proceedings the analogous allocation period for contingencies is the reorganization period, which ends at the confirmation date. Therefore, adjustments to the amounts initially recorded for preconfirmation contingencies at the adoption of fresh-start accounting should be reflected in earnings.

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## Section 12,120

# **Practice Bulletin 12** **Reporting Separate Investment Fund** **Option Information of Defined-Contribution** **Pension Plans**

September, 1994

### **NOTICE TO READERS**

Practice Bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA practice bulletins as a source of established accounting principles generally accepted in the United States that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. If relevant to the circumstances of the transaction or event, the accounting treatment specified by this practice bulletin should be used, or the member should be prepared to justify the departure.

## **Introduction**

.01 The Accounting Standards Executive Committee (AcSEC) and the Employee Benefit Plans Committee of the American Institute of Certified Public Accountants (AICPA) are aware that paragraph 3.23*k* of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide), regarding the reporting of separate investment fund option information of defined-contribution pension plans, is confusing to financial statement preparers and auditors and has created a divergence of practice. As a result, these Committees believe that it is desirable to provide clarification of the reporting requirements set forth in paragraph 3.23*k* of the Guide.

.02 Paragraph 3.23*k* of the Guide establishes requirements for the reporting of separate investment fund option information of defined-contribution pension plans. Paragraph 3.23*k* requires plans that provide for participant-directed investment programs (for example, equity, debt, or employer securities) to disclose amounts relating to those individual programs as a separate fund, either in columnar form in the financial statements (by participant-directed and nonparticipant-directed categories) or in the related disclosures, or by separate financial statements for each program.

.03 A plan provides for participant-directed investment programs if it allows participants to choose among various investment alternatives. The available alternatives are usually pooled fund vehicles, such as registered investment companies or commingled funds of banks, that provide varying types of investments—for example, equity funds or fixed-income funds. The participant can select among the various available alternatives and periodically change that selection. Each investment alternative provided is considered a separate investment fund option. For example, if the plan provides two bond funds, an equity fund, a fixed-income fund, and an employer securities fund, the plan would offer five separate investment fund options.

## Conclusion

.04 The plan should disclose information about the net assets and significant components of the changes in net assets for each investment fund option. If an investment fund option contains both participant-directed and nonparticipant-directed investments, the participant-directed and nonparticipant-directed portions should be disclosed separately.

.05 Aggregation of investment fund options with similar investment objectives is not appropriate except that, for materiality considerations, any individual investment fund option with net assets of less than 5 percent of the plan's total net assets may be combined with funds having similar investment objectives. If investment fund options are aggregated, that fact should be disclosed. If the plan provides for self-directed investing whereby each participant selects his or her own specific investments, such as individual stocks or bonds, changes in these investments may be aggregated and presented in one column as one fund option.

.06 The information about the net assets and the significant components of the changes in net assets for each investment fund option is a required part of the basic financial statements. Such information may be presented in a multicolumnar format on the face of the financial statements, in the notes to the financial statements, or in separate financial statements for each investment fund option. Single line item presentation of the net assets available for benefits may be appropriate, unless an individual investment fund option has a material asset or liability other than investments that requires disclosure. An illustration of a single line item presentation in the statement of net assets available for benefits, along with a multicolumnar presentation of the changes in net assets available for benefits for each fund option, is presented in the Appendix [paragraph .08] to this practice bulletin.

## Effective Date

.07 This practice bulletin is effective for plan years beginning after December 15, 1993. Earlier application is encouraged.



.08

## Appendix

### Illustration of 401(k) Plan Financial Statements

**A.1** This appendix illustrates certain applications of the provisions of chapter 3 of the Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) that apply for the annual financial statements of the hypothetical XYZ Company 401(k) Plan. The illustration includes both a single line item presentation and an alternative multicolumnar presentation of fund information in the statement of net assets available for benefits, along with a multicolumnar presentation of the changes in net assets available for benefits for each investment fund option. It does not illustrate other provisions of chapter 3 of the Guide that might apply in circumstances other than those assumed in this example. The format presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations.

**A.2** Although generally accepted accounting principles (GAAP) encourage but do not require comparative financial statements, the Employee Retirement Income Security Act of 1974 (ERISA) requires a comparative statement of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

**A.3** ERISA and U.S. Department of Labor (DOL) regulations require that certain information be included in supplemental schedules, which are not required under GAAP, and reported on by the independent auditor. See appendix A of the Guide for a further discussion of the ERISA and DOL requirements.

XYZ Company 401(k) Plan  
Statement of Net Assets Available for Benefits

	December 31,	
	19X1	19X0
<i>Assets</i>		
Investments:		
At fair value—(Note B)		
Shares of registered investment companies:		
Prosperity Investments Common Stock Fund	\$1,973,000	\$2,600,000
Prosperity Investments Balanced Fund	3,949,000	3,500,000
XYZ Company	655,000	200,000
Participant notes receivable	100,000	45,000
	6,677,000	6,345,000
At contract value—(Note C)		
National Insurance Company Investment Contract #2012A, matures 12/31/X2	2,500,000	1,650,000
Total investments	9,177,000	7,995,000
Receivables:		
Employer's contribution	14,000	10,000
Participants' contributions	52,000	50,000
Total receivables	66,000	60,000
Total assets	9,243,000	8,055,000
<i>Liabilities</i>		
Accounts payable	10,000	20,000
Accrued expenses	15,000	—
Total liabilities	25,000	20,000
Net assets available for benefits	\$9,218,000	\$8,035,000

The accompanying notes are an integral part of these financial statements.

**[Alternative presentation for statement of net assets available for benefits]**

The accompanying notes are an integral part of these financial statements.





## XYZ Company 401(k) Plan

### Notes to Financial Statements

#### A. Description of Plan

The following description of the XYZ Company (Company) 401(k) Plan (Plan) provides only general information. Participants should refer to the Plan agreement for a more comprehensive description of the Plan's provisions.

1. *General.* The Plan is a defined-contribution plan covering all full-time employees of the Company who have one year of service and are age twenty-one or older. It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).
2. *Contributions.* Each year, participants may contribute up to 12 percent of pretax annual compensation, as defined in the Plan. Participants may also contribute amounts representing distributions from other qualified defined-benefit or contribution plans. The Company contributes 25 percent of the first 6 percent of base compensation that a participant contributes to the Plan. Additional amounts may be contributed at the option of the Company's board of directors. All employer contributions are invested in XYZ Company common stock. Contributions are subject to certain limitations.
3. *Participant accounts.* Each participant's account is credited with the participant's contribution and allocations of (a) the Company's contribution and (b) Plan earnings, and charged with an allocation of administrative expenses. Allocations are based on participant earnings or account balances, as defined. Forfeited balances of terminated participants' nonvested accounts are used to reduce future Company contributions. The benefit to which a participant is entitled is the benefit that can be provided from the participant's vested account.
4. *Vesting.* Participants are immediately vested in their contributions plus actual earnings thereon. Vesting in the Company's matching and discretionary contribution portion of their accounts plus actual earnings thereon is based on years of continuous service. A participant is 100 percent vested after five years of credited service.
5. *Investment options.* Upon enrollment in the Plan, a participant may direct employee contributions in 25 percent increments in any of four investment options.
  - a. *Prosperity Investments Common Stock Fund*—Funds are invested in shares of a registered investment company that invests mainly in common stocks.
  - b. *Prosperity Investments Balanced Fund*—Funds are invested in shares of a registered investment company that invests in corporate bonds, common stocks, and U.S. Government securities.
  - c. *XYZ Company Stock*—Funds are invested in common stock of XYZ Company.

- d. **National Insurance Company Investment Contract**—Funds are invested in a guaranteed investment contract with an insurance company.

Participants may change their investment options quarterly.

6. **Participant notes receivable.** Participants may borrow from their fund accounts a minimum of \$1,000 and to a maximum equal to the lesser of \$50,000 or 50 percent of their account balance. Loan transactions are treated as a transfer to (from) the investment fund from (to) the Participant Notes fund. Loan terms range from one to five years or up to twenty-five years for the purchase of a primary residence. The loans are secured by the balance in the participant's account and bear interest at a rate commensurate with local prevailing rates as determined quarterly by the Plan administrator. Interest rates range from 6 percent to 10 percent. Principal and interest are paid ratably through monthly payroll deductions.
7. **Payment of benefits.** On termination of service due to death, disability, or retirement, a participant may elect to receive either a lump-sum amount equal to the value of the participant's vested interest in his or her account, or annual installments over a ten-year period. For termination of service due to other reasons, a participant may receive the value of the vested interest in his or her account as a lump-sum distribution.

## **B. Summary of Accounting Policies**

### **Basis of Accounting**

The financial statements of the Plan are prepared under the accrual method of accounting.

### **Investment Valuation and Income Recognition**<sup>1</sup>

The Plan's investments are stated at fair value, except for its investment contract, which is valued at contract value (Note C). Shares of registered investment companies are valued at quoted market prices, which represent the net asset value of shares held by the Plan at year end. The Company stock is valued at its quoted market price. Participant notes receivable are valued at cost, which approximates fair value.

Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date.

### **Payment of Benefits**

Benefits are recorded when paid.

## **C. Investment Contract With Insurance Company**<sup>1</sup>

In 19X0, the Plan entered into an investment contract with National Insurance Company (National). National maintains the contributions in a pooled account. The account is credited with earnings on the underlying investments (principally bank certificates of deposit) and charged for Plan withdrawals and administrative expenses charged by National. The contract is included in the financial statements at contract value, which approx-

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<sup>1</sup> In September 1994, the AICPA issued Statement of Position 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans* [section 10,620], which may substantially change the way some defined-contribution pension plans report investment contracts.

imates fair value, as reported to the Plan by National. Contract value represents contributions made under the contract, plus earnings, less Plan withdrawals and administrative expenses.

**D. Related-Party Transactions**

Certain Plan investments are shares of mutual funds managed by Prosperity Investments. Prosperity Investments is the trustee as defined by the Plan and, therefore, these transactions qualify as party-in-interest. Fees paid by the Plan for the investment management services amounted to \$105,000 for the year ended December 31, 19X1.

**E. Plan Termination**

Although it has not expressed any intent to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions of ERISA. In the event of Plan termination, participants will become 100 percent vested in their accounts.

**F. Reconciliation of Financial Statements to Form 5500**

The following is a reconciliation of net assets available for benefits according to the financial statements to Form 5500:

	<u>December 31,</u>	
	<u>19X1</u>	<u>19X0</u>
Net assets available for benefits per the financial statements	\$9,218,000	\$8,035,000
Amounts allocated to withdrawing participants	<u>(50,000)</u>	<u>(35,000)</u>
Net assets available for benefits per Form 5500	<u>\$9,168,000</u>	<u>\$8,000,000</u>

The following is a reconciliation of benefits paid to participants according to the financial statements to Form 5500:

	<u>Year Ended December 31, 19X1</u>
Benefits paid to participants per the financial statements	\$1,144,000
Add: Amounts allocated to withdrawing participants at December 31, 19X1	50,000
Add: Amounts allocated to withdrawing participants at December 31, 19X0	<u>(35,000)</u>
Benefits paid to participants per Form 5500	<u>\$1,159,000</u>

Amounts allocated to withdrawing participants are recorded on Form 5500 for benefit claims that have been processed and approved for payment prior to December 31 but not yet paid as of that date.



**G. Tax Status**

The Internal Revenue Service has determined and informed the Company by a letter dated August 30, 19XX, that the Plan and related trust are designed in accordance with applicable sections of the Internal Revenue Code (IRC). The Plan has been amended since receiving the determination letter. However, the Plan administrator and the Plan's tax counsel believe that the Plan is designed and is currently being operated in compliance with the applicable requirements of the IRC.

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## Section 12,130

# **Practice Bulletin 13** **Direct-Response Advertising and Probable Future Benefits**

December, 1994

### **NOTICE TO READERS**

Practice Bulletins are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice Bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Practice Bulletins as a source of established accounting principles generally accepted in the United States that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. If relevant to the circumstances of the transaction or event, the accounting treatment specified by this Practice Bulletin should be used, or the member should be prepared to justify the departure.

## **Introduction**

.01 In December 1993, the AICPA's Accounting Standards Executive Committee (AcSEC) issued Statement of Position (SOP) 93-7, *Reporting on Advertising Costs* [section 10,590]. SOP 93-7 [section 10,590] provides guidance on financial reporting on advertising costs and requires that an entity report the costs of all advertising as expenses either in the periods in which those costs are incurred, or the first time the advertising takes place, except for certain direct-response advertising. The costs of direct-response advertising that result in probable future benefits should be capitalized and amortized over the estimated period of the future benefits.

## **Direct-Response Advertising**

.02 Paragraph 33 of SOP 93-7 [section 10,590.33] states that the costs of direct-response advertising should be capitalized if both of the following conditions are met:

- a. The primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising. (Paragraph 34 of SOP 93-7 [section 10,590.34] discusses the conditions that must exist in order to conclude that the advertising's purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising.)

- b. The direct-response advertising results in probable future benefits. (Paragraph 37 of SOP 93-7 [section 10,590.37] discusses the conditions that must exist in order to conclude that direct-response advertising results in probable future benefits.)

.03 Paragraph 36 of SOP 93-7 [section 10,590.36] states that “probable future benefits of direct-response advertising activities are probable future revenues arising from that advertising in excess of future costs to be incurred in realizing those revenues.” Practice has interpreted *probable future revenues* in different ways. Some believe that future revenues should be limited to revenue received from sales to customers receiving and responding to the direct-response advertisement. Others believe that future revenues should include revenue indirectly related to the advertisement. SOP 93-7 [section 10,590] does not explicitly address this issue.

.04 This practice bulletin interprets paragraphs 33, 36, and 46 through 48 of SOP 93-7 [section 10,590.33, .36, .46–.48] by clarifying that only revenue from sales to customers receiving and responding to the direct-response advertisement should be considered when determining probable future revenues.

## Probable Future Revenues

.05 Revenues associated with direct-response advertising are as follows:

- a. *Primary*: Revenues from sales to customers receiving and responding to the direct-response advertising
- b. *Secondary*: Revenues other than revenues from sales to customers receiving and responding to the direct-response advertising

For example, most publishers receive revenue from customers that subscribe to the publications; these subscription revenues are primary revenues. Publishers also receive secondary revenues such as advertisements in the publications (referred to as *placement fees*). Placement fee revenues are affected by several factors, including the total number of subscribers to the publication and the selling efforts devoted to obtaining the placement fees.

## Conclusion

.06 When determining *probable future revenues*, those revenues should be limited to revenues from sales to customers receiving and responding to the direct-response advertising (primary revenues).

.07 When evaluating whether the direct-response advertising results in probable future benefits (paragraph 33b of SOP 93-7 [section 10,590.33b]), probable future benefits should include only primary revenues. When amortizing and assessing the realizability of the direct-response advertising reported as assets, future revenues should be limited to primary revenues (paragraphs 46 through 48 of SOP 93-7 [section 10,590.46–.48]).

## Effective Date and Transition

.08 This practice bulletin is effective for advertising costs incurred after December 31, 1994, or upon the adoption of SOP 93-7 [section 10,590], if later.

**.09** Entities that adopt SOP 93-7 [section 10,590] on or prior to December 31, 1994, and that report the costs of direct-response advertising as assets based on the inclusion of secondary revenues in determining probable future revenues, may report advertising costs incurred on or prior to December 31, 1994, using one of the following alternatives:

- a. Continue to include secondary revenues in determining probable future revenues for purposes of amortizing and assessing the realizability of direct-response advertising reported as assets at December 31, 1994.
- b. For entities that have issued annual financial statements reflecting the adoption of SOP 93-7 [section 10,590], use only primary revenues for purposes of reporting the costs of direct-response advertising reported as assets and report the change in accounting as the cumulative effect of a change in accounting principle as prescribed by paragraph 20 of Accounting Principles Board Opinion No. 20, *Accounting Changes*.
- c. For entities that have not issued annual financial statements, use only primary revenues for purposes of reporting the costs of direct-response advertising as assets.

## Discussion of Conclusion

### Probable Future Revenues

**.10** SOP 93-7 [section 10,590] establishes narrow conditions for reporting the costs of advertising as an asset beyond the first time the advertising takes place. Those conditions are based, in part, on future benefits resulting from the advertising. Some entities have interpreted SOP 93-7 [section 10,590] to allow the inclusion of secondary sources of revenue when determining probable future benefits. That practice extends, beyond AcSEC's intent, the link between the customers responding to the direct-response advertising and the probable future revenues resulting from the advertising. This practice bulletin clarifies that AcSEC intended that only primary revenues should be included in the determination of probable future revenues.

### Transition

**.11** SOP 93-7 [section 10,590] was issued in December 1993 and is effective for financial statements for years beginning after June 15, 1994, with earlier application encouraged in fiscal years for which financial statements previously have not been issued. SOP 93-7 [section 10,590] did not explicitly address the issue of whether secondary revenues should be included in probable future benefits. Therefore, some entities that early adopted SOP 93-7 [section 10,590] included secondary revenues in determining probable future revenues, and as a result reported direct-response advertising costs as assets that would not be reported as assets under this practice bulletin.

**.12** AcSEC acknowledges that transition, to a significant extent, is a practical matter. A major objective of transition is to mitigate disruption to the extent possible without unduly compromising the objectives of the accounting guidance in this practice bulletin and consistency among reporting entities.

AcSEC believes that those entities that adopted SOP 93-7 [section 10,590] prior to its effective date did so in good faith and should not be required to restate annual financial statements previously issued. AcSEC further believes that few entities both adopted SOP 93-7 [section 10,590] prior to its effective date and included secondary revenues when determining probable future revenues. Therefore, consistency among reporting entities has not been compromised significantly.

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## Section 12,140

# **Practice Bulletin 14** **Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships**

April, 1995

### NOTICE TO READERS

Practice Bulletins are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice Bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Practice Bulletins as a source of established accounting principles generally accepted in the United States that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. If relevant to the circumstances of the transaction or event, the accounting treatment specified by this Practice Bulletin should be used, or the member should be prepared to justify the departure.

## Introduction

.01 The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) prepared the following guidance regarding the application of existing authoritative literature to limited liability companies and limited liability partnerships.

.02 U.S. limited liability companies and limited liability partnerships (hereinafter referred to as *limited liability companies or LLCs*) are formed in accordance with the laws of the state in which such entities are organized. Because those laws are not uniform, the characteristics of LLCs vary from state to state. However, LLCs generally have the following characteristics:<sup>1</sup>

- An LLC is an unincorporated association of two or more "persons."
- Its members have limited personal liability for the obligations or debts of the entity.

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<sup>1</sup> The characteristics listed in this paragraph are not intended to be representative of characteristics in the statutes of each state. Preparers of an LLC's financial statements should be cognizant of the LLC legislation enacted in the jurisdiction in which the LLC is organized.

- It is classified as a partnership for federal income tax purposes.

.03 Under the rules in existence as of the date of this practice bulletin, to be classified as a partnership for federal income tax purposes, a limited liability company must lack at least two of the following corporate characteristics:<sup>2</sup>

- Limited liability
- Free transferability of interests
- Centralized management
- Continuity of life

## Scope

.04 This practice bulletin provides reporting guidance for limited liability companies organized in the United States that prepare financial statements in accordance with generally accepted accounting principles. The practice bulletin also provides guidance on certain accounting issues for LLCs organized in the United States. For accounting issues not addressed in this practice bulletin, an LLC should comply with the existing requirements of generally accepted accounting principles.

## Conclusions

### Accounting Issues

#### *Accounting for Assets and Liabilities Previously Owned by Predecessor Entities*

.05 An LLC formed by combining entities under common control or by conversion from another type of entity initially should state its assets and liabilities at amounts at which they were stated in the financial statements of the predecessor entity or entities in a manner similar to a pooling of interests.

#### *Accounting for Income Taxes*

.06 As discussed in paragraph .02 of this practice bulletin, LLCs generally are classified as partnerships for federal income tax purposes. An LLC that is subject to federal (U.S.), foreign, state, or local (including franchise) taxes based on income should account for such taxes in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. Paragraph 17 of FASB Statement No. 109 requires a jurisdiction-by-jurisdiction computation.

.07 In accordance with paragraph 28 of FASB Statement No. 109, an entity whose tax status in a jurisdiction changes from taxable to nontaxable should eliminate any deferred tax assets or liabilities related to that jurisdiction as of the date the entity ceases to be a taxable entity. Paragraph 45 of

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<sup>2</sup> Many states have adopted similar requirements for limited liability companies to be classified as partnerships for state income or franchise tax purposes. However, certain states have enacted LLC legislation that includes income tax requirements. Additionally, if an LLC operates in a jurisdiction where either LLC legislation has not been enacted or LLCs are subject to income taxation, it may be subject to income tax requirements on income derived from operations in those jurisdictions.

FASB Statement No. 109 requires disclosure of significant components of income tax expense attributable to continuing operations including “adjustments of a deferred tax liability or asset for . . . a change in the tax status of the enterprise.”

## Financial Statement Display Issues

**.08** A complete set of LLC financial statements should include a statement of financial position as of the end of the reporting period, a statement of operations for the period, a statement of cash flows for the period, and accompanying notes to financial statements. Additionally, the LLC should present information related to changes in members' equity for the period. This information may be presented as a separate statement, combined with the statement of operations, or in the notes to the financial statements.

**.09** The headings of a limited liability company's financial statements should identify clearly the financial statements as those of a limited liability company.

### *Presentation of the Equity Section of the Statement of Financial Position*

**.10** The financial statements of a limited liability company should be similar in presentation to those of a partnership. The LLC owners are referred to as “members”; therefore, the equity section in the statement of financial position should be titled “members' equity.” If more than one class of members exists, each having varying rights, preferences, and privileges, the LLC is encouraged to report the equity of each class separately within the equity section. If the LLC does not report the amount of each class separately within the equity section, it should disclose those amounts in the notes to the financial statements (see paragraph .15).

**.11** Even though a member's liability may be limited, if the total balance of the members' equity account or accounts described in the preceding paragraph is less than zero, a deficit should be reported in the statement of financial position.

**.12** If the LLC maintains separate accounts for components of members' equity (for example, undistributed earnings, earnings available for withdrawal, or unallocated capital), disclosure of those components, either on the face of the statement of financial position or in the notes to the financial statements, is permitted.

**.13** If the LLC records amounts due from members for capital contributions, such amounts should be presented as deductions from members' equity. Presenting such amounts as assets is inappropriate except in very limited circumstances when there is substantial evidence of ability and intent to pay within a reasonably short period of time, as described in Emerging Issues Task Force (EITF) Issue No. 85-1, *Classifying Notes Received for Capital Stock*.

### *Comparative Financial Statements*

**.14** Presentation of comparative financial statements is encouraged, but not required, by Chapter 2A, “Comparative Financial Statements,” of Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*. If comparative financial statements are presented, amounts shown for comparative purposes must be in fact comparable with those shown for the most recent period, or any exceptions to comparability must be disclosed in the notes to the financial statements. Situations may exist in which financial statements of the same reporting entity for periods prior to

the period of conversion are not comparable with those for the most recent period presented, for example, if transactions such as spin-offs or other distributions of assets occurred prior to or as part of the LLC's formation. In such situations, sufficient disclosure should be made so the comparative financial statements are not misleading. If the formation of the LLC results in a new reporting entity, the guidance in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, paragraphs 34 and 35, should be followed and financial statements for all prior periods presented should be restated.

## Financial Statement Disclosure Issues

.15 The following disclosures should be made in the financial statements of a limited liability company:

- A description of any limitation of its members' liability
- The different classes of members' interests and the respective rights, preferences, and privileges of each class. Additionally, as discussed in paragraph .10, if the LLC does not report separately the amount of each class in the equity section of the statement of financial position, those amounts should be disclosed.

If the LLC has a finite life, the date the LLC will cease to exist should be disclosed.

.16 For limited liability companies formed by combining entities under common control or by conversion from another type of entity, the notes to the financial statements for the year of formation should disclose that the assets and liabilities previously were held by a predecessor entity or entities. LLCs formed by combining entities under common control are encouraged to make the relevant disclosures in paragraph 64 of APB Opinion 16, *Business Combinations*.

.17 FASB Statement No. 109 requires specific disclosures relating to accounting for income taxes. LLCs subject to income tax in any jurisdiction should make the relevant FASB Statement No. 109 disclosures.

.18 As discussed in paragraph .14, if comparative financial statements are presented, additional disclosures may be required.

## Effective Date

.19 This practice bulletin is effective for financial statements issued after May 31, 1995.

## Discussion of Conclusions

### Accounting Issues

.20 If an LLC is formed by combining entities under common control or by conversion from another form of entity, the assets and liabilities transferred to the LLC from the predecessor entity or entities should be recorded at historical cost in a manner similar to a pooling of interests. This position is supported by the following authoritative pronouncements:

- AICPA Accounting Interpretation No. 39 to APB Opinion 16, "Transfers and Exchanges Between Companies Under Common Control," which discusses transfers of net assets and exchanges of shares be-

tween companies under common control. The Interpretation states that assets and liabilities transferred between entities under common control would be accounted for in a manner similar to a pooling of interests.

- EITF Issue No. 88-16, *Basis in Leveraged Buyout Transactions*, which provides guidance as to when a new basis of accounting is appropriate in a leveraged buyout. Section 1 of Issue No. 88-16 states that a partial or complete change in accounting basis is appropriate only when there has been a change in control of voting interest (that is, a new controlling shareholder or group of shareholders must be established).

## Financial Statement Display Issues

.21 AcSEC believes that the financial statements required by paragraph .08 of this practice bulletin are necessary to provide the information needed to meet the financial reporting objectives of a limited liability company and to report that information in a manner that is both comprehensive and understandable. The required financial statements are consistent with paragraph 13 of FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.

.22 AcSEC believes that, because the members' liability is limited, the headings of the financial statements should state prominently that the entity is a limited liability company, even in jurisdictions where LLCs are not required by law to include the LLC designation in its name.

.23 In corporate financial statements, the amounts initially invested (capital stock) are kept separate from subsequent income and distribution amounts. In a partnership, such separation is not maintained. AcSEC believes that such a separation is not needed for LLCs. Consequently, AcSEC believes that the presentation of the equity section of the statement of financial position should be similar to that of a partnership rather than to that of a corporation.

.24 ARB 43, chapter 2A, recommends presentation of comparative financial statements. It states, however, that "it is necessary that prior-year figures shown for comparative purposes be in fact comparable with those shown for the most recent period, or that any exceptions to comparability be clearly brought out." Formation of a limited liability company by conversion from another type of entity (such as a partnership or corporation) generally does not result in a different reporting entity; formation of an LLC by combining entities under common control should result in a change in reporting entity, unless the entities were presented previously in combined financial statements.

.25 EITF Issue No. 85-1 addresses a situation in which an enterprise receives a note, rather than cash, as a contribution to equity. The task force reached a consensus that reporting the note as an asset generally is not appropriate, except in very limited circumstances when there is substantial evidence of ability and intent to pay within a reasonably short period of time.

## Financial Statement Disclosure Issues

.26 As discussed in paragraph .03 of this practice bulletin, a limited liability company must lack at least two corporate characteristics to avoid being classified as an association for federal income tax purposes, and most limited liability companies do lack at least two of those characteristics. If one of the characteristics that the LLC lacks is "continuity of life," AcSEC believes

that fact should be disclosed since it may be of significant interest to financial statement users that enter into transactions with the LLC. For example, a limited life would be significant information to a lender lending funds to an entity on a long-term basis.

.27 If an LLC is formed by a combination of entities under common control, the LLC is encouraged to make the relevant disclosures required by paragraph 64 of APB Opinion 16, because those transactions are considered to be similar to poolings of interests.

.28 AcSEC believes that the relationship between preferences of the classes may be of major significance to users of financial statements of those companies. Therefore, disclosure of the different classes and their respective rights, preferences, and privileges is encouraged.

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## Section 12,150

### ***Practice Bulletin 15*** ***Accounting by the Issuer of Surplus Notes***

January, 1997

#### **NOTICE TO READERS**

Practice Bulletins are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice Bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Practice Bulletins as a source of established accounting principles generally accepted in the United States that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. If relevant to the circumstances of the transaction or event, the accounting treatment specified by this Practice Bulletin should be used, or the member should be prepared to justify the departure.

## **Introduction and Background**

.01 Surplus notes<sup>1</sup> are financial instruments issued by insurance enterprises that are includable in surplus for statutory accounting purposes as prescribed or permitted by state laws and regulations.

.02 The following are some general characteristics of surplus notes:

- Approval of the issuance by the domiciliary state insurance commissioner (commissioner)
- Stated maturity date in most but not all cases
- Scheduled interest payments
- Approval of the payment of principal and interest by the commissioner
- Nonvoting
- Subordinate to all claims except those of shareholders for stock companies

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<sup>1</sup> The term surplus notes is the most common term applied to these financial instruments. Some jurisdictions refer to these financial instruments as certificates of contribution, surplus debentures, or capital notes.

- Subordinate to all claims except policyholder residuals for mutual companies (after policyholder liabilities are settled)
- No or limited acceleration rights other than for rehabilitation, liquidation, or reorganization of the insurer by a governmental agency
- Proceeds from issuance in the form of cash, cash equivalent, or some other asset with a readily determinable fair value satisfactory to the commissioner

**.03** Mutual insurance enterprises are owned by their policyholders and cannot raise capital by issuing shares of common or preferred stock; thus, many mutual insurance enterprises have issued surplus notes. Early issuances of surplus notes were generally by financially troubled mutual insurance enterprises in need of raising capital with limited alternatives to do so. More recently, mutual life insurance enterprises which do not have access to traditional equity capital markets, have viewed these instruments as a viable method of raising capital and improving risk-based capital ratios.

**.04** Mutual life insurance enterprises currently account for surplus notes under statutory accounting practices almost universally as equity capital or surplus. Surplus treatment is allowed for statutory accounting purposes because of the regulatory control over an insurance enterprise's ability to repay interest and principal that is maintained through required approval of payment by the commissioner.

**.05** The accounting for and presentation of surplus notes under generally accepted accounting principles (GAAP) is a significant issue to mutual life insurance enterprises when implementing FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, and FASB Statement of Financial Accounting Standards No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*. According to FASB Interpretation No. 40 as amended by FASB Statement No. 120, mutual life insurance enterprises that issue financial statements for fiscal years beginning after December 15, 1995, that are described as prepared "in conformity with generally accepted accounting principles" are required to apply all applicable authoritative accounting pronouncements in preparing those statements. Current authoritative accounting pronouncements are silent as to the accounting for surplus notes. Due to the prevalence and increasing use of these instruments by all kinds of insurance enterprises in the marketplace, GAAP guidance is necessary.

## Scope

**.06** This Practice Bulletin applies to life and health insurance enterprises (including mutual life insurance enterprises), property and casualty insurance enterprises, reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies that issue surplus notes. It provides guidance on accounting, financial statement presentation, and disclosure by the issuers of surplus notes in their GAAP financial statements. This Practice Bulletin does not apply to investors in surplus notes.

## Conclusions

### Balance-Sheet Classification of Outstanding Surplus Notes

.07 Surplus notes should be accounted for as debt instruments and presented as liabilities in the financial statements of the issuer. Equity treatment for surplus notes is inappropriate. This Practice Bulletin does not establish new guidance for accounting for debt instruments by the issuer.

.08 Consistent with paragraph 16 of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, a debtor shall derecognize a surplus note if and only if it has been extinguished. According to paragraph 16 of FASB Statement No. 125,<sup>2</sup> a liability has been extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.
- b. The debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. [Footnote omitted]

### Accrual of Interest

.09 Interest should be accrued over the life of the surplus note, irrespective of the approval of interest and principal payments by the insurance commissioner, and recognized as an expense in the same manner as other debt.

### Disclosure

.10 Issuers of surplus notes should comply with existing disclosure requirements for debt instruments. In addition, disclosure is required regarding the commissioner's role and ability to approve or disapprove any interest and principal payments.

### Effective Date and Transition

.11 This Practice Bulletin is effective for financial statements for fiscal years beginning after December 15, 1995. The effect of initially applying this Practice Bulletin shall be reported retroactively through restatement of all previously issued financial statements presented for comparative purposes. The cumulative effect of adopting this Practice Bulletin, including the accrual of interest, if any, shall be included in the earliest year restated.

**The provisions of this Practice Bulletin need not be applied to immaterial items.**

### Basis for Conclusions

.12 This section discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this Practice Bulletin. It includes reasons for accepting certain views and rejecting others.

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<sup>2</sup> FASB Statement No. 125 supersedes FASB Statement No. 76, *Extinguishment of Debt*.

## Balance-Sheet Classification of Outstanding Surplus Notes

.13 AcSEC considered the characteristics of surplus notes and deemed them liabilities in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements*.

.14 FASB Concepts Statement No. 6 defines both liabilities and equity and describes their essential characteristics. Paragraph 35 of the Concepts Statement defines liabilities as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.”

.15 Paragraph 36 of FASB Concepts Statement No. 6 describes the following three essential characteristics of a liability.

(a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened.

.16 Surplus notes represent a present duty to the holders of the notes that entails settlement by probable future transfers of cash. The future transfers of cash are normally on specified dates, subject to the approval of the commissioner. If the commissioner does not grant approval for payment on a specified date, the future transfer of cash takes place on occurrence of a specified event, which is the ultimate approval of the commissioner. Therefore, surplus notes meet the first characteristic of a liability. In addition, AcSEC observed that declaration of bankruptcy by an enterprise and the role of the court in determining when and in what amounts an obligation will be settled do not affect whether the debt instrument continues to qualify as a liability.

.17 Should the commissioner not grant approval for an interest or principal payment, the issuer cannot make the payment and the holders of the notes have no recourse. The commissioner will grant approval only if it is consistent with his or her responsibility and objective to maintain the solvency and financial stability of the insurer. Although the commissioner has discretion, AcSEC concluded that the commissioner is not part of the organization. The discretion described in FASB Concepts Statement No. 6 is not delegable outside the enterprise. The entity has little or no discretion to avoid the future sacrifice and thus surplus notes do meet the second characteristic of a liability.

.18 AcSEC concluded that the previous transfer of cash to enterprises from the noteholder in return for the issuance of the surplus note is the event needed to obligate the entity and therefore surplus notes meet the third characteristic of a liability.

.19 Equity of a business enterprise is defined in paragraph 60 of FASB Concepts Statement No. 6 simply as a residual interest—the difference between an enterprise’s assets and its liabilities. Equity of a business enterprise stems from ownership rights or the equivalent, and it involves a relationship between an enterprise and its owners as owners rather than as employees, suppliers, lenders, or in other nonowner roles.

.20 FASB Concepts Statement No. 6 explains that the essential characteristics of equity center on the conditions for transferring enterprise assets to the holders of equity interests. Distributions to owners are at the discretion and

volition of the owners or their representatives after satisfying restrictions imposed by law, regulation, or agreements with other entities. In most circumstances, an enterprise is not obligated to transfer assets to owners except in the event of the enterprise's liquidation unless it formally acts to do so, such as by declaring a dividend. An enterprise's liabilities and equity are mutually exclusive claims to or interests in its assets by other entities, and liabilities take precedence over ownership interests.

.21 Surplus note payments require the approval of the commissioner. The commissioner's responsibilities and objectives include maintaining the solvency and financial stability of the insurer. AcSEC concluded that although the commissioner has the ability to restrict payments of interest and principal, the issuer continues to have the obligation even though the timing may be uncertain. Actions by the commissioner do not formally discharge the issuer's obligation to pay the principal or interest. Therefore, the characteristics of surplus notes are not consistent with the characteristics of equity as described in FASB Concepts Statement No. 6.

## Surplus Notes—Statutory Basis

.22 Statutory accounting practices for surplus notes generally are consistent among all the states. Once approved by the commissioner, these instruments are classified as surplus on the balance sheet. Interest is reported as an expense and a liability only after payment has been approved by the commissioner. Interest that has not yet been approved for payment is not accrued as an expense and liability but rather disclosed in the notes to the financial statements. AcSEC observed that the objectives of regulatory accounting requirements are not always consistent with GAAP, and differences in accounting for other transactions currently exist.

## Other Instruments With Similar Characteristics

.23 AcSEC considered other instruments with similar characteristics to surplus notes. Subordinated liabilities of broker/dealers, mandatorily redeemable preferred stock, and hybrid preferred securities such as monthly/quarterly income preferred stock (MIPS/QUIPS) have characteristics of both liabilities and equity and are generally presented on the balance sheet as a separate component between liabilities and equity.

### *Subordinated Liabilities of Broker/Dealers*

.24 Insurance enterprise surplus notes have many of the same characteristics as subordinated liabilities of brokers and dealers in securities. Both kinds of instruments qualify as capital for regulatory purposes, are subordinated to all other claims except those of owners, and require regulatory approval or meeting of prescribed regulatory conditions before repayment. The revised AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* does not permit reporting combined subordinated liabilities with stockholders' equity in the statement of financial condition, which was acceptable under the superseded guide. The superseded presentation was believed to be misleading because it implied that subordinated liabilities are a component of stockholders' equity, unencumbered by the right of the creditor to be repaid. Liabilities frequently have repayment limitations of one sort or another, but nevertheless remain liabilities. AcSEC concluded that accounting for surplus notes as a liability is consistent with the accounting for subordinated liabilities of brokers and dealers.

***Mandatorily Redeemable Preferred Stocks and Hybrid Preferred Securities***

.25 Surplus notes and mandatorily redeemable preferred stocks are similar in that both are subordinated to other claims and because of the terms of the redemption as prescribed by the instrument; once issued, redemption is outside the control of the issuer. AcSEC concluded that although practice is to show mandatorily redeemable preferred stock in a separate category between liabilities and equity, to treat surplus notes in the same manner would be inappropriate. AcSEC was not persuaded that surplus notes, an instrument that meets all the characteristics of a liability, should be required or permitted to be displayed other than as a liability.

.26 Hybrid preferred securities such as monthly and quarterly income preferred securities (MIPS/QUIPS) are securities issued by a special-purpose entity that lends the proceeds to its controlling company. AcSEC concluded that although the practice is to show hybrid preferred securities in a separate category between liabilities and equity, to treat surplus notes in the same manner would be inappropriate. AcSEC concluded that surplus notes meet all of the characteristics of a liability and to record surplus notes in a separate category between liabilities and equity outside of liabilities would not provide users with as relevant information.

**Income Statement Presentation**

.27 Because surplus notes are presented on the balance sheet as liabilities, interest payments on surplus notes should be recorded as interest expense through operations. This treatment is consistent with current accounting practice for interest expense on debt.

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## IP Section 15,000

### ***Issues Papers of the Accounting Standards Division***

Issues Papers of the AICPA's Accounting Standards Division are developed primarily to identify financial accounting and reporting issues the division believes need to be addressed or clarified by the Financial Accounting Standards Board. Issues Papers present neutral discussions of the issues identified, including reviews of pertinent existing literature, current practice, and relevant research, as well as arguments on alternative solutions. Issues Papers normally include advisory conclusions that represent the views of at least a majority of the Institute's Accounting Standards Executive Committee.

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Accounting for Termination Indemnities (superseded by FASB Statement No. 88, <i>Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits</i> )	12/12/78
Accounting for Changes in Estimates	12/15/78
Accounting for Involuntary Conversions (superseded by FASB Interpretation No. 30, <i>Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets</i> )	12/20/78
Accounting for Time Paid But Not Worked (superseded by FASB Statement No. 43, <i>Accounting for Compensated Absences</i> )	1/11/79
The Meaning of "In Substance a Repossession or Foreclosure" and Accounting for Partial Refinancing of Troubled Real Estate Loans Under FASB Statement No. 15 (superseded by AICPA Practice Bulletin No. 7, <i>Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed</i> )	1/15/79
Personal Financial Statements (superseded by AICPA <i>Personal Financial Statements Guide</i> )	2/26/79
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